



This report reflects modifications made to the bill on December 20, 2017. KPMG will release an updated report when the legislation is enacted.

# Conference Agreement for H.R. 1 - Initial Observations

December 20, 2017



## Introduction

On December 15, the conference committee approved the report of its agreement on H.R. 1, the tax reform bill. The conference report is a compromise bill, blending elements of both the previously passed House and Senate versions of the bill. The conference report was approved by all Republican conferees, but was not approved by any Democratic conferees.

On December 19, the House passed the conference agreement by a vote of 227 to 203. Only 12 Republicans voted against the bill, while no Democrats voted for the bill.

Later that same day, the Senate parliamentarian determined that three provisions violated budget reconciliation rules that were being used to move the legislation through the Senate with fewer than 60 votes. Ultimately, these measures were stricken in the early morning of December 20. The stricken provisions related to the following:

- The ability to use section 529 distributions for home schooling expenses
- A “tuition-paying” requirement in determining whether an institution meets the 500-student threshold for the excise tax on endowments of certain private colleges and universities
- The descriptive title of the bill (i.e., the name “the Tax Cuts and Jobs Act”)

The Senate passed the legislation by a vote of 51-48, with all Republicans present voting for it and all Democrats voting against it. Because the House and the Senate must pass identical versions of legislation before such legislation is transmitted to the president, the Senate version was returned to the House.

The House considered the legislation shortly after noon on December 20, approving it by a vote of 224-201. No Democrats voted in favor of the legislation.

The legislation now will be sent to President Trump for his expected signature and enactment. The president has indicated his intent to sign the bill.

## Background

House and Senate passage of H.R. 1 potentially represents the culmination of a long process in pursuit of tax reform. There have been many fits and starts towards tax reform over the last 20 years and over several administrations. The current effort began in earnest with the June 2016 release of the [House GOP “Blueprint”](#) on tax reform. While the Blueprint never progressed beyond conceptual form, it began to build Republican consensus for major revisions to the tax code centered on reduction of the corporate tax rate and reform of the system governing taxation of international business income. Many of the Blueprint’s concepts are incorporated in the conference report. Momentum for this concept of tax reform increased with the November 2016 election of Donald Trump as president and continued GOP majorities in the House and Senate. Tax reform, a major Republican campaign issue, moved to the top of the agenda for the 115<sup>th</sup> Congress.

Still, most of 2017 saw little visible progress made on tax reform, as the Republican-controlled Congress chose to focus on healthcare issues instead. When healthcare legislation efforts failed late in the summer, the Congressional Republicans turned to tax reform.

On September 27, the so-called “Big Six” Republican tax reform principals released their 9-page “[Unified Framework on Tax Reform](#).” The Framework identified the broad areas of policy agreement between the House, Senate, and Administration. House and Senate Republicans began to work separately on tax bills consistent with the Framework.

On November 2, Ways and Means Chairman Kevin Brady released his legislative proposal, H.R. 1, the “Tax Cuts and Jobs Act.” H.R. 1 was then referred to the Ways and Means Committee where it was amended several times and favorably reported out of committee on November 9. The bill was then approved by the full House on November 16 and then referred to the Senate. (Read: [KPMG’s description and analysis of the House-passed bill](#)).

Meanwhile, the Senate began action on November 9, when Chairman of the Senate Finance Committee Orrin Hatch (R-UT) released his “Chairman’s mark” of proposed tax reform legislation. The Senate Finance Committee made amendments to the Chairman’s mark before favorably reporting the bill on November 16. The Senate Finance Committee bill then was considered by the full Senate, which narrowly passed it after further amendment, 51-49, with no Democratic support, on December 2. (Read: [KPMG’s description and analysis of the Senate-passed bill](#)).

House and Senate conferees were appointed during the week of December 4 to reconcile the differences between the House-passed and the Senate-passed versions of H.R. 1.

## Highlights of H.R. 1

### Domestic Business provisions

#### *Corporate Rate and Corporate AMT*

The centerpiece of the conference agreement is the permanent reduction in the corporate income tax rate from 35% to 21%. The rate reduction would generally take effect on January 1, 2018. Special rules would provide fiscal-year filers with a blended tax rate for their tax year straddling January 1, 2018 (application of the rate to fiscal years is discussed in greater detail below).

The conference agreement also would repeal the corporate AMT – a significant change from the Senate bill.

The full list of other proposed changes for businesses is extensive, including both additional tax benefits and offsetting tax increases. Some highlights are listed below.

### *Expensing*

The conference agreement would temporarily introduce expensing as the principal capital cost recovery regime, increasing the 168(k) first-year “bonus” depreciation deduction to 100% and allowing taxpayers to write off immediately the cost of acquisitions of plant and equipment. This expensing regime would go further than current law bonus depreciation by applying to both new and used property. The 100% bonus depreciation rule would apply through 2022, and then would ratably phase down over the succeeding five years.

### *Temporary Deduction against Business Income Earned by Passthrough entities*

The conference agreement adopts a provision which would permit certain non-corporate owners (i.e., owners who are individuals, trusts, or estates) of certain partnerships, S corporations and sole proprietorships to claim a 20% deduction against qualifying business income. The conference agreement includes numerous limitations on the income eligible for the deduction, with the apparent goal of treating compensation for services as ordinary income that is not eligible for the special deduction. Importantly, the deduction against qualifying income would expire for tax years beginning after December 31, 2025.

### *Revenue-Raising Provisions*

To partially offset the costs of these tax benefits, the conference agreement would repeal or modify a number of existing provisions in the tax law. For example, the agreement generally proposes to:

- Repeal the section 199 domestic manufacturing deduction (beginning in 2018)
- Limit the deductibility of net business interest expense to 30% of adjusted taxable income. This provision would start with a broader definition of adjusted taxable income, but would significantly narrow that definition beginning in 2022.
- Limit the carryover of net operating losses to 80% of taxable income and eliminate the carryback (with special rules for certain insurance and farming businesses), generally effective for losses arising in tax years beginning after 2017
- Narrow the scope of the rules relating to contributions to capital (without repealing current section 118 as was proposed in the House bill)
- Modify the deductibility of business entertainment expenses
- Provide significant changes for taxation of the insurance industry
- Require certain research or experimental (R&E) expenditures to be capitalized beginning in 2022.

Nonetheless, the conference agreement did not include some of the revenue raisers that had been included in the House bill or Senate bill, including, for example, the proposed

requirement that the cost of securities sold or exchanged be determined on a first-in first-out basis.

### Multinational entity taxation

The conference agreement would make fundamental changes to the taxation of multinational entities. In general, the conference agreement would shift from the current system of worldwide taxation with deferral to a participation exemption regime with current taxation of certain foreign income. To accomplish this, the conference agreement would adopt several features, including:

- A 100% deduction for dividends received from 10%-owned foreign corporations
- A minimum tax on “global intangible low-taxed income” (GILTI), and
- As a transition to the new regime, deemed repatriation of previously untaxed “old earnings.” A 15.5% rate would apply to earnings attributable to liquid assets and an 8% rate would apply to earnings attributable to illiquid assets

Furthermore, the conference agreement would adopt significant additional anti-base erosion measures. Notably, the agreement adopts what it calls a “Base Erosion Anti-Abuse Tax” (BEAT). The BEAT would generally impose a minimum tax on certain deductible payments made to a foreign affiliate, including payments such as royalties and management fees, but excluding cost of goods sold. The BEAT generally would apply to certain payments paid or accrued in tax years beginning after December 31, 2017.

The conference agreement includes several other provisions targeted at cross-border transactions, including revised treatment of hybrids, a new special deduction for certain foreign-derived intangible income, and rules for outbound transfers of intangibles.

The conference agreement does not, however, include the House and Senate proposals to add a new section 163(n) to the Code to limit the amount of interest a domestic corporation can deduct to a measure of its proportionate share of the worldwide group’s external indebtedness.

### Individual provisions—subject to sunset after 2025

#### KPMG observation

Many of the changes affecting individual taxpayers (including the deduction for certain owners of passthrough businesses) would cease to apply after December 31, 2025, and would revert to their pre-2018 form. Future legislation would be required to make the provisions effective beyond 2025.

The 2025 sunset would not apply to the conference agreement’s repeal of the Affordable Care Act’s individual shared responsibility payment (the individual mandate) or the substitution of a new, lower inflation index for individual rate brackets (discussed below).

The agreement would make a number of changes to the individual rate structure, as well as to deductions and credits.

The conference agreement would retain seven tax brackets but would modify the “breakpoints” for the brackets and reduce the rate for the top bracket to 37%. The temporary new brackets would be 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The top rate would apply to single filers with income over \$500,000 and married joint filers with income over \$600,000.

The standard deduction would be temporarily increased to \$24,000 for joint filers and \$12,000 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 the phase-out thresholds would be substantially increased.

The revenue cost of these changes would be offset by temporarily modifying or eliminating a number of tax preferences, many of them significant and long-standing. These include capping the home mortgage interest deduction to interest expenses attributable to mortgage balances no greater than \$750,000 (for mortgages incurred December 15, 2017 or later), elimination of deductions for home equity loan interest, and, most significantly, capping the deduction for state and local taxes at \$10,000. The “Pease” limitation would be repealed.

The estate, GST, and gift tax exemption amount would be doubled to \$10 million (indexed for inflation) through 2025. The conference agreement does not incorporate a House proposal to repeal the gift and estate tax.

### **Affordable Care Act modifications – “individual mandate”**

The conference agreement would effectively repeal the individual mandate in the Patient Protection and Affordable Care Act by reducing the individual responsibility payment under section 5000A to zero for individuals who do not purchase health insurance that qualifies as minimum essential coverage, starting in 2019.

### **Taxation of investment income**

The tax rates for capital gains and dividends would be left unchanged. Also left unchanged is the net investment income tax.

A Senate proposal to generally eliminate the ability of most taxpayers to use the specific identification method to identify the cost of any specified security sold, exchanged or otherwise disposed of was not included in the conference agreement. As a result, current law continues to apply to the specific identification method.

### **Exempt organizations**

In addition to a number of generally applicable provisions that may affect exempt organizations (e.g., reduced corporate income tax rates, changes to the deductibility of

various fringe benefits, tax-exempt bond reform), the conference agreement proposes several changes that are specifically relevant to exempt organizations. In particular, the conference agreement would:

- Impose an excise tax on compensation in excess of \$1 million and on “excess parachute payments” paid to certain employees of exempt organizations
- Impose a 1.4% excise tax on the investment income earned by private colleges and universities with large endowments
- Require unrelated business taxable income to be computed separately for each trade or business
- Increase unrelated business taxable income by the amount of certain fringe benefit expenses for which deductions are disallowed

The conference agreement does not include a number of notable provisions that were in the House bill (e.g., uniform rate for the excise tax on private foundation net investment income and a provision allowing section 501(c)(3) organizations to engage in de minimis political activity).

## Impact of reconciliation rules

Because it was considered under a special procedure called “budget reconciliation,” the conference agreement was not subject to filibuster in the Senate and thus was able to pass with a simple majority vote. The proposals contained in the agreement have been at least partially shaped by the numerous requirements of the reconciliation procedure.

Budget reconciliation is a procedure by which spending and revenue legislation (including tax measures) can avoid a potential Senate filibuster and be passed by a simple majority vote in the Senate. The ability to use these rules was “unlocked” when the House and Senate agreed to a budget resolution for FY 2018. The budget resolution permitted H.R. 1, as a reconciliation bill, to increase the federal deficit by up to \$1.5 trillion over the 10-year budget window. The conference agreement appeared to have been structured with this revenue target in mind; the JCT has estimated that the agreement would lose approximately \$1.456 trillion over the 10-year period, not taking into account possible macroeconomic (dynamic) effects.

To retain the protection from a Senate filibuster that the reconciliation rules provide, the conference agreement to H.R. 1 had to meet a number of complex requirements.

For tax legislation, one of the most important requirements is intended to prevent an increase in the long-term deficit of the United States. Even though the FY18 budget resolution allows a net tax cut of up to \$1.5 trillion **within** the 10-year window, no title of the agreement can result in a net tax cut in any year **beyond** the 10-year budget window unless offset by an equivalent reduction in spending. The Congressional Budget Office analysis of the conference agreement found that the legislation has met the requirement.

### **KPMG observation**

The requirements put forth by these budget rules affected some details of this legislation. For example, decisions to include sunset dates for most of the individual tax changes and the passthrough deduction presumably were at least partially related to the need to fulfill the reconciliation-imposed rules regarding long-term deficits.

Importantly, as discussed above, several provisions of the conference agreement were stricken during Senate consideration after the Senate parliamentarian concluded they ran afoul of certain procedural rules governing reconciliation bills.

## **Effective dates for fiscal year filers – Code section 15**

Current Code section 15 provides special rules for determining how certain “rate changes” apply to taxpayers whose tax years straddle relevant effective dates (e.g., fiscal year filers in the case of law changes that are effective as of the beginning or end of the calendar year).

### *Conference agreement*

The conference agreement does not repeal or modify section 15, but it does include a provision explicitly indicating that section 15 would not apply to the temporary changes to the section 1 rates that would be in new Code section 1(j). The provision permanently reducing the Code section 11 corporate rate, however, does not reference section 15. Thus, section 15 presumably would apply to the C corporation rate change without modification. Note also that proposed new Code section 965(c)(2) (relating to treatment of deferred foreign income on transition to a participation exemption system) would explicitly reference U.S. shareholders to which section 15 applies. See conference agreement section 14103.

### *Code section 15 rules — in general*

Very generally, section 15 applies if any rate of tax imposed by chapter 1 of the Code<sup>1</sup> changes and the tax year includes the effective date of the change (unless the effective date is the first day of the tax year). For this purpose, (1) if the rate changes for tax years “beginning after” or “ending after” a certain date, the following day is considered the effective date of the change; and (2) if the rate changes for tax years “beginning on or after” a certain date, that date is considered the effective date. In addition, if a tax imposed under Code chapter 1 is repealed, the repeal is considered a change of rate, with the rate after repeal being zero. Section 15, however, generally does not apply to inflation adjustments for individuals under section 1(f).<sup>2</sup> Further, as indicated above,

<sup>1</sup> Chapter 1 consists of sections 1 through 1400.

<sup>2</sup> Under section 15(f), the section 15 rules also are inapplicable to certain rate changes that were enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001.



under the conference agreement, section 15 would not apply to the temporary rate changes under section 1.

If section 15 applies, the rate of tax for the year of the change generally is a blended rate. More specifically, section 15(a) states that:

- (1) tentative taxes shall be computed by applying the rate for the period before the effective date of the change, and the rate for the period on and after such date, to the taxable income for the entire tax year; and
- (2) the tax for such tax year shall be the sum of that proportion of each tentative tax which the number of days in each period bears to the number of days in the entire tax year.

Further, if the rate change involves a change in the highest rate of tax imposed by section 1 or section 11(b), section 15(e) provides that any reference in Code chapter 1 to such highest rate (other than in a provision imposing a tax by reference to such rate) is treated as a reference to the weighted average of the highest rates before and after the change, determined by reference to the respective portions of the tax year before and on or after the change.

## What is next?

The conference report will now be clerically processed in accordance with House and Senate rules and will be transmitted to the president for his action. The president has indicated his intention to sign the bill.

## Documents

Read the [updated bill](#) approved by the Senate

The [conference agreement](#) [PDF 4.25 MB] (1097 pages) includes (1) bill language, (2) an explanatory statement, and (3) a preliminary revenue table prepared by the staff of the Joint Committee on Taxation (JCT). (Note that this document does not reflect the changes made on December 20.)

Read the [CBO cost estimate](#) for the conference agreement on H.R. 1.

The Joint Committee on Taxation (JCT) provided estimates of the budget effects of the conference agreement on H.R. 1. Read [JCX-67-17](#)

For documents relating to the House and Senate bills, see KPMG's reports with preliminary analyses and observations on those bills.

- [House tax reform bill – Initial observations on House-passed bill](#) [PDF 1.8 MB]

- [Senate tax reform bill – Initial observations on Senate-passed bill](#) [PDF 1.3 MB]

## This report

This report provides KPMG's preliminary analysis and observations regarding the conference agreement to H.R. 1, the "Tax Cuts and Jobs Act". This is one of a series of reports that KPMG has prepared on tax reform legislation as it has moved through various stages of the legislative process. To read KPMG's reports and coverage of legislative developments, see [TaxNewsFlash-Tax Reform](#).

## Contents

Individuals .....	16
Ordinary income tax rates – in general .....	16
New indexing method .....	19
Filing status, standard deductions, and personal exemptions.....	19
Reform of the child tax and qualifying dependents credits.....	21
Treatment of business income and losses of individuals .....	21
Tax rates on capital gains and dividends .....	21
Suspension and reform of certain itemized deductions and income exclusions .....	22
Deduction for taxes (including SALT) not paid or accrued in a trade or business... 22	
Suspend and modify deduction for home mortgage interest and home equity debt	23
Increased percentage limitation for certain charitable contributions .....	23
Modify deduction for personal casualty and theft losses.....	24
Suspension of miscellaneous itemized deductions subject to the 2% floor .....	24
Suspension of overall limitation on itemized deductions (“Pease” limitation).....	24
Suspension of exclusion for qualified bicycle commuting reimbursement .....	25
Suspension of exclusion for qualified moving expense reimbursements .....	25
Suspension of deduction for moving expenses .....	25
Modification to the limitation on wagering losses .....	26
Modification to individual Alternative Minimum Tax (AMT).....	26
Estate, gift, and generation-skipping tax .....	27
Other.....	27
Temporary reduction in medical expense deduction floor.....	27
Allow increased contributions to ABLE accounts, and allow contributions to be eligible for saver’s credit .....	28
Rollovers between qualified tuition programs and qualified ABLE programs .....	28
Combat zone tax benefits to Armed Forces in Sinai Peninsula of Egypt .....	28
Exclude income from the discharge of student debt .....	29
Modification of education savings rules (529 plans) .....	29
Relief for 2016 disaster areas.....	29
Repeal of deduction for alimony payments and corresponding inclusion in gross income .....	30
Eliminate deduction for member of Congress living expenses .....	30

Excluded House and Senate proposals .....	31
Affordable Care Act—Healthcare .....	32
Reduce Affordable Care Act individual shared responsibility payment to zero .....	32
Business – In general.....	32
Reductions in corporate tax rate and dividends received deduction .....	32
Corporate AMT .....	34
Modified net operating loss (NOL) deduction .....	35
Revisions to treatment of capital contributions.....	36
Cost recovery .....	37
Modification of rules for expensing depreciable business assets .....	37
Temporary 100% expensing for certain business assets.....	38
Requirement to capitalize section 174 research and experimental expenditures ...	40
Modifications to depreciation limitations on luxury automobiles and personal use property .....	41
Modifications of treatment of certain farm property.....	41
Applicable recovery period for real property .....	42
Expensing certain citrus replanting costs.....	43
Business-related deductions, exclusions, etc.....	43
Limitation on the deduction of net business interest expense.....	43
Repeal deduction for income attributable to domestic production activities.....	47
Modify tax treatment of certain self-created property.....	48
Repeal of rollover of publicly traded securities gain into specialized small business investment companies .....	48
Limits on like-kind exchange rules .....	49
Limitation of deduction by employers of expenses for entertainment and certain fringe benefits .....	50
Unrelated business taxable income increased by amount of certain fringe benefit expenses for which deduction is disallowed .....	51
Repeal deduction for local lobbying activities .....	51
Deny deduction for settlements subject to a nondisclosure agreement paid in connection with sexual harassment or sexual abuse.....	52
Accounting methods .....	52
Certain special rules for tax year of inclusion .....	52
Small business accounting .....	54

Business credits.....	56
Modification of credit for clinical testing expenses for certain drugs for rare diseases or conditions .....	56
Modification of rehabilitation credit.....	57
Employer credit for paid family and medical leave.....	57
Miscellaneous business provisions .....	58
Qualified opportunity zones .....	58
Alaskan Native Corporation payments and contributions to settlement trusts .....	59
Aircraft management services .....	59
Expand non-deductibility of certain fines and penalties .....	60
Compensation .....	61
Modification of limitation on excessive employee remuneration.....	61
Treatment of qualified equity grants.....	62
Excise tax on excess tax-exempt organization executive compensation .....	64
Retirement savings.....	66
Repeal of special rule permitting recharacterization of IRA contributions .....	66
Extended rollover period for the rollover of plan loan offset amounts .....	66
Modification of rules for length of service award plans.....	67
Passthrough entities and sole proprietorships.....	67
Treatment of business income and loss of certain non-corporate taxpayers .....	67
Deduction of 20% for certain passthrough income (subject to sunset) .....	67
Loss limitation rules for taxpayers other than C corporations (subject to sunset) ...	70
Tax gain on the sale of a partnership interest on look-through basis .....	72
Modification of the definition of substantial built-in loss in the case of transfer of partnership interest .....	75
Partnership charitable contributions and foreign taxes taken into account in determining partner loss limitation under section 704(d).....	76
Short-term capital gain with respect to applicable partnership interests .....	76
Repeal of partnership technical termination rules .....	80
Provisions applicable to “eligible terminated S corporations” .....	80
Changes relating to electing small business trusts .....	82
Banks and financial institutions .....	83
Deduction limits for FDIC premiums .....	83

Bonds .....	83
Repeal of tax credit bonds .....	83
Repeal of advance refunding bonds .....	84
Insurance .....	84
Net operations loss deductions of life insurance companies.....	85
Net operations loss deductions of property and casualty insurance companies .....	85
Repeal small life insurance company deduction .....	86
Repeal Code section 807(f) spread—Adjustment for change in computing reserves	86
Repeal special rule for distributions to shareholders from pre-1984 policyholders surplus accounts .....	87
Modify proration rules for property and casualty (P&C) insurance companies.....	87
Repeal elective deduction and related special estimated tax payment rules .....	88
Computation of life insurance tax reserves .....	89
Modify rules for life insurance proration for purposes of determining the dividends received deduction (DRD).....	90
Capitalize certain policy acquisition expenses (DAC) .....	90
Tax reporting for life settlement transactions, clarification of tax basis of life insurance contracts, and exception to transfer for valuable consideration rules.....	91
Modify discounting rules for property and casualty (P&C) insurance companies.....	93
Exempt organizations.....	95
Unrelated business taxable income separately computed for each trade or business activity.....	95
Excise tax based on investment income of private colleges and universities .....	96
Repeal of deduction for amounts paid in exchange for college athletic event seating rights .....	97
Repeal of substantiation exception in case of contributions reported by donee.....	97
International .....	97
Establishment of participation exemption system for taxation of foreign income .....	98
Add U.S. participation exemption.....	98
Add special rules relating to sales or transfers involving specified 10% owned foreign corporations .....	100
Mandatory repatriation.....	101
Rules related to passive and mobile income.....	109

Current year inclusion of global intangible low-taxed income by United States shareholders.....	109
Add deduction for foreign-derived intangible income .....	113
Other modifications of subpart F provisions.....	114
Eliminate inclusion of foreign base company oil related income.....	114
Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment.....	115
Modification of stock attribution rules for determining status as a controlled foreign corporation.....	115
Modification of definition of U.S. shareholder .....	116
Elimination of requirement that corporation must be controlled for 30 days before subpart F inclusions apply .....	116
Prevention of base erosion .....	117
Adds limitations on income shifting through intangible property transfers .....	117
Limit deduction of certain related-party amounts paid or accrued in hybrid transactions or with hybrid entities.....	118
Surrogate foreign corporations not eligible for reduced rate on dividends .....	119
Modifications related to foreign tax credit system .....	120
Repeal section 902 indirect foreign tax credits; determination of section 960 credit on a current-year basis.....	120
Separate foreign tax credit limitation basket for foreign branch income.....	121
Determine source of income from sales of inventory solely on basis of production activities.....	121
Amend section 904(g) to allow increased overall domestic loss (ODL) recapture .....	122
Limit foreign tax credits for global intangible low-taxed income .....	122
Inbound provisions.....	122
Add base erosion and anti-abuse tax (BEAT).....	122
Other provisions.....	127
Modify insurance exception to the passive foreign investment company rules.....	127
Repeal fair market value method of interest expense apportionment.....	129
Modify Code section 4985 excise tax .....	129
Procedural provisions.....	129
Extension of time limit for contesting IRS levy.....	129
CRAFT beverages.....	130

Exempt the aging period of beer, wine and spirits from UNICAP rules related to interest .....	130
Reduced rate of excise tax on beer .....	131
Transfers of beer in bond .....	131
Reduced rate of tax on certain wine.....	132
Adjust alcohol content level of wine for application of excise taxes .....	133
Reduced rate of tax on mead and certain carbonated wines .....	133
Reduced excise tax rates on distilled spirits.....	134
Allow transfer of bonded spirits in bottles.....	134
REITs .....	135
RICs .....	139
Natural resources .....	141
State and local tax implications .....	143
Impact of tax reform on accounting for income taxes .....	155
Corporate tax rate reduction .....	156
Excessive executive compensation .....	157
Interest expense limitation .....	157
Net operating losses .....	158
Alternative minimum tax.....	158
Mandatory repatriation .....	159
Global intangible low-taxed income .....	159
Base erosion anti-abuse tax.....	160
Foreign derived intangible income .....	160
Financial statement disclosure .....	161
Summary.....	161
KPMG contacts .....	162



## Individuals

### Ordinary income tax rates – in general

The conference agreement would modify the current income rate structure under which individuals are taxed. The current rate structure has seven rates: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. The conference agreement would maintain the seven-rate structure, but would tax a taxpayer's income at modified rates: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The new rate structure would be effective for tax years beginning in 2018.

The conference agreement also includes special rules regarding the treatment of business income of individuals (e.g., individuals that conduct businesses through sole proprietorships, partnerships, and S corporations). See discussion of *Passthrough Entities* below.

#### KPMG observation

Lower rates and generally higher tax brackets mean that a given amount of taxable income will generally attract a lower effective tax rate. However, since the calculation of taxable income will also change, not all taxpayers will experience a lower tax burden. Also note that while the alternative minimum tax (discussed below) is modified by the agreement, it is not repealed.

**For married taxpayers filing a joint return (or for a surviving spouse):** The 10% rate would apply to taxable income up to \$19,050; the 12% rate would apply to taxable income over \$19,050, up to \$77,400; the 22% rate would apply to taxable income over \$77,400, up to \$165,000; the 24% rate would apply to taxable income over \$165,000, up to \$315,000; the 32% rate would apply to taxable income over \$315,000, up to \$400,000; the 35% rate would apply to taxable income over \$400,000, up to \$600,000; the 37% rate would apply to taxable income over \$600,000.

The following table compares the tax brackets under current law to those proposed under the conference agreement for married taxpayers filing a joint return:

Married Filing Joint			
2018 Current Law		Conference Agreement	
Tax Rate	If taxable income is:	Tax Rate	If taxable income is:
10%	\$0 to \$19,050	10%	\$0 to \$19,050
15%	\$19,051 to \$77,400	12%	\$19,051 to \$77,400
25%	\$77,401 to \$156,150	22%	\$77,401 to \$165,000
28%	\$156,151 to \$237,950	24%	\$165,001 to \$315,000

33%	\$237,951 to \$424,950	32%	\$315,001 to \$400,000
35%	\$424,951 to \$480,050	35%	\$400,001 to \$600,000
39.6%	\$480,051 or more	37%	\$600,001 or more

**For married taxpayers filing a separate return:** The 10% rate would apply to taxable income up to \$9,525; the 12% rate would apply to taxable income over \$9,525, up to \$38,700; the 22% rate would apply to taxable income over \$38,700, up to \$82,500 the 24% rate would apply to taxable income over \$82,500, up to \$157,500; the 32% rate would apply to taxable income over \$157,500, up to \$200,000; the 35% rate would apply to taxable income over \$200,000, up to \$300,000; the 37% rate would apply to taxable income over \$300,000.

The following table compares the tax brackets under current law to those proposed under the conference agreement for married taxpayers filing separate returns:

Married Filing Separate			
2018 Current Law		Conference Agreement	
Tax Rate	If taxable income is:	Tax Rate	If taxable income is:
10%	\$0 to \$9,525	10%	\$0 to \$9,525
15%	\$9,526 to \$38,700	12%	\$9,526 to \$38,700
25%	\$38,701 to \$78,075	22%	\$38,701 to \$82,500
28%	\$78,076 to \$118,975	24%	\$82,501 to \$157,500
33%	\$118,976 to \$212,475	32%	\$157,501 to \$200,000
35%	\$212,476 to \$240,025	35%	\$200,001 to \$300,000
39.6%	\$240,026 or more	37%	\$300,001 or more

**For taxpayers filing as head of household:** The 10% rate would apply to taxable income up to \$13,600; the 12% rate would apply to taxable income over \$13,600, up to \$51,800; the 22% rate would apply to taxable income over \$51,800, up to \$82,500; the 24% rate would apply to taxable income over \$82,500, up to \$157,500; the 32% rate would apply to taxable income over \$157,500, up to \$200,000; the 35% rate would apply to taxable income over \$200,000, up to \$500,000; the 37% rate would apply to taxable income over \$500,000.

The following table compares the tax brackets under current law to those proposed under the conference agreement for a taxpayer filing as head of household:

Head of Household			
2018 Current Law		Conference Agreement	
Tax Rate	If taxable income is:	Tax Rate	If taxable income is:

10%	\$0 to \$13,600	10%	\$0 to \$13,600
15%	\$13,601 to \$51,850	12%	\$13,601 to \$51,800
25%	\$51,851 to \$133,850	22%	\$51,801 to \$82,500
28%	\$133,851 to \$216,700	24%	\$82,501 to \$157,500
33%	\$216,701 to \$424,950	32%	\$157,501 to \$200,000
35%	\$424,951 to \$453,350	35%	\$200,001 to \$500,000
39.6%	\$453,351 or more	37%	\$500,001 or more

### KPMG observation

Absent the possible mitigating impact of the increased standard deduction and the increased child and dependent tax credits, the conference agreement would eliminate much of the tax benefit that exists under current law for a taxpayer filing as head of household versus filing as single. Under current law, the income thresholds for a head of household filer are more generous than for a single individual. The conference agreement would eliminate the discrepancy in income thresholds between a head of household filer and a single individual for all income subject to the 24% rate and above.

**For all other individual taxpayers:** The 10% rate would apply to taxable income up to \$9,525; the 12% rate would apply to taxable income over \$9,525, up to \$38,700; the 22% rate would apply to taxable income over \$38,700, up to \$82,500; the 24% rate would apply to taxable income over \$82,500, up to \$157,500; the 32% rate would apply to taxable income over \$157,500, up to \$200,000; the 35% rate would apply to taxable income over \$200,000, up to \$500,000; the 37% rate would apply to taxable income over \$500,000.

The following table compares the tax brackets under current law to those proposed under the conference agreement for a taxpayer filing as single:

Single			
2018 Current Law		Conference Agreement	
Tax Rate	If taxable income is:	Tax Rate	If taxable income is:
10%	\$0 to \$9,525	10%	\$0 to \$9,525
15%	\$9,526 to \$38,700	12%	\$9,526 to \$38,700
25%	\$38,701 to \$93,700	22%	\$38,701 to \$82,500
28%	\$93,701 to \$195,450	24%	\$82,501 to \$157,500
33%	\$195,451 to \$424,950	32%	\$157,501 to \$200,000
35%	\$424,951 to \$426,700	35%	\$200,001 to \$500,000
39.6%	\$426,701 or more	37%	\$500,001 or more

## **KPMG observation**

The conference agreement would eliminate the so-called “marriage penalty” in all but the highest tax brackets, and thus would also remove much of the disadvantage of the married filing separate filing status.

### ***The “kiddie tax”***

Under current law, the net unearned income of a child is taxed at the higher of the parents’ tax rates or the child’s tax rates. The conference agreement would simplify how the tax on a child’s net unearned income (kiddie tax) is calculated, by effectively applying the ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child.

### ***JCT estimate***

The JCT has estimated that the proposed rate structure (subject to December 31, 2025 sunset) would decrease revenues by approximately \$1.2 trillion over 10 years.

## **New indexing method**

The conference agreement 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 conference agreement, 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 was estimated by the JCT to increase revenues by approximately \$134 billion over 10 years.

The change to chained CPI for inflation indexing would be effective for tax years beginning after 2017 and would remain in effect after 2025 – it is not subject to the sunset provision that applies to other individual provisions.

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

The conference agreement 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 conference agreement would impose due diligence requirements for paid preparers in determining eligibility for a taxpayer to file as head of household and a \$500 penalty each time a paid preparer fails to meet these requirements.

The conference agreement 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 conference agreement, the standard deduction in 2018 would be \$12,000 for a taxpayer filing as single or married filing separately, \$18,000 for a taxpayer filing as head of household, and \$24,000 for taxpayers filing as married filing jointly (and surviving spouses). These amounts would be adjusted for inflation for tax years beginning after December 31, 2018 and would sunset December 31, 2025.

The conference agreement would retain the additional standard deduction for the elderly and the blind.

The proposed temporary 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 suspended by the conference agreement for tax years 2018 through 2025. The suspension would apply to the exemptions for the taxpayer, the taxpayer's spouse, and any dependents.

The JCT has estimated that the proposed modification to the standard deduction (subject to a December 31, 2025 sunset) would decrease revenues by approximately \$720 billion over 10 years and the proposed repeal of deductions of personal exemptions (subject to a December 31, 2025 sunset) would increase revenues by approximately \$1.21 trillion over 10 years.

#### **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, \$5,600 greater than the deduction allowed under the conference agreement. However, personal exemptions are subject to phase-outs under current law and the conference agreement proposes an expanded child tax credit (discussed below) that could provide a greater tax benefit compared with the personal exemptions allowed under current law. 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.

## Reform of the child tax and qualifying dependents credits

Through tax year 2025, the conference agreement would increase the child tax credit to \$2,000 per qualifying child from the current credit of \$1,000 per qualifying child. The conference agreement would also temporarily provide a \$500 nonrefundable credit for qualifying dependents other than qualifying children.

Under the conference agreement, \$1,400 of the child tax credit would be refundable. The refundable portion would be indexed for inflation in future years using an indexing convention that rounds the \$1,400 amount to the next lowest multiple of \$100. The adjusted gross income (AGI) levels at which this credit is subject to phase-out would increase from \$110,000 to \$400,000 for joint filers, and from \$75,000 to \$200,000 for single filers (these thresholds are not indexed for inflation). Additionally, the earned income threshold for the refundable child tax credit would be lowered from \$3,000 under current law to \$2,500. This threshold would not be indexed for inflation.

The conference agreement would require the taxpayer to provide a social security number (SSN) for each qualifying child for whom the credit is claimed on the tax return. This requirement does not apply to the \$500 non-refundable credit for a non-child dependent. A qualifying child who is ineligible to receive the child tax credit due to not having a SSN will still be eligible for the non-refundable \$500 credit, including children with an Individual Taxpayer Identification Number rather than a Social Security Number.

The JCT has estimated that the proposed modifications to the child tax credit (subject to a December 31, 2025 sunset) would decrease revenues by approximately \$573 billion over 10 years and the SSN requirement (subject to a December 31, 2025 sunset) would increase revenues by approximately \$30 billion over 10 years.

## Treatment of business income and losses of individuals

The conference agreement would provide a temporary new deduction for certain business income of individuals (as well as trusts and estates) earned for tax years beginning in 2018. The agreement also would expand loss limitation rules. These provisions are scheduled to sunset after 2025.

These provisions would be relevant to many owners of businesses conducted as passthrough entities and sole proprietorships. See the *Passthrough Entities* section below for a more robust discussion of these provisions.

## Tax rates on capital gains and dividends

The conference agreement would keep in place the current system whereby net capital gains and qualified dividends are generally subject to tax at a maximum rate of 20% or 15%, with higher rates for gains from collectibles and unrecaptured depreciation. The conference agreement retains the same “breakpoints” for application of these rates as

under current law, except the breakpoints would be adjusted for inflation after 2018. For 2018, the 15% breakpoint would be \$77,200 for married taxpayers filing jointly, \$51,700 for head of household filers and \$38,600 for all other filers. The 20% breakpoint would be \$479,000 for married taxpayers filing jointly, \$452,400 for head of household filers, and \$425,800 for all other filers.

The conference agreement also would leave in place the current 3.8% net investment income tax.

### **Suspension and reform of certain itemized deductions and income exclusions**

Under current law, individual taxpayers may claim itemized deductions to decrease taxable income. The conference agreement includes a number of provisions that would suspend or modify these deductions.

Combined, the JCT has estimated that the following provisions related to certain taxes, interest on mortgage debt, home equity debt, charitable contributions, non-disaster casualty losses, miscellaneous expenses, and the overall limitation on itemized deductions (all subject to a December 31, 2025 sunset) would increase revenue by approximately \$668 billion over 10 years.

#### *Deduction for taxes (including SALT) not paid or accrued in a trade or business*

Under the conference agreement, itemized deductions for state and local income taxes, state and local property taxes, and sales taxes would be limited to \$10,000 in the aggregate (not indexed for inflation)—this cap would not apply if the taxes are incurred in carrying on a trade or business or otherwise incurred for the production of income. In addition, foreign real property taxes, other than those incurred in a trade or business, would not be deductible.

The effective date would be for tax years beginning after December 31, 2017 and beginning before January 1, 2026.

The conference agreement also would not permit an itemized deduction for 2017 on a prepayment of state or local *income* tax for a future tax year. Thus, a prepayment of 2018 state and local income tax paid in tax year 2017 could not be claimed as an itemized deduction on an individual's 2017 income tax return.

#### **KPMG observation**

Both the House and Senate bills proposed an itemized deduction of up to \$10,000 (\$5,000 for a married taxpayer filing a separate return) for state and local real property taxes not paid or accrued in a trade or business or incurred for the production of income.

Under the conference agreement, the \$10,000 deduction limit would apply to any combination of state and local income and property taxes, or sales taxes, paid or accrued

during the tax year, which may provide additional tax relief for taxpayers in high-tax state and local jurisdictions.

### *Suspend and modify deduction for home mortgage interest and home equity debt*

Under current law, qualified residence interest is allowed as an itemized deduction, subject to limitations. Qualified residence interest includes interest paid or accrued on debt incurred in acquiring, constructing, or substantially improving a taxpayer's residence ("acquisition indebtedness") and home equity indebtedness. Interest on qualifying home equity indebtedness is deductible, regardless of how the proceeds of the debt are used, but such interest is not deductible in computing alternative minimum taxable income.

The conference agreement would suspend the deduction for interest on home equity indebtedness for tax years 2018 through 2025.

For the same tax years, the conference agreement would limit the deduction available for mortgage interest by reducing the amount of debt that can be treated as acquisition indebtedness from the current level of \$1 million to \$750,000.

Debt incurred before December 15, 2017, would not be affected by the reduction and would therefore be "grandfathered." Any debt incurred before December 15, 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.

For tax years after December 31, 2025, the \$1,000,000 limitation would apply, regardless of when the indebtedness was incurred.

### **KPMG observation**

The proposal to reduce the amount of debt that can be treated as acquisition indebtedness to \$750,000 was a compromise between the House bill, which would have reduced the debt limit to \$500,000, and the Senate bill which would have retained the current \$1 million limit.

Under the House bill, only interest paid on acquisition debt in respect of a taxpayer's principal residence would be included in the deduction. A taxpayer would not receive a deduction for interest paid on debt used to acquire a second home. The conference agreement would not modify the treatment of interest attributable to mortgages secured by a second home (e.g., vacation homes). However, interest on the combined acquisition indebtedness of a taxpayer's principal residence and a second qualifying residence cannot exceed the \$750,000 cap, or \$1 million limit for grandfathered debt.

### *Increased percentage limitation for certain charitable contributions*

The conference agreement 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). This proposal would apply to contributions made in tax years beginning after December 31, 2017 and before January 1, 2026.

### **KPMG observation**

The conference agreement follows the Senate bill. It retains the charitable contribution deduction, even increasing the amount individual taxpayers may claim as a deduction in a single tax year; however, other proposed changes (e.g., lower tax rates and a higher standard deduction) might have an indirect impact on charitable giving. For a discussion of other changes affecting charitable giving (e.g., disallowed deduction for the right to purchase seating at a collegiate athletic event), see the Exempt Organizations discussion below.

#### *Modify deduction for personal casualty and theft losses*

Under current law, a deduction may be claimed for any loss sustained during the tax year that is not compensated by insurance or otherwise, subject to certain limitations. The conference agreement would temporarily limit the deduction for personal casualty and theft losses to losses incurred in a federally-declared disaster.

The effective date would be for losses incurred in tax years beginning after December 31, 2017 and before January 1, 2026.

#### *Suspension of miscellaneous itemized deductions subject to the 2% floor*

Under current law, individuals may claim itemized deductions for certain miscellaneous expenses. Some expenses (for example, investment fees, repayments of income, and safe deposit box rental fees) are not deductible unless, in aggregate, the expenses exceed 2% of the taxpayer's adjusted gross income. Unreimbursed business expenses incurred by an employee generally are deductible as an itemized deduction only to the extent the expenses exceed 2% of adjusted gross income. Other miscellaneous expenses that are subject to the 2% floor would include the taxpayer's share of deductible investment expenses from passthrough entities, and certain repayments including items of income received under a claim of right (if \$3,000 or less).

The conference agreement would suspend all miscellaneous itemized deductions that are subject to the 2% floor for years 2018-2025. The effective date would be for tax years beginning after December 31, 2017.

#### *Suspension of overall limitation on itemized deductions ("Pease" limitation)*

Under current law, the total amount of allowable itemized deductions (with the exception of medical expenses, investment interest, and casualty, theft or gambling losses) 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 conference agreement would suspend the overall limitation on itemized deductions for years 2018-2025.

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

#### *Suspension of exclusion for qualified bicycle commuting reimbursement*

Current law excludes up to \$20 a month in qualified bicycle commuting reimbursement from an employee's gross income. The conference agreement would suspend this exclusion for years 2018 through 2025 such that any reimbursement of this expense would be taxable.

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

The JCT has estimated this provision (subject to a December 31, 2025 sunset) would increase revenue by less than \$50 million over 10 years.

#### *Suspension of exclusion for qualified moving expense reimbursements*

Under current law, qualified moving expense reimbursements are excludible from an employee's gross income and from the employee's wages for employment tax purposes. Such expenses include amounts received (directly or indirectly) from an employer as payment for (or reimbursement of) expenses which would be deductible as moving expenses if directly paid or incurred by the employee. Qualified moving expense reimbursements do not include amounts actually deducted by the individual. For members of the U.S. Armed Forces (and family members), moving and storage reimbursements and allowances for these expenses are excluded from gross income.

The conference agreement would suspend the exclusion from gross income and wages for qualified moving expense reimbursements for years 2018 through 2025. The exclusion would be preserved for U.S. Armed Forces members (and family members).

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

The JCT estimated that this provision (subject to a December 31, 2025 sunset) would increase revenues by approximately \$4.8 billion over 10 years. The estimate includes policy that retains the exclusion (under section 217(g)) related to members of the U.S. Armed Forces.

#### *Suspension of deduction for moving expenses*

Under current law, individuals are permitted an above-the-line deduction for moving expenses paid or incurred in connection with starting work either as an employee or as a self-employed individual at a new principal place of work. The expenses are deductible only if specific distance and employment status requirements are met. In the case of

certain members of the U.S. Armed Forces (and family members), the rules governing moving expenses also provide a special rule creating a targeted income exclusion for moving and storage expenses furnished in kind.

The conference agreement would suspend the deduction for moving expenses for years 2018 through 2025. However, the targeted rules providing income exclusions to members of the U.S. Armed Forces (or their spouse or dependents) would be retained.

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

The JCT estimated that this provision (subject to a December 31, 2025 sunset) would increase revenue by approximately \$7.6 billion over 10 years. (Note that the retention of the target income exclusion rules for military families appears to be included in the revenue analysis for the general exclusion rule described above.)

### **KPMG observation**

Repeal (or suspension) 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.

### *Modification to the limitation on wagering losses*

Under current law, losses sustained on wagering transactions are allowed as a deduction only to the extent of gains from wagering.

The conference agreement would clarify that “losses from wagering transactions” includes any deduction otherwise allowable that is incurred in carrying on any wagering transaction. Thus, the limitation on losses from wagering transactions would apply to the actual costs of wagers incurred by an individual, and to other expenses incurred in connection with the conduct of the gambling activity. For instance, an individual’s otherwise deductible expenses in traveling to or from a casino are subject to the limitation.

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

The JCT estimated that this provision (subject to a December 31, 2025 sunset) would increase revenue by approximately \$100 million over 10 years.

### **Modification to individual Alternative Minimum Tax (AMT)**

The conference agreement temporarily increases the AMT exemption amounts and the phase out thresholds for individuals.

*For married taxpayers filing a joint return (or for a surviving spouse):* The AMT exemption amount for 2018 would be increased from \$86,200 under current law to \$109,400. The phase out threshold would be increased from \$164,100 to \$1,000,000.

*For married taxpayers filing a separate return:* The AMT exemption amount would be increased from \$43,100 (under current law for 2018) to \$54,700. The phase out threshold would be increased from \$82,050 to \$500,000.

*For all other individual taxpayers:* The exemption amount for 2018 under current law is \$55,400. The conference agreement would raise this amount to \$70,300. The phase out threshold would be increased from \$123,100 to \$500,000.

The increased exemption amounts and phase out thresholds would sunset after December 31, 2025.

The JCT has estimated that the temporary increase in the exemption amounts and phase out thresholds would decrease revenues by approximately \$637 billion over 10 years.

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

The conference agreement would double the basic exclusion amount from \$5,000,000 to \$10,000,000 per individual (as indexed for inflation). This enhanced exclusion would apply to estates of decedents dying, generation-skipping transfers, and gifts made after 2017, but would sunset after December 31, 2025.

The committee was unable to reach a consensus providing for the future elimination of the estate and generation-skipping transfer taxes as was proposed in the House bill.

The JCT has estimated this provision (subject to a December 31, 2025 sunset) would decrease revenues by \$83 billion over 10 years.

### **Other**

#### *Temporary reduction in medical expense deduction floor*

Under the conference agreement, individuals would be allowed to deduct qualified medical expenses in excess of 7.5% of adjusted gross income (AGI) for tax years 2017 and 2018 for regular tax and alternative minimum tax purposes. Under current law, the deduction is limited to medical expenses in excess of 10% of (AGI). After 2018, the 10% AGI threshold would be applicable.

The JCT estimated the provision would decrease revenue by approximately \$5 billion over 10 years.

### **KPMG observation**

Under current law, the deduction is limited to medical expenses in excess of 10% of AGI. For tax years before January 1, 2017, the current law threshold is 7.5% for seniors (age 65 or older). For all taxpayers, the deduction threshold is currently 10% for alternative minimum tax purposes.

#### *Allow increased contributions to ABLE accounts, and allow contributions to be eligible for saver's credit*

The conference agreement would increase the contribution limit by a designated beneficiary to ABLE accounts. The overall limit on contributions would remain the same (\$14,000 for 2017). After the limit is reached, the designated beneficiary could contribute an additional amount up to the lesser of the Federal poverty line for a one-person household as determined for the preceding calendar year, or the individual's compensation for the tax year. The designated beneficiary could claim the saver's credit for contributions to the ABLE account.

The provision would apply to tax years beginning after the date of enactment, but would sunset after December 31, 2025.

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

#### *Rollovers between qualified tuition programs and qualified ABLE programs*

The conference agreement provides that amounts from qualified tuition programs under section 529 could be rolled over to an ABLE account without penalty provided that the ABLE account was owned by the designated beneficiary of the 529 account or a member of the designated beneficiary's family. The rollover would count towards the overall limitation on amounts that can be contributed to an ABLE account in a tax year. Amounts in excess of the limit would be included in income as provided under section 72.

The effective date would be for tax years beginning after the date of enactment, but would not apply to distributions after December 31, 2025.

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

#### *Combat zone tax benefits to Armed Forces in Sinai Peninsula of Egypt*

The conference agreement would grant combat zone tax benefits to Armed Forces members performing services in the Sinai Peninsula of Egypt, generally effective June 9, 2015. "Special pay" benefits include limited gross income and excise tax exclusions, surviving spouse benefits, and filing extensions. This provision would sunset after 2025.

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

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

The conference agreement would exclude any income resulting from the discharge of student debt due to death or disability. The exclusion would apply to discharges of loans after December 31, 2017 and before January 1, 2026.

The JCT estimated that the proposal would decrease revenues by approximately \$100 million over 10 years.

#### *Modification of education savings rules (529 plans)*

Under current law, earnings from 529 plans are not currently taxable for federal purposes and distributions are not taxable for federal purposes so long as the distributions are used for qualified higher education expenses such as tuition and room and board as well as fees, books, supplies, and equipment required for enrollment.

Under the conference agreement, the definition of qualified higher education expenses would be expanded to include public, private, and religious elementary and secondary schools.

The conference agreement would also limit the tax-free distribution amount to an aggregate of \$10,000 per student per year when used for expenses with respect to elementary and secondary schools. The \$10,000 per student per year limitation would not apply to distributions for post-secondary school expenses.

The provision would be effective for distributions made after December 31, 2017 and is not subject to a sunset clause

The JCT estimated that the proposal would decrease revenues by approximately \$500 million through 2025.

#### **KPMG observation**

As approved on December 15, the conference agreement's definition of qualified higher education expenses included expenses related to home schooling. The home schooling language was deleted on December 20 after a point of order was successfully raised in the Senate. See introduction for more information.

#### *Relief for 2016 disaster areas*

The conference agreement would provide tax relief for any area for which a major disaster has been declared by the President during 2016.

The conference agreement would provide an exception to the 10% early withdrawal tax related to a qualified 2016 disaster distribution from a qualified retirement plan, a section 403(b) plan or an IRA. In addition, income attributable to such distribution would be included in income ratably over three years. Further, the amount of the distribution could be recontributed to an eligible retirement plan within three years. The total amount of distributions from all eligible retirement plans that could be treated as qualified 2016 disaster distributions would be \$100,000 per individual.

The conference agreement would also provide relief for personal casualty losses which arose in a 2016 disaster area where the loss was attributable to the events giving rise to the Presidential disaster declaration. The losses would be deductible without regard to whether aggregate net losses exceed 10% of a taxpayer's adjusted gross income, as required under current law. However, to be deductible the losses must exceed \$500 per casualty. The proposal also would allow the losses to be claimed in addition to the standard deduction. This relief applies to losses arising in tax years beginning after December 31, 2015 and before January 1, 2018.

The proposal would be effective on the date of enactment.

JCT has estimated the proposal would decrease revenues by approximately \$4.6 billion over 10 years.

#### *Repeal of deduction for alimony payments and corresponding inclusion in gross income*

Under current law, alimony and separate maintenance payments are deductible by the payor spouse and includible in income by the payee spouse.

Under the conference agreement, alimony and separate maintenance payments would not be deductible by the payor spouse and would not be includible in the income of the payee spouse. The effective date of this provision is delayed by one year. Thus, it would be effective for any divorce or separation agreement executed after December 31, 2018, and for any agreement executed before but modified after that date if the modification expressly provides that this new provision applies to such modification.

The JCT estimated this provision would increase revenue by approximately \$6.9 billion over 10 years.

#### *Eliminate deduction for member of Congress living expenses*

Under current law, Senators and House members are able to deduct up to \$3,000 per year in living expenses while away from their home states or Congressional districts. The conference agreement would repeal the ability to deduct these expenses for tax years beginning after the date of enactment. The JCT estimated that this provision would increase federal revenues by less than \$50 million over a 10-year period.

## Excluded House and Senate proposals

Several House and Senate proposals are not included in the conference agreement. As a result, individuals would remain subject to tax under the provisions currently provided in the Code.

*Modification of exclusion of gain on the sale of a principal residence:* Current law permits individuals to exclude up to \$250,000 (\$500,000 if married filing jointly) of gain realized on the sale or exchange of a principal residence provided certain requirements regarding ownership and use are met. The House and Senate proposals would have extended the length of time a taxpayer must own and use the residence to qualify for the exclusion. In addition, the House bill would have subjected the exclusion to phase-out for taxpayers whose income exceeded a specified threshold calculated as a three-year average.

*Limitation on exclusion for employer-provided housing:* The House proposal would have limited the exclusion from gross income for employer-provided lodging to \$50,000, subject to phase-out based on the employee's level of compensation.

*Sunset of exclusion for dependent care assistance programs:* Current law permits an employee to exclude from gross income up to \$5,000 per year for employer-provided dependent care assistance. The House bill would have repealed the exclusion.

*Repeal of exclusion for educational assistance programs:* Up to \$5,250 annually of employer-provided educational assistance is currently excludible from an employee's gross income. The House bill would have repealed the exclusion.

*Repeal of exclusion for adoption assistance programs:* An exclusion from an employee's gross income is allowed for qualified adoption expenses paid or reimbursed by an employer, if furnished pursuant to an adoption assistance program. For 2017, the maximum exclusion amount is \$13,570 and is phased-out ratably for taxpayers with modified adjusted gross income above certain thresholds. This provision is retained as provided under current law.

*Deduction for educator expenses:* The House bill would have repealed the present-law provision allowing for above-the-line deductions for educator expenses. The Senate bill proposal would have temporarily increased the deduction limit for an educator's expenses from \$250 to \$500. Neither proposal was adopted in the conference agreement and the provision is retained as provided under current law.

*Exclusion from gross income of certain amounts received by wrongly incarcerated individuals:* A provision proposed by the Senate related to the exclusion from gross income of certain amounts received by wrongly incarcerated individuals was not included in the conference agreement.



## Affordable Care Act—Healthcare

The conference agreement contains a significant amendment to the Patient Protection and Affordable Care Act (“Affordable Care Act” or “ACA”). Specifically, the excise tax imposed on individuals who do not obtain minimum essential coverage would be reduced to zero, starting in 2019.

However, no other ACA provisions are addressed in the conference agreement, including provisions that have been the subject of individual bills such as the medical device excise tax and the annual health insurer fee.

### Reduce Affordable Care Act individual shared responsibility payment to zero

Under current law, the individual shared responsibility provision requires individuals to be covered by a health plan that provides at least minimum essential coverage, or be subject to a tax for failure to maintain the coverage. The tax is imposed for any month that an individual does not have minimum essential coverage, unless the individual qualifies for an exemption.

Under the conference agreement, the amount of the individual shared responsibility payment would be reduced to zero, starting in 2019.

This provision would not be subject to the December 31, 2025, expiration date applicable to many other provisions affecting the taxation of individuals in this bill. The JCT has estimated that reducing the individual shared responsibility payment to zero would increase revenues by approximately \$314 billion over 10 years.

## Business – In general

### Reductions in corporate tax rate and dividends received deduction

The conference agreement would eliminate the progressive corporate tax rate structure, currently imposing a maximum corporate tax rate of 35%, and replace it with a flat tax rate of 21% (and make various corresponding changes throughout the Code). Further, it would eliminate the special corporate tax rate on personal service corporations (PSCs). The new rate would be effective for tax years beginning after 2017. In addition, the conference agreement would lower the 80% dividends received deduction (for dividends from 20% owned corporations) to 65% and the 70% dividends received deduction (for dividends from less than 20% owned corporations) to 50%, effective for tax years beginning after 2017.

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

The JCT has estimated that the rate reduction would decrease revenues by approximately \$1.35 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 conference agreement, this provision would lower tax rates in exchange for the elimination of certain tax benefits.

The corporate rate reduction proposed by the conference agreement could affect choice-of-entity decisions for some business entities. The proposed flat 21% corporate tax rate would differ from the effective rate for domestic business income of individuals earned through passthrough entities after giving effect to the proposed 20% deduction discussed elsewhere in this document. Also as described elsewhere in this document, certain income from business activities of passthrough entities still would be taxed at the individual rates, for which the conference agreement would provide a maximum tax rate of 37%.

The conference agreement does not distinguish between investment income and business income earned by corporations for purposes of applying the 21% tax rate. In addition, even though Senate Finance Committee Chairman Hatch had been exploring integrating the corporate and individual income taxes, the conference agreement does not contain a corporate integration proposal, meaning that corporate income subject to a 21% rate could be subject to a further tax in the hands of shareholders when distributed to them as dividends. In making choice-of-entity determinations, taxpayers should consider the reduced corporate rate and the impact of other changes to the Code proposed under the conference agreement, as well as current law provisions such as the accumulated earnings and personal holding company taxes. Ultimately, choice-of-entity decisions will continue to depend on individual facts and circumstances.

The conference agreement would reduce the personal service corporation (PSC) tax rate to the general corporate tax rate. Generally, a professional service corporation is a C corporation (i) substantially all of the activities of which consist of the performance of services in fields such as accounting, health, law, etc., and (ii) of which employees performing services for the corporation in the identified fields own, directly or indirectly, substantially all of its stock. By reducing the general corporate rate and the PSC rate to 21%, and providing for a top 37% rate for individuals while limiting the pass through deduction for personal service income, the conference agreement may encourage the incorporation of personal service businesses.

As described in the introduction to this report, section 15 would generally result in the application of a “blended” tax rate for tax years of fiscal year taxpayers that include the effective date of the rate change (December 31, 2017).

The conference agreement’s proposed 21% corporate tax rate is slightly higher than the 20% rate proposed in the House and Senate bills. The effective date of the change is the

same as in the House bill, but reflects a one year acceleration from the effective date provided by the Senate bill.

The House and Senate bills had modified the dividends received deduction to provide parity between the marginal tax rate on dividends received by corporations (1) under current law and (2) at a 20% rate. The conference agreement would not further adjust the dividends received deduction to reflect the increase in the corporate rate to 21%.

The corporate rate under the conference agreement would be substantially below the top individual tax rate (37%), which would re-establish the relationship between these tax rates that was in place beginning with the enactment of the Revenue Act of 1913 until the enactment of the Tax Reform Act of 1986.

## Corporate AMT

The conference agreement 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 2018, 2019, and 2020, 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 fully refundable in 2021.

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

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 conference agreement would allow the full use of the credits to (i) reduce or eliminate regular tax liability, and (ii) obtain tax refunds to the extent the AMT credit carryovers exceed regular tax liability.

While the conference agreement would repeal the AMT, it also generally would limit the NOL deduction for a given year to 80% of taxable income, adding a more restrictive version of the 90% limitation that currently exists only in the AMT regime. As shorthand, the 90% limitation in the AMT regime can be viewed as imposing a 2% tax rate (20% AMT rate multiplied by the 10% of income that cannot be offset with an NOL deduction). This "shorthand" rate would be 4.2% under the conference agreement (21% corporate tax multiplied by the 20% of income that cannot be offset with NOLs).

The repeal of the corporate AMT in the conference agreement is consistent with the House bill but represents a change from the Senate bill, which would have retained the corporate AMT. The Senate bill's preservation of the corporate AMT, when combined with

its proposed 20% corporate tax rate, would have increased the number of corporations subject to the AMT and would have resulted in significant collateral consequences and additional complexity.

### *Natural resources*

Taxpayers other than corporations would continue to be subject to the AMT and may need to make adjustments for mine exploration and development costs (section 56(a)(2)(A)); mine depletion (sections 56(g)(F)(i) and 57(a)(1)); and the oil and gas and geothermal intangible drilling and development costs preference (section 57(a)(2)). Section 59(f) (which coordinates section 59(e) with a corporate section 291) is being repealed. It appears that Congress did not expect corporations to use 59(e) after 2017. A corporation with domestic NOLs and foreign source income covered by foreign tax credits may want to consider using section 59(e) to eliminate the domestic NOL.

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

The conference agreement would limit the NOL deduction for a given year to 80% of taxable income, effective with respect to losses arising in tax years beginning after December 31, 2017. This limitation is similar to, although more restrictive than, the current 90% limitation for NOLs in the corporate AMT regime (which, as indicated above, would be repealed by the conference agreement).

The conference agreement also would repeal the current carryback provisions for NOLs arising in tax years ending after December 31, 2017, although it would permit a new two-year carryback for certain farming losses and would retain present law for NOLs of property and casualty insurance companies. Current law generally provides a two-year carryback and twenty-year carryforward for NOLs, 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 conference agreement would provide for the indefinite carryforward of NOLs arising in tax years ending after December 31, 2017, as opposed to the current 20-year carryforward.

The JCT has estimated that the proposal would increase revenue by approximately \$201.1 billion over 10 years (approximately \$45 billion more than the estimates for each of the House and Senate proposals).

### **KPMG observation**

The conference agreement 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 conference agreement would require corporations to track NOLs arising in tax years beginning (1) on or before December 31, 2017, and (2) after December 31, 2017, separately, as only the latter category of NOLs would be subject to the 80% limitation.

The 80% limitation would apply to losses arising in tax years beginning after December 31, 2017, whereas the elimination (for most taxpayers) of the NOL carryback and the indefinite carryover allowance would apply to losses arising in tax years ending after December 31, 2017. Accordingly, the NOLs of fiscal year taxpayers arising in tax years that begin before December 31, 2017 and end after December 31, 2017 would not be subject to the 80% limitation but (for most taxpayers) could not be carried back and could be carried forward indefinitely.

The changes to the NOL carryover provisions possibly could have a significant effect on the financial statement treatment of loss carryovers incurred in future tax years, given that unused loss carryovers no longer would expire. In addition, the potential 80% limitation on post-2017 NOLs and the elimination of post-2017 NOL carrybacks, combined with the reduction of the corporate tax rate, provides corporations with a significant incentive to accelerate deductions into 2017 and to defer income into 2018. Further, taxpayers may want to consider the interaction of the 80% limitation and the increased expensing allowances described elsewhere in this document. For example, if a taxpayer's deduction for the purchase of property would give rise to an NOL, it may be advantageous to defer the purchase until the succeeding year (if full expensing is still available in that year), as such purchase could then offset 100% (not 80%) of taxable income in that succeeding year. In general, taxpayers may find it beneficial to stagger purchases as long as full expensing is available, if doing so would avoid creating or increasing NOLs subject to the 80% limitation.

The NOL changes also would 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 no longer would be able to carry back losses to obtain refunds of taxes paid in prior years.

The conference agreement does not include a formula to increase NOL carryforwards by an interest factor over time, as was provided in the House bill.

### **Revisions to treatment of capital contributions**

The conference agreement would modify section 118, which provides an exclusion from gross income for contributions to the capital of a corporation. Specifically, the conference agreement would exclude from section 118 any contribution in aid of construction or any other contribution as a customer or potential customer, as well as any contribution by any

government entity or civic group (other than a contribution made by a shareholder as such). This provision would apply to contributions made after the date of enactment, unless the contribution is made by a government entity pursuant to a master development plan that is approved prior to the effective date by a government entity.

The JCT has estimated that the proposal would increase revenue by approximately \$6.5 billion over 10 years.

### **KPMG observation**

The conference agreement's modifications to section 118 generally would require corporations to include the specified types of contributions in gross income.

The conference agreement significantly modifies the corresponding provision in the House bill (the Senate bill did not include a similar provision), which would have repealed Code sections 118 (that provides for nonrecognition by a corporation on the receipt of a contribution to capital) and 108(e)(6) (that harmonizes the discharge of indebtedness income rules with section 118) and enacted new Code section 76 (that affirmatively would have required corporations and partnerships to recognize income on the receipt of a contribution to capital). The report on the House bill indicated that these changes were intended to eliminate a federal tax subsidy for state and local incentives and concessions granted to corporations to incentivize them to locate operations within the grantor's jurisdiction. However, the changes in the House bill would have applied to a much broader range of situations than suggested by the policy description and would have created a number of apparently unintended and unexpected consequences, including a particularly destabilizing impact on workouts and efforts to rehabilitate troubled companies.

The summary explanation notes that the conference agreement follows the policy of the House bill, but takes a different approach. The conference agreement eliminates the House bill's specific section 76 recognition provision and limits section 118 nonrecognition in a manner consistent with the policy justification given for the House bill. This approach would avoid many of the problematic and uncertain consequences raised by the House bill. See "Critique of House's Treatment of Capital Contributions," Tax Notes, Dec. 11, 2017, p. 1641.

The summary explanation also notes that the conferees, consistent with the Internal Revenue Service's current view, intend that section 118, as modified, continues to apply only to corporations.

## **Cost recovery**

### *Modification of rules for expensing depreciable business assets*

Under the conference agreement, the section 179 expensing election would be modified to increase the maximum amount that could be deducted to \$1 million (up from \$500,000 under present law) (the "dollar limit"). The dollar limit would be reduced dollar-for-dollar

to the extent the total cost of section 179 property placed in service during the tax year exceeds \$2.5 million (up from \$2 million under present law) (the “phase-out amount”). These limits would be adjusted annually for inflation. The changes would be effective for property placed in service in tax years beginning after 2017.

Under current law, the section 179 deduction for a sports utility vehicle is \$25,000. For tax years beginning after 2017, the conference agreement would adjust this limitation annually for inflation.

In addition, the conference agreement would expand the availability of the expensing election to depreciable tangible personal property used in connection with furnishing lodging – e.g., beds and other furniture for use in hotels and apartment buildings. The election would be further expanded to include, at the taxpayer’s election, roofs, HVAC property, fire protection and alarm systems, and security systems, so long as these improvements are made to nonresidential real property and placed in service after the date the realty was first placed in service. These expansions to the definition of property eligible for the section 179 expensing election would also be effective for property placed in service in tax years beginning after 2017.

The JCT estimated that the provision would decrease revenues by approximately \$26 billion over 10 years.

#### **KPMG observation**

The amendment making the inclusion of qualified real property elective may give taxpayers the ability to avoid or reduce their exposure to the dollar limit in certain cases.

#### *Temporary 100% expensing for certain business assets*

The conference agreement would extend and modify the additional first-year depreciation deduction (“bonus depreciation”).

Under the conference agreement, 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. It also would provide a phase down of the bonus depreciation percentage, allowing an 80% deduction for property placed in service in 2023, a 60% deduction for property placed in service in 2024, a 40% deduction for property placed in service in 2025, and a 20% deduction for property placed in service in 2026. These same percentages would apply to specified plants planted or grafted after September 27, 2017, and before 2027. Longer production period property and certain aircraft would get an additional year to be placed in service at each rate.

Property that is acquired prior to September 28, 2017, but placed in service after September 27, 2017, would remain subject to the bonus depreciation percentages available under current law – i.e., 50% for property placed in service in 2017, 40% for property placed in service in 2018, and 30% for property placed in service in 2019. Under

the conference agreement, the acquisition date for property acquired pursuant to a written binding contract would be the date of such contract.

#### **KPMG observation**

Prior legislation, and IRS regulations issued in 2003 interpreting such legislation, provided specific rules for determining the acquisition date of self-constructed property for bonus depreciation purposes. The conference agreement, however, is silent as to the determination of the acquisition date for self-constructed property. Thus, it is unclear whether prior law standards would be used for acquisition date determinations for self-constructed property under the proposed legislation.

The conference agreement would change the definition of qualified property (i.e., property eligible for bonus depreciation) by including used property acquired by purchase so long as the acquiring taxpayer had not previously used the acquired property and so long as the property is not acquired from a related party. In addition, the agreement would exclude any property used in providing certain utility services if the rates for furnishing those services are subject to ratemaking by a government entity or instrumentality or by a public utility commission, and any property used in a trade or business that has “floor plan financing indebtedness.”

#### **KPMG observation**

As in the House and Senate bills, the conference agreement excludes from bonus-eligible qualified property any property used in trades or businesses that is not subject to the proposed limitation of net business interest expense under section 163(j). The conference agreement also would expand the exclusion from the interest expense limitation to include property used in a farming business, but subject such property with a recovery period of 10 years or more to ADS (and by definition such property would not be qualified property eligible for bonus depreciation). While the proposed legislation would remove qualified improvement property from the definition of qualified property for bonus depreciation purposes, such property would appear to remain bonus eligible since it would now have a specified recovery period of 15 years and thus meet the general “20 years or less recovery period” requirement for bonus qualification.

The change in the definition of qualified property 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 (subject, in general, to an 80% of taxable income limitation as described elsewhere in this document) to shield future income.

In addition, the conference agreement creates a new category of qualified property that includes qualified film, television, and live theatrical productions, as defined under section



181(d) and (e), effective for productions placed in service after September 27, 2017, and before 2027. Under the agreement, a production would be treated as placed in service on the date of its first commercial exhibition, broadcast, or live staged performance to an audience.

In the case of a taxpayer's first tax year ending after September 27, 2017, the conference agreement would permit the taxpayer to elect to apply a 50% allowance in lieu of 100%.

The JCT estimated that the provision would decrease revenues by approximately \$86.3 billion over 10 years.

### **KPMG observation**

The conference agreement incorporates the most favorable provisions of both the House and Senate bills by expanding the availability of bonus depreciation to purchased non-original use property, and by instituting a four-year phase down period from 2023 through 2026.

### *Requirement to capitalize section 174 research and experimental expenditures*

The conference agreement would provide that specified research or experimental ("R&E") expenditures under section 174 paid or incurred in tax years *beginning after December 31, 2021* should be capitalized and amortized ratably over a five-year period, beginning with the midpoint of the tax year in which the specified R&E expenditures were paid or incurred. Specified R&E expenditures which are attributable to research that is conducted outside of the United States (for this purpose, the term "United States" includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States) would be capitalized and amortized ratably over a period of 15 years, beginning with the midpoint of the tax year in which such expenditures were paid or incurred. Specified R&E expenditures subject to capitalization include expenditures for software development.

In the case of retired, abandoned, or disposed property with respect to which specified R&E expenditures are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

The application of this rule would be treated as a change in the taxpayer's method of accounting for purposes of section 481, initiated by the taxpayer, and made with the consent of the Secretary. This rule would be applied on a cutoff basis to R&E expenditures paid or incurred in tax years beginning after December 31, 2021 (hence there is no adjustment under section 481(a) for R&E expenditures paid or incurred in tax years beginning before January 1, 2022).

The JCT has estimated that this provision would raise approximately \$119.7 billion in the 10-year budget window (taking into account the delayed effective date).

### **KPMG observation**

This proposal would substantially change the treatment of R&E and software development costs. Under current section 174, a taxpayer may currently expense R&E costs under section 174(a) or elect to treat R&E costs as deferred expenses under section 174(b), and such deferred expenses are allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures). Further, under current law an election to recover section 174 amounts over 10 years is available under section 59(e), which itself would be repealed under the proposed overall AMT repeal. Reg. section 1.174-2 provides a general definition of R&E expenditures, and it does not appear that this definition would change under the legislative proposal.

The IRS has had a long-standing rule of administrative convenience that permits taxpayers to treat the costs of developing software as deductible section 174 expenses, whether or not the particular software is patented or copyrighted or otherwise meets the requirements of section 174. See Rev. Proc. 2000-50 and its predecessor Rev. Proc. 69-21. The proposal would terminate this rule of convenience and require capitalization of software development expenses otherwise eligible for expensing under Rev. Proc. 2000-50.

### *Modifications to depreciation limitations on luxury automobiles and personal use property*

The conference agreement would increase the depreciation limitations for passenger automobiles placed in service after 2017. If bonus depreciation is not claimed, allowable depreciation would be limited to \$10,000 in year one; \$16,000 in year two; \$9,600 in year three; and \$5,760 in all subsequent years. These limitations would be indexed for inflation for automobiles placed in service after 2018.

Computers and peripheral equipment placed in service after 2017 would no longer be considered "listed property," and thus would not be required to be depreciated using the straight-line method if their business use fell below 50%.

The JCT included the estimated revenue impact of this provision with that of the proposal to increase and expand bonus depreciation.

### *Modifications of treatment of certain farm property*

The conference agreement would shorten the depreciation recovery period of certain machinery and equipment used in a farming business from seven to five years. To be eligible for the shortened recovery period, the equipment must be placed in service after 2017 and the taxpayer must be the original user of the equipment.

Under current law, property with depreciation recovery periods of 10 years or less that is used in a farming business is required to be depreciated using the 150% declining

balance method instead of the 200% declining balance method for which it would otherwise be eligible. The conference agreement would repeal this requirement for property placed in service after 2017.

The conference agreement also would require any farming trade or business that elects out of the interest deduction limitation to depreciate property with a recovery period of 10 years or more using ADS, in tax years beginning after 2017.

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

### *Applicable recovery period for real property*

The conference agreement would eliminate the special 15-year recovery period for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property; instead, it seems intended to provide a single 15-year recovery period (20 years for ADS) for qualified improvement property, defined as certain interior improvements to nonresidential real property that are placed in service after the initial placed-in-service date of the realty. However, the legislative text itself seems to include a “technical glitch,” which leaves the applicable recovery periods (both MACRS and ADS) for qualified improvement property uncertain.

### **KPMG observation**

Qualified restaurant property, which currently has a 15-year recovery period, includes section 1250 building and building improvement property. It may include newly constructed property that is otherwise qualified. Since the proposed legislation would limit the 15-year recovery period to qualified restaurant property that meets the definition of qualified improvement property, a large portion of restaurant building and building improvement property would be required to be depreciated as non-residential real property over a 39-year recovery period. Additionally, as indicated above, a “technical glitch” in the legislative text appears to result in uncertainty as to whether qualified improvements of any nature (not just restaurant property) would be eligible for the benefits of a shorter life and bonus depreciation.

In addition, the ADS recovery period for residential rental property would be shortened from 40 years to 30 years.

These provisions would be effective for property placed in service after 2017.

The conference agreement also would require any real property trade or business that elects out of the interest deduction limitation to depreciate building property under ADS. As a result, a real property trade or business’s nonresidential real property and residential rental property would be depreciated using the straight-line method over 40 years and 30 years, respectively, and its qualified improvement property would be depreciated using

the straight-line method over 20 years. This provision would be effective for tax years beginning after 2017.

The JCT estimated these provisions would decrease revenue by approximately \$4.9 billion over 10 years.

#### **KPMG observation**

As described above, the conference agreement cost recovery requirements relating to real property trades or business that elect out of the interest deduction limitations would apply for tax years beginning after 2017. As such, the election out would affect property already placed in service for the year the election is made. As indicated in the explanation to the Senate bill that was posted on the Budget Committee website, the election out would require the taxpayer to treat a change in the recovery period and method as a change in use.

#### *Expensing certain citrus replanting costs*

The conference agreement would provide a special rule for replanting costs paid or incurred after the date of enactment, but not more than 10 years after such date, for citrus plants lost or damaged due to casualty. Under the rule, such costs could be deducted by a person other than the taxpayer if either (1) the taxpayer has an equity interest of at least 50% in the replanted citrus plants and the other person owns the remaining equity interest, or (2) such other person acquires all the taxpayer's equity interest in the land on which the citrus plants were located when damaged and replants on such land.

The JCT has estimated that this provision would lose less than \$50 million over a 10-year period.

#### **Business-related deductions, exclusions, etc.**

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

The conference agreement 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 plus floor plan financing interest. The explanatory statement indicates that the section 163(j) limitation should be applied after other interest disallowance, deferral, capitalization or other limitation provisions. Thus, the provision would apply to interest deductions that are deferred in the tax year in which such deductions are deferred, capitalized, or disallowed.

The new limitation would not apply to certain small businesses; that is, any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) that meets the gross receipts test of section 448(c) (which would be modified to \$25 million under section 13102 the conference agreement)

for any tax year. This exception to the limitation would apply to taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior tax year that do not exceed \$25 million.

The new limitation would also not apply to the trade or business of performing services as an employee or to certain regulated public utilities and electric cooperatives. In addition, certain taxpayers could elect for the interest expense limitation not to apply, such as certain real estate businesses and certain farming businesses; businesses making this election would be required to use the alternative depreciation system (ADS) to depreciate certain property. For an electing real estate business, ADS would be used to depreciate nonresidential real property, residential rental property, and qualified improvement property. For an electing farming business, ADS would be used to depreciate any property with a recovery period of 10 years or more.

Adjusted taxable income generally would be a business's taxable income 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; (4) the 20% deduction for certain passthrough income, and (5) in the case of tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. The proposal would permit the Secretary to provide other adjustments to the computation of adjusted taxable income. A business's adjusted taxable income may not be less than zero for purposes of the limitation.

Business interest would be defined as any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for tax purposes would be treated as "interest" for purposes of this proposal. The term "business interest" would not include investment interest within the meaning of section 163(d). "Floor plan financing interest" is interest paid or accrued for "floor plan financing indebtedness," which means indebtedness used to finance the acquisition of motor vehicles held for sale or lease. The term "motor vehicle" means any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road; boat; or farm machinery or equipment.

Subject to the exclusions or those business that may elect out, the provision would apply to all businesses, regardless of form, and any disallowance or excess limitation would generally be determined at the filer level (e.g., at the partnership level instead of the partner level). For a group of affiliated corporations that join in filing a consolidated return, it applies at the consolidated tax return filing level. Subject to the special rules for partnerships, any business interest disallowed would be carried forward indefinitely. Carryover amounts would be taken into account in the case of certain corporate acquisitions described in section 381 and would be subject to limitation under section 382.

Special carryforward rules, described below, apply to partners in the case of business interest not allowed as a deduction to a partnership. These special carryforward rules do

not apply in the case of an S corporation. The general carryforward rule applies to an S corporation.

The conference agreement would prevent a partner (or shareholder of an S corporation) from double counting a partnership's (or S corporation's) adjusted taxable income when determining the partner's (or shareholder's) business interest limitation. More specifically, a partner's (or shareholder's) adjusted taxable income would be determined without regard to the partner's (or shareholder's) distributive share of the partnership's (or S corporation's) items of income, gain, deduction, or loss.

The explanatory statement illustrates the double counting rule with the following example. ABC is a partnership owned 50-50 by XYZ Corporation and an individual. ABC generates \$200 of noninterest income. Its only expense is \$60 of business interest. Under the proposal, the deduction for business interest is limited to 30% of adjusted taxable income, that is,  $30\% \times \$200 = \$60$ . ABC deducts \$60 of business interest and reports ordinary business income of \$140. XYZ's distributive share of the ordinary business income of ABC is \$70. XYZ has net taxable income of zero from its other operations, none of which is attributable to interest income and without regard to its business interest expense. XYZ has business interest expense of \$25. In the absence of a double counting rule, the \$70 of taxable income from XYZ's distributive share of ABC's income would permit XYZ to deduct up to an additional \$21 of interest ( $30\% \times \$70 = \$21$ ), and XYZ's \$100 share of ABC's adjusted taxable income would generate \$51 of interest deductions, well in excess of the intended 30% limitation. If XYZ were a passthrough entity rather than a corporation, additional deductions might be available to its partners as well, and so on.

The double counting rule prevents this result by providing that XYZ has adjusted taxable income computed without regard to the \$70 distributive share of the non-separately stated income of ABC. As a result, it has adjusted taxable income of \$0. XYZ's deduction for business interest is limited to  $30\% \times \$0 = \$0$ , resulting in a deduction disallowance of \$25.

The conference agreement would allow a partner or shareholder to use its distributive share of any excess (i.e., unused) taxable income limitation of the partnership or S corporation in computing the partner's or shareholder's business interest limitation. The excess taxable income with respect to any partnership is the amount that bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30% of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership exceeds the business interest income of the partnership bears to 30% of the adjusted taxable income of the partnership. Any such excess adjusted taxable income would be allocated in the same manner as non-separately stated income and loss.

The explanatory statement provides the following example. Assume the partnership described above had only \$40 of business interest. ABC has a limit on its interest deduction of \$60. The excess of this limit over the business interest of the partnership is  $\$60 - \$40 = \$20$ . The excess taxable income for ABC is  $\$20 / \$60 \times \$200 = \$66.67$ . XYZ's distributive share of the excess taxable income from ABC partnership is \$33.33. XYZ's

deduction for business interest is limited to 30% of the sum of its adjusted taxable income plus its distributive share of the excess taxable income from ABC partnership ( $30\% * (\$0 + \$33.33) = \$10$ ). As a result of the rule, XYZ may deduct \$10 of business interest and has an interest deduction disallowance of \$15.

As noted earlier, special carryforward rules apply to partners and partnership. Excess business interest of a partnership is not treated as paid or accrued by the partnership in the succeeding tax year. Instead excess business interest is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. Excess business interest allocated to a partner is treated as business interest paid or accrued by the partner in the next succeeding tax year in which the partner is allocated excess taxable income from the partnership but only to the extent of such excess taxable income. Any remaining excess business interest can be carried forward by the partner and deducted subject to the excess taxable income limitation. A partner's adjusted basis in its partnership interest is reduced (but not below zero) by the amount of excess business interest allocated to the partner. If a partner disposes of its partnership interest, including in a non-recognition transaction, the partner's basis in the interest is increased, immediately prior to the disposition, by the excess of: (i) the amount basis was reduced as described above over (ii) the amount of excess business interest allocated to the partner and treated as paid or accrued in a succeeding tax year.

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

The JCT estimated the provision would increase revenues by approximately \$253.4 billion over 10 years.

#### **KPMG observation**

Under the conference agreement, any net interest disallowance 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 to its partners. There may also be uncertainties created when applying the rules at the partnership level when references are made to the rules of section 469 which apply at the partner level.

Special rules would allow a partnership's unused interest limitation for the year to be used by its partners and to ensure that net income from the pass-through entity would not be double counted at the partner level. With respect to the double-counting rule, the conference agreement would exclude a partner's distributive share of all partnership items.

The conference agreement would permit interest disallowed at the partnership level to be passed through to the partners and deducted in succeeding tax years in which, and to the extent that, the partners are allocated excess taxable income from such partnership. The

conference agreement also provides for adjustments to the partners' bases in partnership interests to account for disallowed interest that is passed through.

The provision 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. In addition, payments that are not interest such as capitalized debt costs that are amortized like OID under Reg. section 1.446-5 would not be covered.

The provision 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.

While the bill language does not explicitly indicate how the proposed rule would interact with other interest disallowance and deferral provisions, the explanatory statement indicates that the provision is intended to apply after other interest disallowance and deferral provisions.

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.

It should be noted that interest expense can occur as a result of repurchasing one's debt instrument at a premium. Under Reg. section 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.

Finally, the provision does not address what happens to a corporation's existing disallowed interest expense for which a deduction was not claimed because of existing section 163(j). Thus, it is unclear if Congress intends that a corporation may treat that disallowed interest expense as business interest paid or accrued in a year after the effective date of the provision.

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

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

JCT has estimated that repealing section 199 would increase revenues by approximately \$98 billion from 2018-2027.



**KPMG observation**

Congress's intent in enacting section 199 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 provision would eliminate the rate reduction created by section 199, a separate provision of the conference agreement proposes a much larger overall corporate rate reduction, as discussed above.

*Modify tax treatment of certain self-created property*

Under the conference agreement, 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 no longer be treated as the sale of a capital asset.

This provision would apply to dispositions after December 31, 2017.

JCT estimates this 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.

The conference agreement follows the House bill without modifications, and notes that the provision is consistent with principle in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), in that the intent of Congress is that profits and losses arising from everyday business operations be characterized as ordinary income and loss and, as such, the general definition of capital asset should be narrowly applied. However, the conference agreement does not follow the House bill with respect to the proposed repeal of Section 1235, which provides capital gain treatment on the transfer of a patent prior to actual commercial use of the patent.

*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.

The conference agreement would repeal this provision, effective for sales after 2017.

The JCT has estimated that this provision would increase revenues by approximately \$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 conference agreement 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.

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

Section 13303 of the conference agreement would limit the like-kind exchange rules under Code section 1031 to exchanges of real property. Deferral under section 1031, however, would not be allowed for an exchange of real property held primarily for sale. In addition, as under current law, real property located in the United States would not be considered like-kind to real property located outside the United States.

The new section 1031 rules would 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 approximately \$31 billion over a 10-year period.

#### **KPMG observation**

The conference agreement's limitation on the like-kind exchange rules would eliminate deferral under section 1031 for exchanges of tangible personal property, including livestock, and intangible property. For tangible personal property, the proposed allowance for full expensing might 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). In addition, under the conference agreement, 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 for

purposes of section 1031. However, the conference agreement would eliminate the special rule under current law that characterizes certain stock in a mutual ditch, reservoir, or irrigation company as real property eligible for like-kind exchange treatment under section 1031.

#### *Limitation of deduction by employers of expenses for entertainment and certain fringe benefits*

The conference agreement would repeal deductions for entertainment, amusement, and recreation when directly related to the conduct of a taxpayer's trade or business. The conference agreement would provide that no deduction is allowed for (1) an activity considered entertainment, amusement, or recreation, (2) membership dues for any club organized for business, pleasure, recreation, or other social purposes, or (3) a facility or portion of a facility used in connection with any of the above.

The conference agreement generally would retain the 50% deduction for food and beverage expenses associated with a trade or business, effective for amounts paid or incurred after December 31, 2017. The conference agreement also would apply the 50% limitation to certain meals provided by an employer that are currently 100% deductible. The expanded use of the 50% limit would apply to food and beverages provided to employees as de minimis fringe benefits, for meals provided at an eating facility that meets the requirements for an on-premises dining facility, at and to meals provided on-premises to employees under section 119 for the convenience of the employer. The 50% deduction limit applies for years after 2017 and before 2026. The on-premises meals and section 119 meals expenses would be nondeductible after 2025.

The conference agreement would disallow any deduction expenses associated with providing qualified transportation fringe and any expense to provide transportation for commuting between the employee's residence and place of employment (unless ensuring the safety of an employee). This would include van pools, subway or transit cards and qualified parking expenses.

JCT has estimated this provision would increase revenue over 10 years by approximately \$23.5 billion for meals and entertainment expenses and \$17.7 billion for qualified transportation fringes.

#### **KPMG observation**

The provisions essentially provide the employer with a choice to include these amounts in employee taxable income and take a 100% tax deduction or exclude the amounts and take a lesser deduction.

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

The conference agreement 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 amounts paid or incurred after December 31, 2017.

The JCT estimate of the effects of this provision on revenue is included in the estimate above for the repeal of the deduction for qualified transportation fringes.

**KPMG observation**

The conference agreement follows the House bill. However, the provision is dependent upon disallowed deductions as set forth in section 13304 of the conference agreement's bill language (see "Limitation of deduction by employers of expenses for entertainment and certain fringe benefits," discussed above). For example, both provisions appear to apply to qualified transportation fringes, except as necessary for ensuring the safety of an employee but section 13304 does not appear to disallow a deduction for on-premises athletic facilities.

*Repeal deduction for local lobbying activities*

The conference agreement would disallow the deduction for lobbying expenses with respect to legislation before local government bodies (including Indian tribal governments). The provision would be effective for amounts paid or incurred on or after the date of enactment.

JCT has estimated that this provision would raise approximately \$800 million over a 10-year period.

**KPMG observation**

The conference agreement conforms the treatment of expenses for lobbying at the local level to the existing disallowance of such expense for lobbying at other levels of government. 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.

The provisions included in the conference agreement to repeal the deduction for local lobbying activities follow the Senate bill.

*Deny deduction for settlements subject to a nondisclosure agreement paid in connection with sexual harassment or sexual abuse*

Taxpayers are generally allowed a deduction under section 162 for ordinary and necessary expenses incurred in carrying on any trade or business. However, there are certain exceptions to the general rule. For example, there is no deduction allowed for certain lobbying and political expenditures, illegal bribes, kickbacks or other illegal payments, and any fine or similar penalty paid to a government for the violation of any law. The conference agreement proposes an additional exception, under which deductions would no longer be available for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement. The provision would be effective for amounts paid or incurred on or after the date of enactment.

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

**KPMG observation**

The conference agreement follows the provision in the Senate bill, without modification.

**Accounting methods**

*Certain special rules for tax year of inclusion*

Under the conference agreement, accrual method taxpayers would have to recognize income no later than the tax year in which the item is recognized as revenue on an applicable financial statement (*i.e.*, the all events test is satisfied no later than the year in which the revenue is recognized for financial accounting purposes). This book conformity requirement would not apply, however, either to an item of gross income earned in connection with a mortgage servicing contract, or to any item of gross income for which the taxpayer uses a special method of accounting provided under any other provision of the Code (such as, for example, long term contracts under section 460 or installment agreements under section 453), except for the various rules for debt instruments contained in Subchapter P, Part V of the Code (sections 1271-1288: rules for original issue discount (OID), discount on short-term obligations, market discount, and stripped bonds and coupons).

In the case of a contract containing multiple “performance obligations,” the taxpayer must allocate the contract’s transaction price among the performance obligations for tax purposes in the same manner as the transaction price is allocated for financial accounting purposes.

Additionally, the conference agreement would codify the current deferral method of accounting for advance payment for goods and services provided by the IRS under Revenue Procedure 2004-34.

Finally, for holders of certain debt instruments with OID, the conference agreement directs taxpayers to apply the revenue recognition rules under section 451 before applying the debt-specific rules such as the OID rules under section 1272. As a result, items included in income when received for financial statement purposes (e.g., late-payment and cash-advance fees) will generally be includible in income at such time in accordance with the general recognition principles under section 451. The provisions related to OID apply to tax years beginning after December 31, 2018. The period for taking into account any adjustments under section 481 is 6 years if required by the amendments of the conference agreement.

Other than the OID provisions, the other provisions related to the tax year of inclusion would apply to tax years beginning after December 31, 2017, and application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

The JCT has estimated that the special rules for tax year of inclusion would increase revenues by approximately \$12.6 billion from 2018-2027.

#### **KPMG observation**

The special rules for tax year of inclusion would cause an acceleration in the recognition of income for many taxpayers. For example, under the proposal, any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes, as opposed to when the services are complete or the taxpayer has the right to bill; advance payments for goods and revenue from the sale of gift cards could no longer be deferred longer than one tax year; and income from credit card fees (such as late-payment, cash advance, and interchange fees) would generally be accelerated.

The proposal should also be considered in relation to ASC 606, Revenue from Contracts with Customers. In particular, tax departments would be required to coordinate with the company's financial accounting function to ensure that the transaction price of contracts containing multiple performance obligations (*i.e.*, bundles of both goods and services) is allocated in the same manner for both book and tax purposes. This allocation may have consequences for both federal and state tax purposes.

One potentially problematic area that could be expected to arise under this provision involves accounting for manufacturing contracts. Under ASC 606, contract manufacturers will move from an inventory method to a progress measure in recognizing revenue and will no longer maintain inventories. Under the conference agreement, contract manufacturers would be required to recognize revenue before the inventory is sold but would continue to be required to maintain inventories and apply section 263A, assuming the contracts are not subject to the percentage of completion under section 460.

Whether the provision under the conference agreement requires certain taxpayers to accelerate the accrual and recognition of market discount is unclear. Market discount arises when a taxpayer purchases a debt instrument on the secondary market at a discount to its principal amount (or its adjusted issue price in the case of a debt instrument with OID). The exception in the provision for special methods of accounting provided under Chapter 1 of the Code specifically provides that it (the exception) does not apply to sections 1271 through 1288, which sections include not only the OID rules but also the market discount rules. On its face the provision therefore appears to apply to debt instruments with market discount. The explanatory statement, however, states in a footnote that “the provision does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred.” The footnote also states that “the provision does not require the recognition of gain or loss from securities that are marked to market for financial reporting purposes if the gain or loss from such investments is not realized for Federal income tax purposes until such time that the taxpayer sells or otherwise disposes of the investment.” Section 1276 generally provides that accrued market discount is treated as ordinary income to the extent of gain on the disposition of or receipt of any partial principal payment on any market discount bond, unless a taxpayer makes an election under section 1278(b) to include market discount in income as it accrues. Therefore, the market discount rules under section 1276 appear to require a realization event before a taxpayer must include market discount in income and accordingly it appears that such market discount rules come within the scope of the footnote stating that the provision does not revise the rules associated with when an item is realized for Federal income tax purposes. However, if instead the provision does apply to debt instruments with market discount and a taxpayer recognizes discount as it economically accrues in an “applicable financial statement” (as defined), then the favorable timing treatment under section 1276 may be limited.

The provision follows the Senate bill, without modifications.

### *Small business accounting*

The conference agreement includes several provisions (described below) to reform and simplify small business accounting methods. These provisions would be effective for tax years beginning after December 31, 2017.

The JCT estimated that the combined effect of these provisions would be a reduction in revenues by approximately \$30.5 billion over 10 years.

### **KPMG observation**

Overall, these provisions would allow businesses greater access to the cash method of accounting, and expand exceptions to the requirement to maintain inventories, the UNICAP rules and the percentage of completion method.

The conference agreement follows the House bill, without modifications.

### 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, for each prior tax year, its average annual gross receipts (based on the prior three tax years) do not exceed \$5 million. In addition, farm corporations and farm partnerships with C corporation partners may use the cash method of accounting if for each prior tax year their gross receipts do not exceed \$1 million (\$25 million for certain family farm corporations).

Under the conference agreement, the threshold under the three-year average annual gross receipts test would be increased to \$25 million (indexed for inflation for tax years beginning after 2018), and would apply to all C corporations and partnerships with C corporation partners (other than tax shelters), including farming C corporations and farming partnerships. The three-year average test would be applied annually under the conference agreement. A change to or from the cash method of accounting as a result of the provision would be treated as a voluntary change in the taxpayer's method of accounting, subject to a section 481(a) adjustment.

### 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 if for each prior tax year its average annual gross receipts (based on the prior three tax years) do not exceed \$1 million, and a second exception is provided for businesses in certain industries if for each prior tax year their average annual gross receipts (based on the prior three tax years) do not exceed \$10 million.

The conference agreement would allow additional businesses with inventories to use the cash method by increasing this threshold to \$25 million. Under the provision, businesses with average annual gross receipts of \$25 million or less (based on the prior three tax years) 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 conform to its financial accounting treatment. A change to or from the cash method of accounting as a result of the provision would be treated as a voluntary change in the taxpayer's method of accounting, subject to a section 481(a) adjustment.

### 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 for the prior three tax years is not subject to the uniform capitalization (UNICAP) rules with respect to personal property acquired for resale.



Under the conference agreement, producers or resellers with average annual gross receipts of \$25 million or less (based on the prior three tax years) would be fully exempt from the UNICAP rules. This exemption would apply to real and personal property for both resellers and manufacturers. A change in the treatment of section 263A costs as a result of the provision would be treated as a voluntary change in the taxpayer's method of accounting, subject to a section 481(a) adjustment.

### 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 conference agreement, 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). The provision would apply to contracts entered after December 31 2017, in tax years ending after such date. A change in the taxpayer's method of accounting as a result of the provision would be applied on a cutoff basis for all similarly classified contracts; thus there would be no change, and no resulting section 481(a) adjustment, in the treatment of contracts entered into before January 1, 2018.

### Business credits

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

The conference agreement would limit the "orphan drug credit" to 25% of qualified clinical testing expenses for the tax year, and would allow an election of reduced credit under section 280C.

The proposal would be effective for amounts paid or incurred in tax years beginning after 2017.

The JCT estimated that the proposal would increase revenue by \$32.5 billion over 10 years.

### **KPMG observation**

The conference agreement generally followed the Senate bill, with a reduced credit rate.

### *Modification of rehabilitation credit*

The conference agreement would repeal the 10% credit for pre-1936 buildings and make a modification to the 20% credit for certified historic structures, generally for amounts paid or incurred after 2017. Specifically, the credit for certified historic structures would remain at 20%, but must be claimed ratably over a five-year period beginning in the tax year in which a qualified rehabilitated structure is placed in service.

The conference agreement includes a transition rule for qualified rehabilitation expenditures incurred with respect to either a certified historic structure or a pre-1936 building, with respect to any building owned or leased at all times on and after January 1, 2018, if the 24-month period selected by the taxpayer or the 60-month period selected by the taxpayer for phased rehabilitation, begins not later than the end of the 180-day period beginning on the date of the enactment of the Act. In such case, the modifications made to the rehabilitation credit provisions would apply to such expenditures paid or incurred after the end of the tax year in which such 24-month or 60-month period ends.

The JCT estimated that the provision would increase revenue by approximately \$3.1 billion over 10 years.

#### **KPMG observation**

The conference agreement follows the Senate amendment with a modification to the transition rule for certain phased rehabilitations.

### *Employer credit for paid family and medical leave*

The conference agreement would allow eligible employers to claim a credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave (“FMLA”) if the rate of payment under the program is 50% of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.

An eligible employer is one that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and that allows all less-than-full-time qualifying employees a commensurate amount of leave on a pro rata basis. A qualifying employee means any employee who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60% of the compensation threshold for highly compensated employees.

The conference agreement also requires the Secretary to determine whether an employer or an employee satisfies applicable requirements based on employer provided information as the Secretary determines to be necessary or appropriate.

The employer credit would generally be effective for wages paid in tax years after 2017 and before 2020.

The JCT estimated that the provision would decrease revenue by approximately \$4.3 billion over 10 years.

#### **KPMG observation**

The conference agreement adopted the Senate bill's new general business credit for eligible employers without change.

### **Miscellaneous business provisions**

#### *Qualified opportunity zones*

The conference agreement would provide for the temporary deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the sale or exchange of an investment held for at least 10 years in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in and holding at least 90% of its assets in qualified opportunity zone property. Qualified opportunity zone property includes any qualified opportunity zone stock, any qualified opportunity zone partnership interests, and any qualified opportunity zone business property.

The designation of a qualified opportunity zone would be the same as the low-income community designation for the new markets tax credit. The certification of a qualified opportunity fund would be done by the Community Development Financial Institutions (CDFI) Fund, similar to the process for allocating the new markets tax credit.

The conference agreement provides that each population census tract in each U.S. possession that is a low-income community is deemed certified and designated as a qualified opportunity zone effective on the date of enactment. The conference agreement also clarifies that chief executive officer of the State (which includes the District of Columbia) may submit nominations for a limited number of opportunity zones to the Secretary for certification and designation. Finally, the conference agreement clarifies that there is no gain deferral available with respect to any sale or exchange made after December 31, 2026, and there is no exclusion available for investments in qualified opportunity zones made after December 31, 2026.

The creation of qualified opportunity funds would be effective on the date of enactment.

The JCT has estimated that the creation of qualified opportunity zones would decrease revenues by approximately 1.6 billion over 10 years.

### *Alaskan Native Corporation payments and contributions to settlement trusts*

The conference agreement would modify the tax treatment of Alaska Native Claims Settlement Act payments and contributions to settlement trusts. First, it would let Alaskan Native Corporations (“ANCs”) assign certain payments to Settlement Trusts without recognizing gross income from the payments.

Second, it would allow ANCs to elect annually to deduct contributions made to Settlement Trusts, subject to limitations. Generally the Settlement Trust must recognize income equal to the deduction allowable to the ANC. For contributions of property other than cash, the Settlement Trust takes a carryover basis in the property (or the fair market value of the property if less than the ANC’s basis). The conference agreement would allow the Settlement Trust to elect to defer recognition of income associate with the contributed property until the time the Settlement Trust sells or disposes of the property.

Third, the conference agreement would require that electing ANCs give the Settlement Trust a statement documenting details of contributions and such other information as the Secretary determines is necessary for the accurate reporting of income relating to contributions.

The first and third proposals would be effective for tax years beginning after 2016. The proposal for the deduction election would be available for tax years still open for refund claims, with a one-year limitations period waiver for a period expiring within one year of enactment.

The JCT has estimated that the proposal would decrease revenues by around \$100 million over 10 years.

#### **KPMG observation**

These provisions were included in the Senate bill.

The Senate explanation for the amendments indicates that restrictions on the activities and assets of ANC Settlement Trusts may discourage contributions by ANCs; Settlement Trusts are an effective tool for reducing dependency upon welfare by Alaska Native communities; and policies designed to promote funding of Settlement Trusts improve the health, education and welfare of Trusts’ beneficiaries.

### *Aircraft management services*

Section 13822 of the conference agreement would amend section 4261 by exempting from the air transportation tax on persons or property payments for “aircraft management services” made by aircraft owners to management companies (related to the management of private aircraft) from the section 4261 federal excise tax imposed on amounts paid for taxable transportation. These payments relate to maintenance and support of the owner’s aircraft or services related to flights on the owner’s aircraft.

Specifically the payments for “aircraft management services” include administrative and support services such as scheduling, flight planning and weather forecasting, obtaining insurance, maintenance, storage and fueling of aircraft, hiring, training, and provision of pilots and crew, establishing and complying with safety standards, and other services necessary to support flights operated by an aircraft owners.

The exemption would apply to payments made by persons that lease aircraft, unless the lease is a “disqualified lease.” Disqualified lease means a lease from a person providing aircraft management services for such aircraft if the lease term is 31 days or less.

The proposal would be effective for amounts paid after the date of enactment.

The JCT has estimated that the proposal would decrease revenues by less than \$50 million over 10 years.

### **KPMG observation**

The conference agreement would provide certainty on the issue of whether amounts paid to aircraft management service companies are taxable. In March 2012, the IRS issued a Chief Counsel Advice concluding amounts paid to aircraft management companies were generally subject to tax and the management company must collect the tax and pay it over to the government. The IRS began auditing aircraft management companies for this tax; however, it suspended assessments in May 2013 to develop further guidance. In 2017, the IRS decided not to pursue examination of this issue and conceded it in ongoing audits. No further guidance has been issued by the IRS to date.

### *Expand non-deductibility of certain fines and penalties*

Fines and penalties paid to a government are currently non-deductible for Federal income tax purposes under section 162(f). The conference agreement would further deny any otherwise deductible amounts paid or incurred to or at the direction of a governmental or specific nongovernmental regulatory entity for the violation or potential violation of any law. As under current law, certain exceptions would apply to payments established as restitution, remediation of property, or required for correction of noncompliance, as well as amounts paid or incurred as taxes due, but only if so identified in the court order or settlement agreement. Such exceptions would not apply to reimbursement of government investigative or litigation costs.

This provision would be effective for amounts paid or incurred on or after the date of enactment, but would not apply to amounts paid or incurred under any binding order or agreement entered into before such date.

The JCT has estimated that this provision would increase revenues by approximately \$100 million over 10 years.

### **KPMG observation**

The conference agreement would expand the definition of non-deductible fines and penalties to include certain payments for violations not made directly to the government. The conference agreement follows the Senate bill, without modifications.

## **Compensation**

The conference agreement does not include some compensation-related provisions that were in the House bill or Senate bill. For example, it does not include provisions relating to: (1) reduction in minimum age for allowable in-service distributions; (2) modification of rules governing hardship distributions; (3) modification of rules relating to hardship withdrawals from cash or deferred arrangements; (4) modification of nondiscrimination rules to protect older, longer service participants; and (5) termination of deduction and exclusions for contributions to medical savings accounts.

The provisions described below are in the conference agreement.

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

The conference agreement would repeal the exceptions to the section 162(m) \$1 million deduction limitation for commissions and performance-based compensation. The conference agreement would clarify that the definition of “covered employee” includes the principal executive officer, principal financial officer, and the three other highest paid employees. The conference agreement also would provide that once an employee is treated as a covered employee, the individual would remain a covered employee for all future years, including payments made after the death of a covered employee. The explanatory statement provides that an individual who is a covered employee in a tax year after December 31, 2016 that individual remains a covered employee for future years.

Further, the conference agreement would expand the definition of a “publicly held corporation” to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs. Under the explanatory statement, the definition of public company may include some corporations that are not publicly traded, such as large private C or S corporations.

The conference agreement would provide a transition rule to the section 162(m) proposed changes. Under this rule, the expansion of section 162(m) would not apply to any remuneration paid under a written, binding contract in effect on November 2, 2017, which was not materially modified on or after this date. The conference agreement expands on the transition rule originally provided in the Senate bill. The explanatory statement provides that compensation paid under a plan qualifies for this transition relief provided that the right to participate in the plan is part of a written, binding contract with the covered

employee in effect on November 2, 2017, even if the covered employee was not actually a participant on November 2, 2017.

The explanatory statement provides an example of a grandfathered arrangement. The example includes a covered employee, newly hired and covered by an employment agreement in effect on October 2, 2017. The written employment contract provided the employee was covered by the company's deferred compensation plan after 6 months of employment. The plan terms provide amounts payable under the plan are not subject to discretion, and the corporation does not have the right to amend materially the plan or terminate the plan, except prospectively before services are provided for an applicable period. The explanatory statement provides that such payments would be grandfathered. The explanatory statement specifies that a plan in existence on November 2, 2017 is not by itself sufficient to meet the exception for binding, written contracts. The explanatory statement also provides that a contract that renews after November 2, 2017 is treated as a new contract.

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

The JCT has estimated the provision would increase revenues by approximately \$9.2 billion over 10 years.

#### **KPMG observation**

The proposed elimination of the exception for performance-based compensation from the \$1 million dollar deduction limitation would be a substantial change to the current rules. The performance-based exception, while complex, is an often-used exception to link compensation to performance in order to preserve a publicly held corporation's deduction for such compensation. 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 as the differences in definitions generated some confusion.

Expanding the definition to apply even after officers terminate would also be a major change. It is not clear how the deduction limitation would apply following a corporate transaction (acquisition, merger, etc.) and there are open questions on the exact application of the transition rule.

#### **Treatment of qualified equity grants**

The conference agreement would allow certain employees to defer the timing of compensation for certain stock options and restricted stock unit (RSU) plans for private companies. Under this provision, if "qualified stock" were granted to a "qualified employee," then the employee could make an election within 30 days of vesting to have the tax deferred. In such case, the employee would have income the earlier of:

- The first date the stock is transferable

- The date the employee becomes an “excluded employee”
- The first date the stock becomes readily tradable on an established securities market
- The date that is five years after vesting, or
- The date the employee revokes the election.

This election would only be allowed on “qualified stock,” which includes stock from the exercise of a stock option or the settlement of an RSU provided that the option or RSU was granted for the performance of services in a calendar year for which the corporation was an “eligible corporation.” In order to be an eligible corporation, the stock of the company could not be readily tradable on an established securities market during any previous year. In addition, the company must have a written plan during the year and not less than 80% of all employees who provide services in the U.S. could be granted options and RSUs with the same rights and privileges. The 80% rule could not be satisfied in a year with a combination of options and RSUs. All employees must be granted stock options or RSUs. Stock would not be qualified stock if the employee could sell or receive cash in lieu of stock from the corporation at the time of vesting.

The election could not be made by an “excludable employee,” which would include:

- An individual who has been a 1% owner during the calendar year or was a 1% owner at any time during the last 10 years
- An employee who is or has at any time been the CEO or CFO or an individual acting in such capacity
- A person who is a family member of an individual described in the above 2 bullets or
- A person who is one of the four highest compensated officers or has been one of the four highest compensated officers of the corporation in the 10 preceding tax years.

The election would have to be made by the employee within 30 days of vesting. The employer would be required to provide the employee with notice of eligibility to make the election.

An election could not be made if the stock is readily tradable on an established securities market, or the company has purchased outstanding stock in the prior year (unless at least 25% is deferral stock and the individuals eligible to participate were determined on a reasonable basis).

A qualified employee would be allowed to make an election on qualified stock from a statutory option, but the option would no longer be treated as a statutory option. Further, the option would be treated as a nonqualified stock option for FICA withholding purposes.

The conference agreement specifies that section 83 does not apply to RSUs, except for the section 83(i) election. RSUs are not eligible for section 83(b) elections.

The election would be valid only for income tax purposes and would change FICA and FUTA timing. In the tax year the income is ultimately required to be included in the employee’s income as wages, the employer would be required to withhold at the highest



individual income tax rate. The employer would be required to report the amount of the election deferral on the Form W-2 in both the year of the election and the year the deferral is required to be included in income. Also, the employer would be required to report annually on the Form W-2 the aggregate amount deferred under such an election.

As part of a transition period and until additional guidance is provided, the conference agreement would provide that a company is in compliance with both the 80% rule and the notice requirements so long as the company complies with a “reasonable and good faith” interpretation of the requirements.

The provision would be effective for options exercised, or RSUs settled, after December 31, 2017.

The JCT has estimated that the provision would decrease revenues by approximately \$1.2 billion over 10 years.

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

This provision would impose an excise tax equal to the corporate tax rate (21% under the conference agreement) 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 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 and would be treated as paid when there is no substantial risk of forfeiture of the rights to such remuneration. However, it would not include any designated Roth contribution (section 402A(c)), amounts that are excludable from gross income, or payments to licensed medical professionals (i.e., doctors, nurses, veterinarians) for the performance of medical or veterinary services. 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)). Further, parachute payments do not include payments to licensed medical professionals for the performance of medical or veterinary services or to individuals who are not highly compensated employees under section 414(q). The excise tax would be applied to the

excess of the parachute payment over the portion of the base amount allocated to the payment.

The provision would apply to remuneration and parachute payments paid in tax years beginning after December 31, 2017 (though it would define covered employees in tax years beginning after December 31, 2016).

The JCT has estimated the provision would increase revenues by approximately \$1.8 billion over 10 years.

### **KPMG observation**

The conference agreement follows the Senate bill with some modifications:

- Determining the excise tax by reference to the corporate rate (rather than as a fixed percentage);
- Defining substantial risk of forfeiture by reference to section 457(f)(3)(B);
- Exempting non-highly compensated employees (as defined in section 414(q)) from the definition of parachute payment; and
- Excluding remuneration paid to a licensed medical professional (e.g., doctor, nurse, or veterinarian) that is directly related to the performance of medical or veterinary services.

Specifically, the conference agreement provides rules for tax-exempt entities that are similar to section 162(m) limits on the deductibility of compensation paid by publicly traded corporations, but it does not incorporate a transition rule similar to that included in the proposed changes to section 162(m), under which remuneration paid pursuant to a written binding contract in effect on November 2, 2017, would be excluded from the new rule, so long as the agreement is not later modified.

The conference agreement also provides rules for tax-exempt entities that are similar to section 280G rules on excess parachute payments that may be applicable to taxable corporations. The provision related to “excess parachute payments” relies upon section 280G guidance for determining the “base amount” calculation.

By excluding remuneration directly related to the provision of medical services, the conference agreement should help alleviate concerns of tax-exempt hospitals that commonly pay certain specialist physicians more than \$1 million.

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 provision 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, the violation of which may result in loss of tax-exempt status, guards against the payment of unreasonable compensation. The proposal appears to not take into account some of these existing rules.

## Retirement savings

### Repeal of special rule permitting recharacterization of IRA contributions

The conference agreement would provide that the special rule allowing contributions to one type of IRA to be recharacterized as a contribution to the other type of IRA would not apply to a conversion to a Roth IRA. The proposal provides that a conversion contribution to a Roth IRA during a tax year could no longer be recharacterized as a contribution to a traditional IRA and unwinding the conversion. Recharacterization would still be permitted for other contributions. This provision would not prohibit a contribution to an IRA and a conversion to a Roth IRA.

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

The JCT has estimated the provision would increase revenues by approximately \$500 million over 10 years.

### Extended rollover period for the rollover of plan loan offset amounts

The conference agreement would allow a qualified plan loan offset amount to be contributed to an eligible retirement plan as a rollover contribution to be extended from the current 60 days to the due date, including extensions, for filing the Federal income tax return for the tax year the loan offset occurs. This extension would occur for a qualified plan loans offset amount distributed from a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan solely because of a termination of the plan or the failure to meet the repayment terms because of a severance from employment.

The effective date would be for plan loan offsets amounts treated as distributed in tax year beginning after December 31, 2017.

The JCT has estimated the provision would have negligible revenue impact over 10 years.

### KPMG observation

The current rules only allow an employee 60 days to pay the qualified loan offset amount to an IRA or retirement plan upon termination of employment or the loan is treated as a distribution. The conference agreement would provide an employee with additional time to contribute the loan offset amount before it is characterized as a taxable distribution.

## Modification of rules for length of service award plans

The conference agreement would provide an increased aggregate amount of length of service awards under the section 457 exemption that may accrue for a bona fide volunteer to any year of service to \$6,000 with an annual cost of living adjustment after the first year. If the plan is a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of length of services awards accruing to any year of service.

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

The JCT has estimated that the provision would decrease revenues by approximately \$500 million over 10 years.

## Passthrough entities and sole proprietorships

### Treatment of business income and loss of certain non-corporate taxpayers

#### *Deduction of 20% for certain passthrough income (subject to sunset)*

For tax years beginning after December 31, 2017 (subject to a sunset at the end of 2025), the conference agreement generally would allow an individual taxpayer (including a trust or estate) a deduction for 20% of the individual's domestic qualified business income from a partnership, S corporation, or sole proprietorship. However, the deduction generally would be subject to a limit based either on wages paid or wages paid plus a capital element. Specifically, the limitation would be the greater of: (i) 50% of the wages paid with respect to the qualified trade or business; or (ii) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis (determined immediately after an acquisition) of all qualified property.

Qualified property means tangible property of a character subject to depreciation that: (i) is held by, and available for use in, the qualified trade or business at the close of the tax year; (ii) is used at any point during the tax year in the production of qualified business income; and (iii) for which the depreciable period has not ended before the close of the tax year. For this purpose, the "depreciable period" with respect to qualified property means the period beginning on the date the property is placed in service by the taxpayer and ending on the later of: (i) 10 years after that date; or (ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (without regard to section 168(g)).

A taxpayer's "W-2 wages" generally equal the sum of wages subject to wage withholding, elective deferrals, and deferred compensation paid by the partnership, S corporation, or sole proprietorship during the tax year. In the case of a trust or estate, rules similar to present law section 199 (as in effect on December 1, 2017) would apply for purposes of apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property. The 50% of wages limitation would not apply in the case of a taxpayer with income of \$315,000 or less for married individuals filing jointly (\$157,500

for other individuals), with phase-out over the next \$100,000 of taxable income for married individuals filing jointly (\$50,000 for other individuals).

With certain exceptions described below, an individual's qualified business income for the tax year would be the net amount of domestic qualified items of income, gain, deduction, and loss (determined by taking into account only items included in the determination of taxable income) with respect to the taxpayer's "qualified business." If the amount of qualified business income for a tax year were less than zero (i.e., a loss), the loss would be treated as a loss from qualified businesses in the next tax year.

A qualified business generally would be any trade or business other than a "specified service trade or business." A specified service trade or business is any trade or business activity involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business the principal asset of which is the reputation or skill of one or more of its owners or employees (excluding engineering and architecture), or any business that involves the performance of services that consist investment and investment managing trading or dealing in securities, partnership interest, or commodities. However, the deduction may apply to income from a specified service trade or business if the taxpayer's taxable income does not exceed \$315,000 (for married individuals filing jointly or \$157,500 for other individuals). Under the conference agreement, this benefit would be phased out over the next \$100,000 of taxable income for married individuals filing jointly (\$50,000 for other individuals).

Twenty percent (20%) of any dividends from a real estate investment trust (other than any portion that is a capital gain dividend) would be qualified items of income, as would 20% of includable dividends from certain cooperatives and qualified publicly traded partnership income. However, qualified business income would not include certain service related income paid by an S corporation or a partnership. Specifically, qualified business income would not include an amount paid to the taxpayer by an S corporation as reasonable compensation. Further, it would not include a payment by a partnership to a partner in exchange for services (regardless of whether that payment is characterized as a guaranteed payment or one made to a partner acting outside his or her partner capacity). Finally, qualified business income would not include certain investment related gain, deduction, or loss.

The 20% deduction would not be allowed in computing adjusted gross income; instead, it is allowed as a deduction reducing taxable income. Thus, the deduction would not affect limitations based on adjusted gross income. Moreover, the deduction would be available to taxpayers that itemize deductions, as well as those that do not.

The conference agreement provides a similar deduction for specified agricultural or horticultural cooperatives.

The provision would be effective for tax years beginning after December 31, 2017. Importantly, however, the 20% deduction would not apply to tax years beginning after

December 31, 2025 – i.e., the deduction would be temporary unless legislation were enacted extending it.

The JCT has estimated that that the 20% deduction would decrease revenue by approximately \$415 billion over a 10-year period.

### **KPMG observation**

The 20% deduction for certain passthrough income was largely modeled on a Senate bill provision, but was modified in several respects, including extending the deduction's availability to trusts and estates.

The explanatory statement provides that the deductible amount for each qualified trade or business would be determined first. The combined qualified business income amount for the tax year is the sum of the deductible amounts determined for each qualified trade or business and 20% of the taxpayer's qualified REIT dividends and publicly traded partnership income (assuming no qualified cooperative dividends). The taxpayer's deduction for qualified business income is then generally equal to the sum of (a) the lesser of the combined qualified business income or an amount equal to 20% of the excess of the taxpayer's taxable income over any net capital gain.

The definition of "W-2 wages" in the conference agreement appears to provide different results for taxpayers that operate a business in an S corporation than for taxpayers that operate as a partnership or sole proprietorship. Wages paid by an S corporation to its owners are W-2 wages, but an equivalent payment made by a partnership or a sole proprietorship to an owner is not.

In addition, the conference agreement may provide a different result for the sale of an interest in a publicly traded partnership than that provided for sale of a nonpublicly traded partnership. Specifically, the definition of "qualified publicly traded partnership income" includes any gain recognized on the sale of an interest in a publicly traded partnership to the extent that gain is characterized as ordinary income under section 751. Under this rule, recapture of items of deduction that reduced qualified business income in prior years would be taxed at the qualified business rate. That seems to be correct from a policy perspective. However, it is unclear whether that would be the case if a taxpayer sells an interest in a non-publicly traded partnership.

The conference agreement directs the Treasury to provide regulations applying the rules for requiring or restricting the allocation of items and wages and such reporting requirements as Treasury determines are appropriate. Further, the conference agreement directs the Treasury to provide regulations (1) applying the provision to tiered entities, and (2) applying the rules in short tax years and years during which the taxpayer acquires or disposes of the major portion of a trade or business or the major portion of a separate unit of a trade or business. In addition, the conference agreement added the requirement for anti-abuse rules with respect to the manipulation of the depreciable period of qualified property using transactions between related parties and for determining the

unadjusted basis of qualified property following a like-kind exchange or involuntary conversion.

The conference agreement appears to provide that qualified business income that is passive income may not benefit from the 20% deduction for purposes of the net investment income tax. As a consequence, liability for the net investment income tax may be unchanged by the provisions intended to benefit businesses conducted through passthrough entities. Although the conference agreement clarified that the 20% deduction is allowed as a deduction in reducing taxable income, it is still the case that the deduction is taken into account at the partner or shareholder level. Thus, absent amendment many partnership agreements may not take into account the deduction for purposes of determining partnership tax distributions which may be made starting with the first quarter of 2018.

Perhaps most importantly, the 20% deduction in the conference agreement would expire after eight years. In contrast, the corporate tax reduction in the mark is permanent. This and other differences should be considered by taxpayers considering whether to continue to operate business in passthrough form (rather than as a corporation) as a result of the large decrease in corporate tax rates.

#### *Loss limitation rules for taxpayers other than C corporations (subject to sunset)*

The conference agreement includes provisions that would expand certain limitations on losses for non-corporate taxpayers for tax years beginning after December 31, 2017, and before January 2, 2026. Specifically, it would expand the application of sections 461(j) (relating to excess farm losses) and 469 (relating to passive activity losses).

Under current law, section 461(j) limits the use of an excess farm loss incurred by a taxpayer (other than a C corporation) that receives an applicable subsidy. Generally, an excess farm loss may be deducted, but only to the extent of the greater of: (i) \$300,000 (\$150,000 in the case of a married taxpayer filing a separate return); or (ii) the taxpayer's total net farm income for the five preceding tax years. Any excess loss is carried forward and treated as a deduction in the following tax year.

Current law also limits deductions and credits of individuals, estates, trusts, and closely held corporations from passive trade or business activities. For this purpose, a passive activity is a trade or business in which a taxpayer does not materially participate (as determined in accordance with the section 469 regulations).

Under current law, loss from a non-passive activity of a taxpayer generally may offset other sources of income (subject to other applicable rules). However, passive activity losses in excess of income from passive activity income may not be used to offset other income of the taxpayer. Instead, they are suspended and carried forward and treated as deductions from passive activities in the following tax year. Remaining suspended losses generally are allowed when a taxpayer disposes of the activity in a fully taxable transaction with an unrelated party.

The conference agreement contains two temporary provisions affecting the loss limitation rules. First, the conference agreement would expand the limitation on excess farm losses. Although not explicitly stated, it appears that the expansion would eliminate a non-corporate taxpayer's ability to deduct an excess farm loss for a tax year in excess of \$500,000 for married individuals filing jointly or \$250,000 for other individuals.

Second, the conference agreement contains a significant change to the treatment of non-passive losses of taxpayers other than C corporations. Under the conference agreement, an excess business loss of such a taxpayer would not be allowed for the tax year. For purposes of this rule, an "excess business loss" for the tax year would be \$500,000 for married individuals filing jointly or \$250,000 for other individuals. Any excess business loss of the taxpayer would be treated as part of the taxpayer's net operating loss (NOL) and carried forward to subsequent tax years. These NOL carryforwards would be allowed for a tax year up to an amount equal to 90% of the taxpayer's taxable income (determined without regard to the NOL deduction).

In the case of a partnership or S corporation, the provision would apply at the partner or shareholder level. Thus, each partner or shareholder's share of the items of the entity would be taken into account in calculating the partner or shareholder's limitation. The provision would give the IRS authority to issue regulations to apply the rules to other passthrough entities or to provide any additional reporting deemed necessary to carry out the purposes of the provision.

The provision applies after application of the passive loss rules of section 469.

The provision generally would be effective for tax years beginning after December 31, 2017, but would expire after December 31, 2025. The JCT has estimated that the changes to the loss limitation rules would increase revenue by approximately \$149.7 billion over a 10-year period.

### **KPMG observation**

The conference agreement effectively would deny business deductions for taxpayers (other than C corporations) for any net business losses in excess of \$250,000 (or \$500,000 in the case of a joint return). This could be relevant for a taxpayer in the farming business that has a "very bad year" after several good years. Under current law, the taxpayer would be able to take into account income in its profitable years to increase the amount of its deduction from farming activities in the bad year.

Further, it appears the provision in the conference agreement could also affect a taxpayer that has previously suspended passive activity losses that are "freed up" as a result of a disposition of the passive activity. In such a case, those losses would be treated as non-passive losses in the year of the disposition. To the extent those losses exceed the threshold amount, they would not be available to the taxpayer in the year of disposition,



but rather would become part of the taxpayer's NOL and carryforward to subsequent years.

### Tax gain on the sale of a partnership interest on look-through basis

The conference agreement proposes to amend section 864(c) to treat gain or loss on a sale of a partnership interest as effectively connected with a U.S. trade or business to the extent that a foreign corporation or foreign individual that owns the partnership interest (whether directly or indirectly through other partnerships) would have had effectively connected gain or loss had the partnership sold its underlying assets.

In 1991, the IRS issued Rev. Rul. 91-32,<sup>3</sup> which much like the current proposal held that a foreign partner's capital gain or loss on the sale of a partnership interest is properly treated as effectively connected with a U.S. trade or business if and to the extent that a sale of the underlying assets by the partnership would have resulted in effectively connected income for the foreign partner. Earlier this year, the Tax Court refused to follow the revenue ruling in determining that a foreign partner was not subject to U.S. tax on a sale of a partnership interest (to the extent the gain was not attributable to U.S. real property interests).<sup>4</sup>

The conference agreement would adopt a look-through rule somewhat similar to that provided in section 897(g) to the sale of all partnership interests, not just those that hold U.S. real property interests. Specifically, the proposal would provide that gain or loss from the sale, exchange or other disposition of a partnership interest is effectively connected with a U.S. trade or business to the extent that a partner that is a foreign individual or foreign corporation would have had effectively connected gain or loss if the partnership had sold all of its assets at fair market value on the date of the exchange. For this purpose, the gain or loss from the hypothetical asset sale by the partnership is allocated to interests in the partnership in the same manner as nonseparately stated items of income or loss. The amount of the gain or loss treated as effectively connected income under the provision is reduced by the amount so treated with respect to U.S. real property interests under section 897. While the provision applies to gain or loss from the sale, exchange, or other disposition of the partnership interest, it gives broad regulatory authority to determine the appropriate application of the provision, including to various corporate nonrecognition transactions, such as contributions, liquidations and reorganizations.

The conference agreement would also require that the transferee of a partnership interest withhold 10% of the amount realized on a sale or exchange of the interest unless the transferor certifies that it is not a U.S. person and provides a U.S. taxpayer identification number. Such a transferee must withhold if it has knowledge or is notified that the affidavit is false, or if the transferee fails to provide the Service with a copy of the transferor's affidavit in the manner required by regulations. If the transferee fails to withhold the correct amount, the conference agreement would impose an obligation on the partnership to

---

<sup>3</sup> 1991-1 C.B. 107.

<sup>4</sup> *Grecian Magnesite Mining, Industrial & Shipping Co. v. Commissioner*, 149 T.C. No. 3 (July 2017).

deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold, plus interest.

The conference agreement would give the Service authority to prescribe a reduced amount of withholding in situations where it determines that such reduced amount will not jeopardize the collection of tax on gain treated as effectively connected under section 864(c)(8).

The JCT estimated that the provision would increase revenues by approximately \$3.8 billion over a 10-year period.

The substantive tax provision would apply to transfers occurring on or after November 27, 2017; however, the withholding tax obligation would only apply to transfers occurring after December 31, 2017.

### **KPMG observation**

This provision is based on the Senate bill with modifications. Much like the rules under section 897(g), it would apply to transactions that otherwise would be subject to a nonrecognition provision. However, broad regulatory authority is given to determine the appropriate application of the substantive tax provision, including with respect to a number of corporate nonrecognition transactions. Hopefully, such guidance would also address the application to partnership nonrecognition transactions, such as contributions or distributions, and mergers and divisions.

This provision would impact foreign partners of partnerships engaged, directly or indirectly through one or more partnerships, in a U.S. trade or business, including partners in various fund structures. Partnerships, whether U.S. or foreign, that transfer such interests would be required to treat the appropriate amount of gain or loss as effectively connected to a U.S. trade or business and withhold on this amount with respect to any foreign partner under section 1446.

The reason for the requirement to allocate gains on a hypothetical sale of assets in the same manner as nonseparately stated income or loss is unclear. The conference agreement does not define “nonseparately stated items” for purposes of this provision. That term possibly could be describing the partnership’s net income or net loss remaining after all items required by section 702(a) to be separately stated are removed, which includes the removal of capital gains and losses and any item that, if separately taken into account by any partner, would result in a differing income tax liability for the partner if not separately stated. Practitioners colloquially use the term to describe net operating income. Of note, the conference report indicates that the use of “nonseparately stated taxable income or loss of the partnership” for purposes of section 163(j) is the ordinary business income or loss reflected on Form 1065 (U.S. Return of Partnership Income), and a partner’s distributive share of this amount is reflected in Box 1 of Schedule K-1. If the intent of the provision is to use the sharing ratios for operating income, similar to the use in section 163(j), the determination of the amount of gain that is effectively connected

seemingly does not make sense. Partnerships often have different sharing ratios in operating income and gains from the sale of assets used in the trade or business. As such, using the ratio of nonseparately stated income to determine the amount of gain or loss on the sale of a partnership interest that is effectively connected with a U.S. trade or business could yield different results from the effectively connected gains or losses allocated to a partner from an actual sale of assets by the partnership that is determined pursuant to the partnership agreement provisions.

The provision would require that gain from the sale, exchange, or other disposition of the interest is treated as effectively connected with the conduct of a U.S. trade or business to the extent it does not exceed the portion of the partner's distributive share of effectively connected gain from a hypothetical sale of partnership assets. As such, the provision would appear to limit effectively connected gain to the gain realized from the exchange of the partnership interest. This result appears to differ from the result under section 751(a) which can result in more ordinary "hot asset" income than the gain otherwise realized on the exchange of the partnership interest. Accordingly, where the partnership holds both appreciated effectively connected assets, and depreciated non-effectively connected assets, it appears that not all of the foreign partner's effectively connected gain, as determined on a look through basis, would be recognized under the provision. A similar provision is provided with respect to effectively connected loss from the exchange.

The withholding provision imposed on transferees would apply to transfers of partnership interests where a foreign partner's gain on the disposition of the interest would be effectively connected gain. It appears that the withholding provisions would apply to nonrecognition exchanges. The proposed withholding regime differs from the withholding regime imposed under section 1445 with respect to the sale or exchange of an interest in a partnership that holds U.S. real property interests in that the only explicit exception from 10% withholding is if the transferor certifies it is not a foreign person, although the IRS is given latitude to provide for reduced withholding and additional exceptions in appropriate circumstances. Note further that the withholding regime applies to transferees where the transferor is a foreign partnership, and there yet there still remains an obligation to withhold by the foreign partnership under section 1446(a) with respect to its foreign partners. Without additional exceptions or coordination, duplicative or over-withholding could result.

Finally, the provision also differs from the section 1445 regime in that an obligation is imposed on the partnership to withhold on distributions to the transferee in an amount that the transferee failed to withhold, plus interest. The conference agreement does not indicate the applicable rate of interest. This would put an onus on the partnership to determine whether there was sufficient withholding, and in some cases could raise questions as to what the amount realized was on which withholding should have been done (in cases of nonrecognition transfers, for example).

## Modification of the definition of substantial built-in loss in the case of transfer of partnership interest

The conference agreement proposes to modify the definition of a substantial built-in loss for purposes of section 743(d).

Under current law, if the partnership has a substantial built-in loss in its property, it must decrease the adjusted basis of partnership property (with respect to the transferee partner) by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership (mandatory section 743(b) adjustment). The current rules determine whether there is a substantial built-in loss at the partnership level, comparing the partnership's adjusted basis in partnership property to the fair market value of its property. If the adjusted basis of all partnership property exceeds the fair market value by more than \$250,000 then the partnership is considered to have a substantial built-in loss and the mandatory section 743(b) adjustment is required to reduce the basis of the partnership assets with respect to the transferee. The purpose of the rule is to prevent the duplication of losses, once by the transferor partner upon the sale of his interest and a second time by the transferee upon the partnership's sale of the partnership property for other than small losses.

The conference agreement would modify the definition of a substantial built-in loss to add a rule that focuses on a partner level determination, to further ensure that losses are not duplicated. The additional definition would look to whether the transfer of the interest has the effect of transferring a loss in excess of \$250,000 to the transferee, rather than just whether the partnership has an overall loss in its assets. Thus, even if the partnership would have an overall gain upon the sale of all of its assets, if the transferee would be allocated more than \$250,000 in losses, as a result of its share of gain or loss with respect to particular assets, a mandatory section 743(b) adjustment would be required. Specifically, the new rule would provide that a substantial built-in loss exists if the transferee would be allocated a net loss in excess of \$250,000 upon a hypothetical sale of all the partnership's assets in a fully taxable transaction for cash equal the assets' fair market value, immediately after the transfer of the partnership interest.

The JCT has estimated that the provision would raise approximately \$0.5 billion over a 10-year period.

The changes would apply to tax years beginning after December 31, 2017.

### **KPMG observation**

This provision could create additional compliance issues, requiring a partnership to calculate whether it has a substantial built-in loss both at the partnership and the transferee partner level.

## Partnership charitable contributions and foreign taxes taken into account in determining partner loss limitation under section 704(d)

The conference agreement provides that a partner's distributive share of a partnership's charitable contributions and foreign taxes paid or accrued would be taken into account for purposes of determining the partner's loss limitation under section 704(d).

In the case of a charitable contribution of property in particular, the amount of a partner's section 704(d) limitation would be reduced by the partner's distributive share of the partnership's tax basis in the property. If a partnership makes a charitable contribution of appreciated property, section 704(d) would not apply to the extent that the value of the property exceeds its tax basis.

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

The JCT has estimated that the provision would increase revenues by approximately \$1.2 billion over 10 years.

### KPMG observation

While the explanatory statement acknowledges that the IRS has taken the position that section 704(d) does not apply to a partner's distributive share of a partnership's charitable contributions (see Private Letter Ruling 8405084), it indicates that the exclusion of such contributions (and foreign taxes) from the section 704(d) limitation is not appropriate.

The proposed modification generally is consistent with rules that limit an S corporation shareholder's losses and deductions to its tax basis in the S corporation's stock and debt, taking the shareholder's pro rata share of the S corporation's charitable contributions and foreign taxes into account.

This provision was in the Senate bill but not the House bill.

## Short-term capital gain with respect to applicable partnership interests

Section 13309 of the conference agreement would add to the Code a new section 1061 addressing the taxation of "applicable partnership interests." The conference agreement provision is identical to the applicable partnership interest provision contained in the Senate bill. Under the provision, if one or more "applicable partnership interests" were held by a taxpayer at any time during the tax year, some portion of the taxpayer's long-term capital gain with respect to those interests would be treated as short-term capital gain. At a high level, the provision would require that, to obtain long-term capital gain treatment for applicable partnership interests, the required asset-holding period must be greater than three years.

Proposed new section 1061 would apply only with respect to "applicable partnership interests." To qualify as such, the partnership interest would have to be transferred to, or

held by, the taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in any “applicable trade or business.” An “applicable trade or business” is an activity that is conducted on a regular, continuous, and substantial basis and that consists (in whole or in part) of – (1) raising or returning capital; and (2) either – (a) investing in or disposing of “specified assets” (or identifying such specified assets for investing or disposition), or (b) developing specified assets. “Specified assets” include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the forgoing assets, or an interest in a partnership to the extent of the partnership’s interest in the forgoing assets.

Two exceptions might apply to exclude treatment of certain partnership interests as applicable partnership interests. First, an applicable partnership interest would not include a partnership interest held by a corporation. Second, an applicable partnership interest would not include a capital interest that provides the partner with a right to share in partnership capital commensurate with – (1) the amount of capital contributed (determined at the time of receipt of the partnership interest); or (2) the value of the interest included in income under section 83 upon receipt or vesting. This exception appears intended to allow a service partner to earn income as long-term capital gain under the normal rules with respect to a partnership interest received in exchange for contributed capital or to the extent the partner included the value of the interest in income under section 83.

To the extent provided by the Secretary, the three-year holding period in proposed section 1061 would not apply to income or gain attributable to any asset not held for portfolio investment on behalf of “third-party investors.” A third-party investor for this purpose is a person who – (1) holds an interest in the partnership that is not held in connection with an applicable trade or business; and (2) is not and has not been actively engaged (and is not and was not related to a person so engaged) in (directly or indirectly) providing substantial services related to an applicable trade or business to the partnership or any applicable trade or business. This provision appears to be aimed at the “enterprise value” issue and would seem to direct the Secretary to promulgate regulations that would exclude gain from the intangible asset value associated with a sponsor’s investment management business from the application of the proposed rules.

Proposed new section 1061 would provide that, upon the transfer of an applicable partnership interest to a related person, the transferor must include short-term capital gain equal to the excess of – (1) the taxpayer’s long-term capital gain with respect to such interest for such tax year attributable to the sale or exchange of any asset held for not more than three years as is allocable to such interest; over (2) any amount already treated as short-term capital gain under the primary provision with respect to the transfer of such interest. For this purpose, a related person includes only persons with a family relationship under section 318(a)(1) and persons who performed services in the current calendar year or the prior three calendar years in any applicable trade or business in which or for which the taxpayer performed any service. This provision appears to be aimed at assignment of income issues, although the provision is drafted in a manner that makes it difficult to determine its exact effect.

The conference agreement provides that short-term capital gain treatment would apply under section 1061 “notwithstanding section 83 or any election in effect under section 83(b),”

Proposed section 1061 provides authority for the issuance of such regulations or other guidance as are necessary to carry out the purposes of the provision. The provisions covered by the amendment would be effective for tax years beginning after December 31, 2017. The bill does not include rules “grandfathering” applicable partnership interests held as of the effective date of such legislation.

The JCT estimated that this provision would raise approximately \$1.1 billion over a 10-year period.

### **KPMG observation**

The proposed new section appears intended to address the long-debated tax treatment of carried interests. Various bills have been proposed relating to this issue. The bill has some similarities to those proposals, but a great many differences.

Although not entirely clear, it appears that the three-year holding period described in the bill would be required for sales of assets held (directly or indirectly) by the applicable partnership, or, in the case of the sale of an applicable partnership interest, the applicable partnership interest itself. Rather than treating amounts failing the three-year test as ordinary income (as has been the typical recharacterization under prior versions of proposed carried interest legislation), proposed section 1061 would treat such gain as short-term capital gain.

Significantly, the proposed new section would operate only by modifying the application of sections 1222(3) and (4) and requiring a holding period for “capital assets” of more than three years in order to recognize long-term capital gain or loss. The Code contains a number of other provisions, such as section 1231, which result in taxation of gain recognized at long-term capital gain rates without reference to section 1222. Read literally, the proposed new section would appear not to impact the application of those provisions, even with respect to assets held for three years or less. On the other hand, the Code also contains provisions, like the REIT capital gain dividend rule in section 857(b)(3)(B), which provide for long-term capital gain treatment by characterizing the relevant income as gain from the sale or exchange of a capital asset “held for more than 1 year.” By virtue of such a provision, long-term capital gain treatment generally would result under section 1222(3). Under a strict reading of section 1061, there is concern that REIT capital gain dividend income allocated to an applicable partnership interest never could satisfy the three-year threshold even if the REIT held the asset generating the relevant gain for significantly longer than three years, since section 857(b)(3)(B) deems the gain to result from the sale or exchange of an asset held only for more than one year.

The exception for applicable partnership interests held by a corporation resolves significant controversy that arose in connection with earlier versions of carried interest legislation as a result of subjecting corporations (which were not rate sensitive) to the complexities and other issues associated with carried interest proposals. This bill would resolve this controversy by simply excluding corporations that hold partnership interests from the proposed rules. Questions have arisen as to whether the reference to a “corporation” for these purposes might include an S corporation. While the answer to this question is not entirely clear, Rev. Rul. 93-36, 1993-1 C.B. 287 (denying an S corporation automatic qualification for a business bad debt deduction under section 166, even though such qualification is available to a “corporation”) may imply that an S corporation should not be treated as a corporation for these purposes.

The provision of an exception for certain capital interests is consistent with prior versions of carried interest legislation, which included provisions intending to permit service partners to earn long-term capital gain with respect to their qualified capital interests. However, the rules defining “qualifying” capital and permissible returns in prior versions were significantly stricter and arguably more clearly defined. According to the explanatory statement, if a partner contributes capital to a partnership, then so long as the partnership agreement provides that the partner’s share of partnership capital is commensurate with the amount of capital that he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent. On the other hand, the explanatory statement also indicates that it is not intended that a partnership interest will fail to be treated as transferred in connection with the performance of services merely because a partner contributes capital, and the Treasury Department is directed to provide guidance implementing this intent. Reading the two statements together, it is difficult to determine what amount of income associated with contributed capital will be exempt from reclassification under section 1061.

The scope of the provision addressing transfers of applicable partnership interests to related parties is unclear. Presumably, this provision would cause recognition of gain or loss with respect to capital assets held for more than one year but not more than three years (i.e., capital assets with respect to which section 1061 would characterize gain as short-term capital gain) to the extent attributable to the transferred interest, even in nonrecognition transactions. With respect to gain-recognition transactions, the provision might require recognition of short-term capital gain upon a related-party transfer of a partnership interest held for more than three years to the extent of gain attributable to capital assets held by the partnership for more than one year but not more than three years.

The conference agreement attempts to clarify the statutory language providing that short-term capital gain treatment will result “notwithstanding section 83 or any election in effect under section 83(b).” According to the explanatory statement, the fact that a taxpayer has included an amount in income under section 83 upon the acquisition of an applicable partnership interest or has made an election under section 83(b) with respect to such an



interest does not change the three-year holding period requirement for obtaining long-term capital gain treatment with respect to the applicable partnership interest

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

The conference agreement would repeal the “technical termination” rules contained in current Code 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 \$1.6 billion over 10 years.

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

### **Provisions applicable to “eligible terminated S corporations”**

The conference agreement contains two generally favorable provisions applicable to “eligible terminated S corporations.” The provisions appear to be based on an expectation that some S corporations may revoke their S corporation status if the conference agreement becomes law. For purposes of both provisions, an eligible terminated S corporation is any C corporation: (i) that was an S corporation on the day before the date of enactment and revokes its S election in the two-year period beginning on the date of such enactment; and (ii) the owners of the stock of which (determined on the date on which such revocation is made) are the same and such owners hold the stock in the same proportions as on the date of enactment.

The first provision relates to accounting method changes required as a result of an S corporation’s conversion to a C corporation. Specifically, the conference agreement provides that, in the case of an eligible terminated S corporation, any section 481 adjustment arising from an accounting method change attributable to the corporation’s revocation of its S corporation election will be taken into account ratably during the six-tax year period beginning with the year of the method change. Thus, a corporation that must change a method of accounting as a result of the revocation of its S election would include any income resulting from that change over six tax years (as opposed to the four-year period under current method change procedures).

The second provision would revise the treatment of distributions made by certain corporations following their conversion to C corporation status. Under current law, distributions by an S corporation generally are treated as coming first from the S corporation’s accumulated adjustments account (AAA), which effectively measures the income of the S corporation that has been taxed to its shareholders but remains undistributed. If AAA is exhausted by the distribution, the excess distribution is treated as coming from any earnings and profits (E&P) of the corporation generated when it was a C corporation (or inherited from a C corporation under section 381). For a shareholder,

distributions out of AAA generally are more favorable, as such distributions are tax-free to the extent of the shareholder's basis in its S corporation stock and then as giving rise to capital gain for the shareholder. In contrast, distributions out of E&P are treated as dividends and taxed accordingly.

If a corporation's S election terminates, special rules apply to distributions made by the resulting C corporation during the post-transition termination period ("PTTP"). The PTTP begins on the day after the last day of the corporation's last tax year as an S corporation and generally ends on the later of: (i) the day that is one year after that day; or (ii) the due date for filing the return for such last year as an S corporation (including extensions). However, the PTTP may be extended in certain situations. A distribution of cash made by a C corporation with respect to its stock during the PTTP is applied against and reduces the shareholder's basis in the stock to the extent the amount of the distribution does not exceed the corporation's AAA. Thus, cash distributions by a former S corporation may be subject to the generally beneficial S corporation treatment of distributions, but only during the PTTP. After expiration of the PTTP, any distributions made by the former S corporation would be treated as coming first from the corporation's E&P and thus taxable as a dividend to the extent thereof.

The conference agreement would extend in part the generally beneficial treatment of distributions for certain former S corporations beyond the PTTP. Specifically, a distribution of money by an eligible terminated S corporation following the PTTP would be treated as coming out of the corporation's AAA or E&P in the same ratio as the amount of the corporation's AAA bears to the amount of the corporation's accumulated E&P. Thus, even after expiration of the corporation's PTTP, some portion of any money distributed by the corporation may nevertheless be treated as a reduction in the shareholder's basis in its stock followed by a capital gain.

The JCT has estimated that the changes applicable to eligible terminated S corporations would decrease revenue by approximately \$6.1 billion over a 10-year period.

The provisions generally would be effective as of the date of enactment.

#### **KPMG observation**

Under current law, an S corporation that becomes a C corporation may be under pressure from its shareholders to distribute cash equal to its AAA during the PTTP because the AAA effectively represents the income of the corporation with respect to which the pre-C corporation conversion shareholders have already been taxed. Thus, the shareholders would like to avoid the additional layer of tax on that income that arises if the distribution is characterized as a dividend. Allowing a portion of post-PTTP distributions to be treated as coming from AAA as the conference agreement does may allow the corporation to avoid the resulting strain on its liquidity.

## Changes relating to electing small business trusts

For a corporation to qualify as an S corporation, ownership of the corporation's stock is limited to certain permitted shareholders; one type of trust permitted to own stock in an S corporation is an electing small business trust (an "ESBT"). The portion of an ESBT that owns stock in an S corporation is treated as a separate trust and the S corporation's income allocated to the ESBT is taxed to the trust itself (rather than to the trust's beneficiaries).

To qualify as an ESBT, a trust must meet certain requirements, including that a nonresident alien individual may not be a potential current beneficiary of an ESBT. This is consistent with a rule that precludes a nonresident alien individual from owning stock in an S corporation.

As noted above, an ESBT's allocable share of the corporation's income is taxed to the trust; that income is taxed at the highest individual tax rate. Because an ESBT is a trust, the charitable contribution deduction applicable to trusts—rather than individuals—applies to the ESBT. A trust generally is allowed a deduction for any amount of gross income (without limitation) which is paid for a charitable purpose; no carryover of excess deductions is allowed. In contrast, an individual's charitable contribution deduction is limited to certain percentages of adjusted gross income, with a carryforward of amounts in excess of the limitation.

The conference agreement would amend current law to provide that the charitable contribution deduction allowed for the portion of an ESBT holding S corporation stock would be determined under the rules applicable to individuals, rather than those applicable to trusts. The provision would apply to tax years beginning after December 31, 2017.

Further, the conference agreement would allow a nonresident alien individual to be a potential current beneficiary of an ESBT. The provision would be effective on January 1, 2018.

The JCT has estimated that the changes relating to ESBTs would decrease revenue by approximately \$300 million over a 10-year period.

### **KPMG observation**

This provision could expand the number of corporations that might elect S corporation status, as well as the ability of S corporation shareholders to engage in gift and estate tax planning. Prior proposed changes to law would have made the same change. However, other aspects of the conference agreement may make operating a business as an S corporation less desirable (and thus the expansion of potential current beneficiaries to include nonresident alien individuals may affect only a limited number of corporations).

## Banks and financial institutions

### Deduction limits for FDIC premiums

The conference agreement would amend Code section 162 to limit the amount certain 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 estimated the limitation on deduction for FDIC premiums would increase revenues by approximately \$14.8 billion over 10 years.

## Bonds

### Repeal of tax credit bonds

Section 13404 of the conference agreement would repeal the rules related to tax credit bonds. Provisions that would be repealed relate to:

- 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

The conference agreement would also repeal Code section 6431, which provides an election that allows an issuer of tax credit bonds to receive a payment in lieu of the holder receiving a credit. This provision would also repeal Code section 1397E, which permits an eligible taxpayer that holds a qualified zone academy bond to claim a credit against taxable income.

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 estimated this provision would reduce revenues by approximately \$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.

**Repeal of advance refunding bonds**

The conference agreement would subject to tax the interest on advance refunding bonds – bonds used to pay principal, interest, or redemption price on a prior bond issue. Advance refunding bonds are those refunding bonds that are issued *more* than 90 days before the redemption of the refunded bonds. In general, governmental bonds and qualified 501(c)(3) bonds may be advance refunded only one time, while private activity bonds (other than qualified 501(c)(3) bonds) may not be advance refunded at all. The provision would apply to bonds issued after December 31, 2017.

The JCT estimated the repeal of advance refunding bonds would increase revenues by approximately \$17.4 billion over 10 years.

**KPMG observation**

Under current law, the advance refunding rules permit an issuer to refinance a prior bond issue to achieve debt service savings even though that issue might not be callable for more than 90 days from the issuance of the refunding bonds. This proposal would likely increase the cost of debt for organizations eligible to advance refund prior bond issues, such as section 501(c)(3) organizations.

Advance refunding bonds issued on or before December 31, 2017, would not be affected by these changes. Notably, the proposal does not appear to include a transition rule that would permit the advance refunding of bonds issued before January 1, 2018. In addition, interest on refunding bonds issued *within* 90 days of the redemption of the refunded bond (i.e., not *advance* refunding bonds) would remain tax-exempt.

**Insurance**

The conference agreement proposes several changes that would affect the taxation of the insurance industry.

## Net operations loss deductions of life insurance companies

The net operation loss provision (section 13511 of the conference agreement) 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 conference agreement also would modify the carryover and carryback rules for all corporations. Generally, all net operating loss carrybacks are repealed and taxpayers are allowed to carry net operating losses forward indefinitely (except for a special two year carryback in the case of certain losses incurred in the trade or business of farming). 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 80% of the taxpayer's taxable income for the year for tax years beginning after December 31, 2017.

The revenue effect is included in the JCT estimate for the broader modification of the net operating loss above.

### **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 for ordinary deferred tax assets since it allows insurance companies to use a reversal period that corresponds to the tax loss carryback provisions of the Code.

## Net operations loss deductions of property and casualty insurance companies

The conference agreement (section 13302) would preserve present law for net operating losses of property and casualty companies. Under the modification, which would be the same as current law, net operating losses of property and casualty companies may be carried back two years and carried forward 20 years.

### **KPMG observation**

This proposal would put life insurance companies and non-life insurance companies on different loss carryback and carryforward schedules. Unlike the impact on the life insurance industry, a non-life insurance's company's deferred tax asset admissibility computation for statutory accounting purposes would not change. The first part of the admissibility test under SSAP 101 would still be applicable and would allow the same computations as under current law. The 80% limitation applicable to life insurance companies and other corporations is not applicable to non-life insurance companies. The mismatch of the treatment of NOLs between life and non-life companies will potentially

lead to consolidation difficulties and the need to keep detailed schedules for tracking purposes.

### **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.

The proposed provision (section 13512 of the conference agreement) 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 increase revenues by approximately \$0.2B 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.

### **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.

The proposed provision (section 13513 of the conference agreement) 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, generally ratably over a four-year period, instead of over a 10-year period.

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

The JCT has estimated that the provision would increase revenues by approximately \$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.

**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.

The proposed provision (section 13514 of the conference agreement) 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 ratably over the first eight tax years beginning after December 31, 2017.

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

**KPMG observation**

This proposal was one suggested by the American Bar Association Tax Section Insurance Companies Committee and is not expected to raise significant revenue.

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

A proration rule applies to P&C companies. In calculating the deductible amount of its reserve for losses incurred, a P&C company must reduce the amount of losses incurred by 15% of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received, and (3) the increase for the tax year in the cash value of life insurance, endowment, or annuity contracts the company owns. The proration rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from deductible dividends, and from other untaxed amounts.

The proposed provision (section 13515 of the conference agreement) replaces the 15% reduction under present law with a reduction equal to 5.25% divided by the top corporate tax rate. The proration percentage will be automatically adjusted in the future if the top



corporate tax rate is changed, so that the product of the proration percentage and the top corporate tax rate always equals 5.25%. The top corporate rate is 21% for 2018 and thereafter, so the percentage reduction is 25% under the proration rules for P&C companies.

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

The JCT has estimated that the provision would increase revenues by approximately \$2.1 billion over 10 years.

#### **KPMG observation**

The explanatory statement indicates that the increase in the 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 provision's purpose under current law, which is 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 rate tied to the product of the proration percentage and top corporate tax rate may still be preferable overall to many insurers as the calculated rate facilitates predictability of after-tax rates of return on tax-exempt bonds and compares those rates to other investments.

#### **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.

The proposed provision (section 13516 of the conference agreement) would repeal the Code section 847 elective deduction and related special estimated tax payment rules. The entire balance of an existing account is included in income of the taxpayer for the first tax year beginning after 2017, and the entire amount of existing special estimated tax payments are applied against the amount of additional tax attributable to the inclusion. Any special estimated tax payments in excess of this amount are treated as estimated tax payments under section 6655.

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

The JCT has estimated that the provision would increase revenues by 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, and, as a result, section 847 is largely unnecessary and administratively burdensome.

**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 13517 of the conference agreement) would allow life insurance companies to take into account the amount of the life insurance reserves for any contract, which is calculated as the greater of: (1) the net surrender value of the contract or (2) 92.81% of the reserve computed as required by the National Association of Insurance Commissioners (NAIC) at the time the reserve is determined.

The conference agreement maintains the requirements that tax reserves cannot be less than the contract's cash surrender value, or greater than the statutory reserve for the contract. The conference agreement eliminates the requirement that the reserve method used for tax purposes be the method prescribed by the NAIC in effect on the date of the issuance of the contract. A no double counting rule provides that no amount or item is taken into account more than once in determining a reserve under subchapter L. The conference report provides several examples of the application of the no-double counting provision. A reporting requirement with respect to the opening and closing balance of reserves and with respect to the method of computing reserves for purposes of determining income is added.

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 \$15.2 billion over 10 years.

**KPMG observation**

The proposed provision in the conference agreement uses a 7.19% haircut of statutory reserves. The elimination of the current law requirement that the reserve method be set at the time the contract is issued will also eliminate any question about whether changes made by the NAIC to reserve methods should be reflected in the tax reserve.

**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 13518 of the conference agreement) would change the life insurance company proration rules for the DRD in Code section 805(a)(4) by changing the company share to 70% and the policyholder share to 30%.

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

The JCT has estimated that the provision would raise \$.6 billion over 10 years.

**KPMG observation**

The current rules are complex and based on an archaic system of life insurance company taxation. This provision would simplify the proration calculation by setting the company share and policyholder share percentages to a fixed amount.

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

The proposed provision (section 13519 of the conference agreement) would increase the capitalization rates applicable to specified insurance contracts under Code section 848. The current proxy rates applied to net premiums on “specified insurance contracts” are as follows:

- Annuity contracts (1.75%)
- Group life contracts (2.05%)
- All other specified contracts (7.7%)

The current provision allows for a 10-year spread.

The proposed provision is as follows:

- Annuity contracts (2.09%)
- Group life contracts (2.45%)
- All other specified contracts (9.2%)

The proposal would extend the amortization period from a 120-month period to a 180-month period. The proposal would not change the special rule providing for the 60-month amortization of the first \$5 million (with phase-out).

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

The JCT has estimated that the provision would increase revenues by approximately \$7.2 billion over 10 years.

#### **KPMG observation**

When section 848 was originally enacted, there was significant debate over the appropriate capitalization percentage and amortization period. Also important to note is that unamortized deferred acquisition cost (DAC) amounts that exist before the law change becomes effective would not be impacted and the associated amortization would continue over the previous 10 year period.

#### **Tax reporting for life settlement transactions, clarification of tax basis of life insurance contracts, and exception to transfer for valuable consideration rules**

Under current law section 101(a)(1) there is an exclusion from federal income tax for amounts received under a life insurance contract paid by reason of the death of the insured. Under section 101(a)(2), under the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable is generally limited.

Further, in Revenue Ruling 2009-13, the IRS ruled that income recognized under section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of a sale of a cash value life insurance contract, the IRS ruled that the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the "inside buildup") and excess is long-term capital gain.

In Revenue Ruling 2009-14, the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includable as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (ex. premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

The conference agreement would impose reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the insurance company issuing the life insurance or annuity contract. Lastly, the provision modifies the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale.

The JCT has estimated that these provisions would increase revenues by approximately \$0.2 billion over 10 years.

### **Reporting requirements for acquisitions of life insurance contracts**

The reporting requirement (section 13520 of the conference agreement) applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the tax year. A reportable policy sale means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract). An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract. Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is (1) the buyer's name, address, and taxpayer identification number ("TIN"), (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, and (4) the amount of each payment. The statement the buyer provides to any issuer of a life insurance contract is not required to include the amount of the payment or payments for the purchase of the contract.

### **Reporting of seller's basis in the life insurance contract**

On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller (1) the basis of the contract (i.e., the investment in the contract within the meaning of section 72(e)(6)), (2) the name, address, and TIN of the seller or the transferor to a foreign person, and (3) the policy number of the contract. Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.

### **Reporting with respect to reportable death benefits**

When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports (1) the gross amount of the payment; (2) the taxpayer identification number of the payee; and (3) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount

paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale. For purposes of these reporting requirements, a payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale.

### **Determination of basis**

The provision (section 13521 of the conference agreement) provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as “cost of insurance”). This reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured’s (seller’s) basis is reduced by the cost of insurance.

### **Scope of transfer for value rules**

The provision (section 13522 of the conference agreement) provides that the exceptions to the transfer for value rules do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

Under the provision, the reporting requirement is effective for reportable policy sales occurring after December 31, 2017, and reportable death benefits paid after December 31, 2017. The clarification of the basis rules for life insurance and annuity contracts is effective for transactions entered into after August 25, 2009. The modification of exception to the transfer for value rules is effective for transfers occurring after December 31, 2017.

### **KPMG observation**

The provision would add to the insurer’s reporting responsibilities by requiring it to identify and report seller information to the IRS. In addition, the reversal of the IRS’s position in Rev. Rul. 2009-13 simplifies the insurer’s reporting responsibilities by eliminating the bifurcated basis and investment in the contract calculations for contracts surrendered at a gain vs. contracts surrendered at a loss. Whether or not to reduce a seller’s basis by the cost of insurance has been a controversial issue, and the provision provides clarity to this situation.

### **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 provision (section 13523 of the conference agreement) 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. The corporate bond yield curve is defined by section 430(h)(2)(D)(i), but a 60-month period is substituted for a 24-month period. The corporate bond yield curve means, with respect to any month, a yield curve that reflects the average, for the preceding 60-month period of monthly yields on investment grade corporate bonds with varying maturities and that in the top three quality levels available.

The provision would also repeal the election in section 846(e) to use company-specific, rather than industry wide, historical loss payment patterns.

The present-law three-year period for discounting certain lines of business other than long-tail lines of business is not modified under the conference agreement.

The special rule that extends the loss payment pattern period for long-tail lines of business remains (but with the five-year limitation on the extended period increased to 14 years) so that:

- The amount of losses which would have been treated as paid in the 10<sup>th</sup> year after the accident year shall be treated as paid in such 10<sup>th</sup> year and each subsequent year in an amount equal to the amount of the average of the losses treated as paid in the 7<sup>th</sup>, 8<sup>th</sup>, and 9<sup>th</sup> years after the accident year (or, if lesser, the portion of the unpaid losses not therefore taken into account).
- To the extent such unpaid losses have not been treated as paid before the 24<sup>th</sup> year after the accident year, they shall be treated as paid in the 24<sup>th</sup> year.

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 approximately \$13.2 billion over 10 years.

### **KPMG observation**

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, but will affect some insurers more significantly than others.

## Exempt organizations

The conference agreement includes a number of proposed changes that would affect tax-exempt organizations.

### KPMG observation

As a result of conference committee negotiations, the conference agreement includes all of the exempt organization provisions that were in the Senate bill but omits most of the proposals from the House bill, including:

- Termination of private activity bonds
- Clarification of unrelated business income tax treatment of public pension plans and other entities treated as exempt from taxation under section 501(a)
- Exclusion of research income limited to publicly available research
- Simplification of excise tax on private foundation investment income
- Private operating foundation requirements relating to operation of art museum
- Exception from private foundation excess business holding tax for independently operated philanthropic business holdings
- 501(c)(3) organizations permitted to make statements relating to political campaign in ordinary course of activities
- Additional reporting requirements for donor advised fund sponsoring organizations

Unless otherwise stated, the provisions described below would be effective for tax years beginning after December 31, 2017.

### Unrelated business taxable income separately computed for each trade or business activity

Under the conference agreement, a tax-exempt organization would be required to calculate separately the net unrelated business taxable income (UBTI) of each unrelated trade or business. Any loss derived from one unrelated trade or business could not be used to offset income from another unrelated trade or business, and net operating loss (NOL) deductions would be allowed only with respect to the trade or business from which the loss arose.

This change would not apply to any NOLs arising in a tax year beginning before January 1, 2018, and such NOLs could be applied to reduce aggregate UBTI arising from all unrelated businesses.



The JCT estimated the provision would increase revenues by approximately \$3.5 billion over 10 years.

#### **KPMG observation**

The conference agreement follows the Senate bill.

Currently, tax-exempt organizations calculate UBTI based on all unrelated business activities regularly carried on, less the deductions directly connected with carrying on those activities. In other words, losses generated by one activity generally can offset income earned from another activity. The conference agreement would prevent organizations from calculating UBTI on an aggregate basis.

Under the proposal, it is unclear how to determine whether an activity constitutes a single or multiple trades or businesses.

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

The conference agreement would impose a 1.4% excise tax on the net investment income of private colleges and universities with at least 500 students (more than 50% of which are located in the United States) and non-exempt use assets with a value at the close of the preceding year of at least \$500,000 per full-time student. A university's assets would include assets held by certain related organizations (including supporting organizations to the university and organizations controlled by the university), and a university's net income would include investment income derived from those assets.

The JCT estimated the provision would increase revenues by approximately \$1.8 billion over 10 years.

#### **KPMG observation**

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

In determining whether the excise tax would apply to a particular college or university, it would be necessary to determine whether and to what extent to include the assets and net investment income of related organizations. For example, the bill language provides that such amounts shall be taken into account with respect to no more than one educational institution. In addition, unless the related organization is controlled by or a supporting organization of the college or university, only assets and net investment income that are intended or available for the use or benefit of the educational institution shall be taken into account.

The explanatory statement indicates that Congress intends for Treasury and the IRS to promulgate regulations describing

- Assets that are used directly in carrying out the educational institution's exempt purpose;
- Computation of net investment income; and
- Assets that are intended or available for the use or benefit of the educational institution.

This provision was modified on December 20 to remove a "tuition-paying" requirement in determining whether an institution meets the 500-student threshold. See introduction for more information.

### **Repeal of deduction for amounts paid in exchange for college athletic event seating rights**

The conference agreement 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.

The JCT estimated the provision would increase revenues by approximately \$2 billion over 10 years.

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

The conference agreement 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. This proposal would apply to contributions made in tax years beginning after December 31, 2016.

The JCT estimated the provision would have negligible revenue effects.

## **International**

In the context of international tax, the conference agreement would substantially eliminate any element of deferred taxation of foreign income within a US-parented multinational group—generally income is taxed as earned, or is permanently exempt from U.S. taxation. Despite allowing permanent exemption for a residual class of income, the conference agreement generally retains current subpart F to provide full and immediate taxation of the classes of income that are captured by current law, and furthermore subjects a new, very broad, class of income ("global intangible low-taxed income") to immediate taxation at a reduced rate. The conference agreement does, however, also grant the benefit of a reduced rate to a new class of income earned directly by a U.S. corporation ("foreign derived intangibles income"). In all of these respects, the conference agreement generally follows the approach set forth in the Senate bill. As a transition from

the former deferral regime to these new rules, existing untaxed earnings of “specified foreign corporations” are deemed repatriated and taxed at a reduced rate that depends upon the extent to which the earnings are matched by cash held offshore.

The conference agreement also contains provisions intended to curtail base erosion. Interest expense is limited to 30% of adjusted taxable income (a measure which initially tracks to EBITDA but transitions to a more stringent standard of EBIT),<sup>5</sup> and deductions are disallowed for transactions involving related parties and hybrid instruments or transactions. The conference agreement also adopts (with modifications) a novel new alternative minimum tax focused on deductible payments made by U.S. persons to related foreign persons originally proposed in the Senate bill.

Certainly, the sum total of these changes represents a significant expansion of the base of cross-border income to which current U.S. taxation would apply.

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

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

The conference agreement would add a new Code section 245A that would allow a domestic corporation that is a U.S. shareholder (as defined in section 951(b)) of a specified 10% foreign corporation a 100% dividends received deduction (“DRD”) for the foreign-source portion of dividends received from the foreign corporation (a “100% DRD”). The 100% DRD would be available only to domestic C corporations that are neither real estate investment trusts nor regulated investment companies.

For the purposes of new section 245A, the term “specified 10% foreign corporation” is defined as any foreign corporation with respect to which any domestic corporation owns at least 10%. Passive foreign investment companies (“PFICs”), however, are specifically excluded from the definition; thus dividends from PFICs would not qualify for the 100% DRD.

The foreign-source portion of a dividend would equal the same proportion of the dividend as the foreign corporation’s undistributed 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.

The conference agreement provides that a DRD is not available for any hybrid dividend, which is generally defined as an amount received from a controlled foreign corporation

---

<sup>5</sup> The conference agreement did not include additional limitations on interest expense based on a worldwide group’s relative levels of indebtedness within and without the United States, despite the fact that the House and Senate bills each contained a proposal (somewhat different from each other) along such lines.

("CFC") for which the foreign corporation received a deduction or other tax benefit related to taxes imposed by a foreign country. Additionally, to the extent a domestic corporation is a U.S. shareholder with respect to tiered CFCs, a hybrid dividend paid from a lower-tier CFC to an upper-tier CFC will be treated as subpart F income to the upper-tier CFC, and the U.S. shareholder will be required to include in gross income an amount equal to the shareholder's pro rata share of subpart F income.

A corporate U.S. shareholder may not claim a foreign tax credit ("FTC") or deduction for foreign taxes paid or accrued with respect to any dividend allowed a 100% 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 100% DRD (or stock that gives rise to a 100% 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. Specifically, a domestic corporation would not be permitted a 100% DRD with respect to a dividend paid on any share of stock that is held for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the dividend is paid. Additionally, the foreign corporation must qualify as a specified 10% foreign corporation and the domestic corporation must likewise qualify as a 10% shareholder at all times during the period.

The 100% DRD provision would apply to distributions made after December 31, 2017 and is expected to reduce revenues by approximately \$223.6 billion over 10 years.

### **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 provision largely follows the participation exemption proposal in the House bill, which was modeled after a 2014 tax reform discussion draft introduced by the then-chairman of the Ways and Means Committee. For corporations earning only foreign source income, the mechanics of the new participation exemption are largely irrelevant.

The explanatory statement indicates that the term "dividend received" should be interpreted broadly. As an example, the explanatory statement describes a domestic corporation that indirectly owns stock of a foreign corporation through a foreign partnership. According to the example, the domestic corporation would be allowed a participation DRD with respect to its distributive share of the partnership's dividend from the foreign corporation if the domestic corporation would qualify for the 100% DRD with respect to dividends from the foreign corporation if the domestic corporation had owned the stock directly.

*Add special rules relating to sales or transfers involving specified 10% owned foreign corporations*

The conference agreement would allow certain deemed dividends under Code section 1248 to qualify for a 100% DRD. Specifically, if a domestic corporation has gain from the sale or exchange of stock of a foreign corporation that it has held for at least one year, any amount that is treated as a dividend under Code section 1248 would be eligible for the 100% DRD. The proposal also includes special subpart F inclusion rules that would have the result of allowing a U.S. shareholder a 100% DRD with respect to gain on the sale of foreign stock by a CFC that is treated under section 964(e) as a dividend to the selling CFC.

The conference agreement provides two loss limitation rules. First, it provides that if a U.S. shareholder that is a domestic corporation has received a dividend from a foreign corporation that is allowed a 100% 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 100% DRD.

Second, the conference agreement would require domestic corporations to recapture foreign branch losses in certain foreign branch transfer transactions. If a domestic corporation transfers substantially all the assets of a foreign branch (within the meaning of Code section 367(a)(3)(C)) to a 10%-owned foreign corporation of which it is a United States shareholder after the transfer, 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 provision would be reduced by all gains recognized on the transfer, except gains attributable to "branch loss recapture" under section 367(a)(3)(C).

Lastly, the conference agreement would repeal the active trade or business exception of section 367(a)(3) for transfers made after December 31, 2017.

The provision requiring basis adjustments to a foreign corporation's stock would apply to distributions made after December 31, 2017.

The provisions relating to section 91 inclusions would be effective for transfers made after December 31, 2017.

The combined proposals are expected to increase revenues by approximately \$11.8 billion over 10 years.

#### **KPMG observation**

The conference agreement provision is similar to provisions in the House and Senate bills, with two important exceptions. First, the conference agreement and the Senate bill would repeal the section 367(a)(3) active trade or business exception; the House bill contains no such provision. The repeal of the section 367(a)(3) active trade or business exception is consistent with the Senate bill's theme of disfavoring the use of foreign branches.

Second, the 2014 reform proposal and the Senate bill would have limited section 91 inclusions to the section 245A DRD amount, with the excess amount carried forward subject to the same section 245A limitation. The conference agreement would not include this limitation.

Unfortunately, like the House and Senate proposals, the conference agreement fails to provide clear rules for coordinating section 91 inclusions with dual consolidated loss recapture, thus creating uncertainty with respect inclusions attributable to these potentially overlapping regimes.

#### *Mandatory repatriation*

The conference agreement includes a transition rule to effect the participation exemption regime. This transition rule would provide that the subpart F income of a specified foreign corporation (SFC) for its last tax year beginning before January 1, 2018, is increased by the greater of its accumulated post-1986 deferred foreign income (deferred income) determined as of November 2 or December 31, 2017 (a measuring date). A taxpayer generally includes in its gross income its pro rata share of the deferred income of each SFC with respect to which the taxpayer is a U.S. shareholder. This mandatory inclusion, however, is reduced (but not below zero) by an allocable portion of the taxpayer's share of the foreign E&P deficit of each SFC with respect to which it is a U.S. shareholder and the taxpayer's share of its affiliated group's aggregate unused E&P deficit.

The transition rule includes a participation exemption, the net effect of which is to tax a U.S. shareholder's mandatory inclusion at a 15.5% rate to the extent it is attributable to the shareholder's aggregate foreign cash position and at an 8% rate otherwise.

#### **KPMG observation**

The conference agreement includes two measuring dates for determining an SFC's deferred income. The conference agreement's November 2 measuring date adds

complexity to the transition rule because it requires each SFC to calculate its deferred income on a date that is not likely to coincide with regular reporting cycles. Additionally, the inclusion of the December 31 measuring date will require SFCs to compute their deferred income twice because the E&P taken into account under the transition rule is the greater amount.

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

An SFC is a foreign corporation that is a controlled foreign corporation (CFC) or foreign corporation that has at least one domestic corporate U.S. shareholder. The conference agreement revises the definition of “U.S. shareholder” in section 951(b) to include any U.S. person that owns at least 10% of the vote *or* value of a foreign corporation. However, this change is made effective for tax years of foreign corporations beginning after December 31, 2017, and thus, does not apply for purposes of the conference agreement’s transition rule.

The conference agreement removes section 958(b)(4) for the last tax year of foreign corporations beginning before January 1, 2018 and all subsequent tax years and for the tax years of a U.S. shareholder with or within which such tax years end. Thus, “downward attribution” of stock ownership from foreign persons is taken into account for purposes of determining whether a U.S. person is a U.S. shareholder of a foreign corporation for purposes of the conference agreement’s transition rule.

### **KPMG observation**

A “U.S. shareholder” includes domestic corporations, partnerships, trusts, estates, and U.S. individuals that directly, indirectly, or constructively own 10% or more of an SFC’s voting power. As a result, non-corporate U.S. shareholders are exposed to inclusions under the conference agreement’s transition rule if the SFC is a controlled foreign corporation or any foreign corporation with at least one domestic corporate U.S. shareholder, even though the proposed participation exemption regime for dividends from foreign subsidiaries in the conference agreement will only apply to corporate U.S. shareholders.

The conference agreement’s repeal of section 958(b)(4) applies for purposes of determining whether a foreign corporation is an SFC and also for purposes of determining whether a U.S. person is a U.S. shareholder. For example, if a domestic corporation owns 9% of a foreign affiliate, and the remaining 91% of the foreign affiliate is owned by the domestic corporation’s foreign parent, the foreign affiliate is an SFC and the domestic corporation is a U.S. shareholder of the affiliate. Therefore, the domestic corporation would have to include its pro rata share of the foreign affiliate’s deferred income, although the amount of the domestic corporation’s mandatory inclusion would be based solely on its direct and indirect ownership (here, 9%) of the foreign affiliate and only take into account E&P accrued during periods the foreign affiliate was an SFC. Also, foreign income taxes paid or accrued by the foreign affiliate would not be attributed to the domestic corporation’s mandatory inclusion because the domestic corporation does not own at least 10% of the foreign affiliate’s voting stock.

## Deferred income and E&P deficits

Deferred income is an SFC's E&P accumulated in tax years beginning after December 31, 1986, for the periods in which the corporation was an SFC, determined as of the measuring date (i.e., November 2 or December 31, 2017) and that are not attributable to effectively connected income that is subject to U.S. tax or amounts that if distributed would be excluded from a U.S. shareholder's gross income under the section 959 previously taxed income (PTI) rules (either previously or in the tax year to which the transition rule applies) (post-1986 E&P). For these purposes, an SFC's post-1986 E&P are not reduced for dividends during the mandatory repatriation year, other than dividends distributed to another SFC.

A U.S. shareholder can reduce, but not below zero, its pro rata share of an SFC's post-1986 E&P by an allocable portion of the shareholder's pro rata share of its SFCs' post-1986 E&P deficits (aggregate E&P deficit); the conference agreement clarifies that hovering deficits are included for these purposes. A U.S. shareholder allocates its aggregate E&P deficit to its SFCs with positive post-1986 E&P in proportion to the amount of their post-1986 E&P. The post-1986 E&P of an SFC that is reduced by an allocable portion of a U.S. shareholder's aggregate E&P deficit is treated as PTI beginning with the SFC's last tax year that begins before January 1, 2018. Additionally, if an SFC's post-1986 E&P deficit is used to offset another SFC's post-1986 E&P, the E&P of the SFC with the post-1986 E&P deficit is increased, for tax years beginning with the SFC's last tax year that begins before January 1, 2018, by the amount of the offset.

After allocating its aggregate E&P deficit, a U.S. shareholder that would otherwise have deferred income (i.e., the aggregate of the U.S. shareholder's pro rata share of its SFCs' post-1986 E&P exceeds its aggregate E&P deficit) can reduce its deferred income by its share of its affiliated group's aggregate unused E&P deficit. An affiliated group's "aggregate unused E&P deficit" is the sum of each group member's "unused E&P deficit," which generally is the amount by which a group member's aggregate foreign E&P deficit exceeds the aggregate of its pro rata share of its SFCs' post-1986 E&P. An affiliated group's aggregate unused E&P deficit is allocated to each group member based on the relative amount of each member's deferred income. The transition rule includes a rule that adjusts the application of these affiliated group "netting" rules to group members that are not wholly owned (measured by value) within the group.

The conference agreement provides a special rule for REITs that would exclude deferred foreign income from a REIT's gross income for purposes of the 95% and 75% gross income tests of section 856(c). Additional details with respect to this provision can be found in the REIT discussion in this report.

### KPMG observation

The conference agreement requires computation of post-1986 E&P without regard to certain current year dividends. In particular, it is clear that dividends paid by an SFC to



its U.S. shareholders during the mandatory repatriation year fail to reduce the E&P available for mandatory repatriation (although such E&P may be converted to PTI and thus not taxed upon receipt).

The conference agreement's definition of post-1986 E&P only includes E&P of a foreign corporation accumulated during periods when the foreign corporation was an SFC. The conference agreement does not, however, define post-1986 E&P by reference to the period that a U.S. shareholder has directly or indirectly owned an SFC. Thus, it appears that a U.S. shareholder must include its pro rata share of an SFC's post-1986 E&P that accumulated during periods the foreign corporation was an SFC as a result of another U.S. shareholder's ownership.

The conference agreement recognizes that basis adjustments to the stock of SFCs may be necessary to account for a U.S. shareholder's inclusion of deferred income or such shareholder's use of a SFC's deficit to offset deferred income. The conference agreement anticipates that the Treasury will issue regulations that will address the timing of adjustments to the basis of the stock of SFCs. These anticipated regulations would appear to be aimed at alleviating the potential for gain recognition on the distribution of amounts treated as PTI as a result of the transition rule. The conference agreement also anticipates regulations that would reduce the basis of SFCs with deficits.

### **Participation exemption**

Under the conference agreement's participation exemption, a U.S. shareholder is taxed at reduced rates on its mandatory inclusion. The portion of the inclusion attributable to the U.S. shareholder's aggregate foreign cash position is taxed at 15.5% and the remaining portion is taxed at 8%. The participation exemption uses a deduction to achieve these reduced rates. The amount of a U.S. shareholder's deduction is the sum of the amounts necessary to tax its mandatory inclusion attributable to its aggregate foreign cash position at 15.5% and the remaining portion at 8% using the highest corporate tax rate in effect for the year of the inclusion.

A U.S. shareholder's "aggregate foreign cash position" is the greater of: (i) the aggregate of its pro rata share of its SFCs' cash positions as of the close of their last tax year beginning before January 1, 2018; or (ii) one half of the aggregate of its pro rata share its SFCs' cash positions as of the close of the their last two tax years ending before November 2, 2017. An SFC's "cash position" generally is the sum of its cash, net accounts receivable, and fair market value of certain other liquid assets (e.g., actively traded personal property, commercial paper, certificates of deposit, government securities, short-term obligations, and foreign currency).

The conference agreement includes a "double counting" rule that prevents a U.S. shareholder from taking into account the cash position of an SFC attributable to the SFC's net accounts receivable, actively traded personal property, or short-term obligations, if the U.S. shareholder demonstrates to the satisfaction of the Secretary that it takes into account such amount with respect to another SFC. Non-corporate entities are treated as SFCs for purposes of determining a U.S. shareholder's aggregate foreign cash position

if an SFC owns an interest in the entity and the entity would be treated as an SFC of the U.S. shareholder if it was a foreign corporation. The determination of a U.S. shareholder's aggregate foreign cash position is subject to an anti-abuse rule.

### **KPMG observation**

The conference agreement ties the calculation of its deduction to the corporate income tax rate, even though its deduction applies to corporate and non-corporate U.S. shareholders. It is possible that section 962 may be elected by individual U.S. shareholders to mitigate this negative impact.

As noted above, amounts included by U.S. shareholders under the transition rule and post-1986 E&P of SFCs that are reduced by deficits are treated as PTI for purposes of section 959. Foreign currency movements between the date PTI is created and the date of distribution may generate foreign currency gain and losses under section 986(c). The explanatory statement accompanying the conference agreement anticipates that the Treasury will provide regulations that will allow a similar participation exemption to reduce the amount of such gain or loss.

The conference agreement provides a list of assets that will be considered to be included in the U.S. shareholder's cash position. The conference agreement does not provide that "blocked" assets (i.e., those that cannot be distributed under local law) are excluded from a U.S. shareholder's cash position.

The conference agreement's double counting rule limits, but does not eliminate, the potential for the cash positions of a U.S. shareholder's SFCs to be double counted. For example, the conference agreement's double counting rule does not appear to apply to short-term obligations between SFCs with different U.S. shareholders. Also, if a calendar year end U.S. shareholder has a calendar year end SFC and a fiscal year end SFC, it appears that the U.S. shareholder's aggregate foreign cash position applies to the deferred income of both SFCs. Specifically, the U.S. shareholder determines its aggregate foreign cash position once, notwithstanding that it includes the deferred income of its calendar year end SFC in its tax year ending December 31, 2017, and the deferred income of its fiscal year end SFC in its tax year ending December 31, 2018. That is, it appears that for purposes of determining the rate at which its fiscal year end SFC's deferred income is taxed, the U.S. shareholder's aggregate foreign cash position is not reduced for the amount of its calendar year end SFC's deferred income that was already attributed to its aggregate foreign cash position.

### **Foreign tax credits**

The conference agreement allows the use of foreign income taxes associated with the taxable portion of the mandatory inclusion. Foreign tax credits are disallowed to the extent that they are attributable to the portion of the mandatory inclusion excluded from taxable income pursuant to the participation deduction (55.7% of the foreign taxes paid attributable to the cash portion of the inclusion taxed at 15.5%; 77.14% of the foreign

taxes paid attributable to the non-cash portion of the inclusion taxed at 8%). Foreign tax credits disallowed may not be taken as a deduction. The U.S. shareholder's section 78 gross-up is equal to the portion of the foreign taxes attributable to the U.S. shareholder's net mandatory inclusion (i.e., the foreign taxes attributable to the gross mandatory inclusion less such taxes attributable to the participation deduction).

### **KPMG observation**

The conference agreement allows foreign income taxes associated with the taxable portion of a U.S. shareholder's mandatory inclusion to offset the U.S. tax on such amount. The conference agreement "haircuts" the foreign tax credits associated with a U.S. shareholder's mandatory inclusion by 55.7% for foreign income taxes associated with the portion of the inclusion attributable to the shareholder's aggregate foreign cash position and 77.1% 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 mandatory inclusion that is offset by the participation exemption that is calculated using a corporate tax rate of 35%. As noted above, the amount of the participation exemption may be reduced to the extent that the corporate tax rate is 21% for the tax year of the mandatory inclusion; however, the amount of disallowed FTCs does not appear to be similarly adjusted. Additionally, a U.S. shareholder's section 78 gross-up appears to exceed the amount of foreign taxes allowed as a credit when the corporate tax rate is 21% because, although the amount of the haircut remains unchanged, the amount of foreign taxes attributable to the U.S. shareholder's net mandatory inclusion will increase due to a reduction in the amount of the participation exemption. As a result, it appears that the net impact on US tax liability ought to be the same whether an amount is included in income during 2017 or during 2018.

The conference agreement does not address the use of foreign tax credit carryforwards to offset a U.S. shareholder's mandatory inclusion or the carryforward of foreign tax credits not used in the tax year in which a U.S. shareholder takes into account its mandatory inclusion. Thus, it appears that the current rules regarding foreign tax credit carryforwards apply to the transition rule. As a result, it appears that a U.S. shareholder can use existing foreign tax credit carryforwards against its mandatory inclusion and the foreign tax credit carryforward period remains 10 years.

### **Overall foreign loss recapture**

The conference agreement does not provide any discussion of the impact of the mandatory inclusion on a U.S. shareholder's overall foreign loss (OFL) or separate limitation losses (SLLs).

### **Net operating loss election**

The conference agreement allows taxpayers to elect out of using net operating losses (NOLs) to offset the mandatory inclusion from the bill's transition rules. This rule allows taxpayers to avoid reducing their foreign source income from the mandatory inclusion to

preserve the use of foreign tax credits in such year and it allows taxpayers to preserve their NOLs for future use.

## **Payment**

The conference agreement provides that the tax assessed on a U.S. shareholder's mandatory inclusion is payable in the same manner as its other U.S. federal income taxes and that such tax assessed may be paid over an 8-year period. The conference agreement requires that 8% of the tax be paid in each of the first five years, 15% in the 6th year, 20% in the 7th year, and 25% in the 8th year. Only the U.S. federal income tax due on the mandatory inclusion is eligible to be paid in installments. The conference agreement would accelerate the payment of the tax 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 to the date of such triggering event. The conference agreement does not provide for any exceptions to acceleration.

The conference agreement would allow REITs to distribute their deferred foreign income to their shareholders over an 8-year period using the same installment percentages that apply to electing U.S. shareholders. Additional details with respect to this provision can be found in the REIT discussion in this report.

## **S corporations**

The conference agreement provides that if an S corporation is a U.S. shareholder of an SFC, each shareholder of the S corporation may elect to defer paying its net tax liability on its mandatory inclusion until its tax year that includes a "triggering event" with respect to the liability. A net tax liability that is deferred under this election appears to be assessed as an addition to tax in the electing shareholder's tax year as the bill provides that the electing shareholder (and the S corporation) would be liable, jointly and severally, for the net tax liability and related interest of penalties.

A "triggering event" for purposes of the conference agreement's S corporation provisions includes the general triggering events noted above, a corporation ceasing to be an S corporation, 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.

An S corporation shareholder that elects to defer paying its net tax liability under the conference agreement's transition rule may also elect to pay this liability in equal installments over an 8-year period after a triggering event has occurred. However, this election is available only with the consent of the Secretary if the triggering event is a liquidation, sale of substantially all of the S corporation's assets, termination of the S corporation or cessation of its business, or a similar event. 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**

The conference agreement 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.

**Recapture from expatriated entities**

The conference agreement includes recapture rules that are intended to deter inversions. Under these rules, if a U.S. shareholder becomes an “expatriated entity” within the meaning of section 7874(a)(2) at any point during the 10-year period following the enactment of the bill, (i) the shareholder would be denied a participation deduction with respect to its mandatory inclusion, (ii) the shareholder’s mandatory inclusion would be subject to a 35% tax rate, and (iii) the shareholder would not be able to offset the additional U.S. federal income tax imposed by the recapture rules with foreign tax credits. An entity that becomes a domestic corporation under section 7874(b) is not subject to these recapture rules. The additional tax from these recapture rules arises in, and is assessed for, the tax year in which the U.S. shareholder becomes an expatriated entity.

**KPMG observation**

For purposes of the conference agreement’s recapture rules, an “expatriated entity” is a domestic corporation or domestic partnership the assets of which are acquired by a “surrogate foreign corporation,” which is not treated as a domestic corporation under section 7874(b), in a “domestic entity acquisition” and any U.S. person related to such domestic corporation or domestic partnership under sections 267(b) or 707(b)(1). A domestic entity acquisition occurs when a foreign corporation directly or indirectly acquires substantially all of the properties directly or indirectly held by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership. A foreign corporation is a surrogate foreign corporation that is not a domestic corporation under section 7874(b) if it completes a domestic entity acquisition and in the acquisition, the former shareholders of the domestic corporation or former partners of the domestic partnership, as applicable, receive at least 60% but less than 80% of the vote or value of the foreign corporation’s stock “by reason of” (e.g., in exchange for or with respect to) their domestic corporation stock or domestic partnership interests, as applicable, and after the acquisition does not have substantial business activities in its country of creation or organization. The U.S. anti-inversion rules are extremely complex and include many ambiguous provisions.

The incorporation of the U.S. anti-inversion rules complicates the conference agreement’s transition rule and could have unintended consequences. In particular, because the definition of expatriated entity includes U.S. persons that share a section 267(b) or 707(b)(1) relationship with the target entity in a domestic entity acquisition, the conference

agreement's inversion recapture rules may apply to U.S. shareholders other than the target entity. Given the punitive treatment of the amounts subject to the conference agreement's inversion recapture rules, the rules likely would be an important diligence item for future merger and acquisition transactions.

## Rules related to passive and mobile income

### *Current year inclusion of global intangible low-taxed income by United States shareholders*

A provision (section 14201 of the conference agreement) would add new Code section 951A, which would require a U.S. shareholder of a CFC to include in income its "global intangible low-taxed income" ("GILTI") in a manner similar to subpart F income. The bill language would allow a deduction for corporate shareholders equal to 50% of GILTI, which would be reduced to 37.5% starting in 2026. In general, GILTI would be the excess of a shareholder's CFCs' net income over a routine or ordinary return.

In general, when 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 U.S. person is a 10% shareholder on that day), then the U.S. person would be required to include in its own income its pro rata share of the GILTI amount allocated to the CFC for the CFC's tax year that ends with or within its own tax year. A U.S. shareholder would increase its basis in the CFC stock for the GILTI inclusion, which generally would be treated as "previously taxed income" for subpart F purposes.

### **KPMG observation**

One of the most important provisions in the conference agreement would impose a tax on a U.S. shareholder's pro rata share of its CFC's GILTI. Similar to other amounts calculated under subpart F, the GILTI would be included in a U.S. shareholder's income each year without regard to whether that amount was distributed by the CFC to the U.S. shareholder during the year.

Although lowering the U.S. statutory rate from 35% to 21% presumably would reduce the incentives to erode the U.S. tax base by shifting profits outside the United States, this provision reflects a concern that shifting to a territorial tax system could exacerbate base erosion incentives because any shifted profits could be permanently exempt from U.S. tax. The inclusion of GILTI 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 some measure of U.S. tax (at a rate potentially as low as 10.5% through 2025<sup>6</sup> when the 50% deduction described above is allowed).

Both the reduction in the corporate tax rate and the exemption from income of dividends received from CFCs are described as increasing the competitiveness of U.S. corporations and levelling the playing field with foreign multinationals. It is worth noting that an immediate tax, which in many cases would be imposed on most of a CFC's earnings, even at an effective rate of 10.5% for corporate shareholders (after taking into account the 50% deduction described above) would be comparatively unfavorable to the CFC regimes of most of the major trading partners of the United States, which typically tax CFC earnings in much more limited circumstances.

**GILTI.** In general, GILTI is described as the excess of a U.S. shareholder's net CFC tested income over its "net deemed tangible income return," which is defined as 10% of its CFCs' "qualified business asset investment," reduced by certain interest expense taken into account in determining net CFC tested income.

Under the conference agreement, the full amount of GILTI would be included in a U.S. shareholder's income. Corporate shareholders would be allowed a deduction equal to 50% of GILTI for 2018 through 2025, which would be decreased to 37.5% beginning in 2026. As a result, the effective tax rate on GILTI when a shareholder is allowed the 50% deduction would be 10.5%<sup>7</sup> prior to 2026. Because the GILTI deduction is limited by taxable income, net operating losses would be absorbed against the gross amount of GILTI before any GILTI deduction is allowed, and there is no carryforward for the foregone portion of any GILTI deduction due to the limitation to taxable income. Non-corporate U.S. shareholders generally would be subject to full U.S. tax on GILTI inclusions, based on applicable rates. The conference agreement clarifies that applicable U.S. shareholders can make a Code section 962 election with respect to GILTI inclusions, pursuant to which the electing shareholder would be subject to tax on the GILTI inclusion based on corporate rates, and would be allowed to claim FTCs on the inclusion as if the shareholder were a corporation. The interaction of the corporate-level GILTI deduction with Code section 962 is not clear because section 962 generally applies the corporate tax rate to the full amount of a section 951 inclusion (increased by the section 78 gross-up amount), without reduction for any deductions.

**Tested income.** The conference agreement defines net "tested income" as the excess of the aggregate CFCs' tested income over its tested loss. For this purpose, "tested income" of a CFC generally is described as the gross income of the CFC other than: (i) ECI; (ii) subpart F income; (iii) amounts excluded from subpart F income under the Code section 954(b)(4) high-tax exception; (iv) dividends received from a related person (as defined in Code section 954(d)); and (v) foreign oil and gas extraction income, over deductions allocable to such gross income under rules similar to Code section 954(b)(5) (or to which such deductions would be allocable if there were such gross income). Tested

<sup>6</sup> The effective tax rate on GILTI would be commensurately higher starting in 2026 after the GILTI deduction is reduced to 37.5%.

<sup>7</sup> This effective rate would increase to 13.125% when the deduction is reduced in 2026.

loss is defined to mean the excess of deductions allocable to such gross income over the gross income.

**Net deemed tangible income return.** The conference agreement describes the “net deemed tangible income return” as 10% of the excess of the CFCs’ qualified business asset investment (“QBAI”) over the amount of interest expense taken into account in determining the shareholder’s net CFC tested income, to the extent the interest income attributable to the expense is not taken into account in determining the shareholder’s net CFC tested income. QBAI would be determined as the average of the adjusted bases (determined at the end of each quarter of a tax year) in “specified tangible property” that is used in the CFC’s trade or business and is subject to Code section 167 depreciation. The adjusted basis of property would be determined under the alternative depreciation rules of Code section 168(g), and by allocating the depreciation deductions ratably to each day during the period in the tax year to which the depreciation relates.

#### **KPMG observation**

The conference agreement would apply a 10% rate to calculate the net deemed tangible income return or “routine return” on QBAI, which would be reduced by interest expense taken into account in determining net CFC tested income, to the extent the interest income allocable to the expense is not taken into account in determining net CFC tested income. As a result, interest expense incurred between two of a shareholder’s CFCs generally would not reduce the routine return, but, for example, interest expense incurred by a CFC as a result of third party debt would reduce the routine return. In certain cases, the routine return may be negligible, for example because (i) the CFC’s primary value-driver is intangible assets (notably, no relief is given for a return on intangible assets even when a taxpayer has purchase basis in the assets); or (ii) the CFC’s tangible property is substantially depreciated. As such, the tax base on which the tax is imposed in many cases may be a U.S. shareholder’s ratable share of net tested income without reduction for any sort of routine return.

**Deemed-paid foreign tax credit.** For any amount of GILTI that is includible in a U.S. corporate shareholder’s income, the conference agreement provides for a limited deemed credit for 80% of the foreign taxes attributable to the tested income (as defined above) of the CFCs. The conference agreement describes the methodology to calculate the foreign taxes deemed paid by the domestic corporation as 80% of (i) the domestic corporation’s “inclusion percentage”, multiplied by (ii) 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 defined above).

The inclusion percentage is described as the ratio of the shareholder’s aggregate GILTI divided by the shareholder’s share of the tested income of the CFCs. 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 GILTI, 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 conference agreement computes 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. Although the gross up amount is included in income as a dividend, it is not eligible for the Code section 245A 100% DRD, but is eligible for the GILTI deduction.

In addition, the conference agreement would 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. Moreover, any deemed-paid taxes on GILTI would not be allowed to be carried back or forward to other tax years.

### **KPMG observation**

The conference agreement would impose current tax on a U.S. shareholder's GILTI, but also would allow corporate U.S. shareholders a deemed paid foreign tax credit of 80% of foreign taxes attributable to the underlying CFCs. Under the conference agreement, only taxes paid or accrued by a CFC that has tested income would be creditable.

Nonetheless, taxpayers may not obtain the full benefit of taxes paid by their "tested income" CFCs when there is at least one loss CFC because the "inclusion percentage" in the conference agreement would reduce the creditable amount whenever there is at least one loss CFC. It is not clear whether this result is intended.

In addition, 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, by precluding carryover, the new deemed FTC proposal may put some taxpayers in a position where they are better off deducting rather than crediting the relevant foreign taxes they are deemed to pay under the proposal.

Finally, as described earlier, the definition of tested income excludes foreign oil and gas extraction income. Since extraction income often is 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.

These rules would be effective 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.

According to JCT, the GILTI rules (including the GILTI deduction) would increase revenues by \$112.4 billion over 10 years.

### **KPMG observation**

To mitigate the impact of these rules 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 would 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 (for example, a CFC with a September 30 year-end would become subject to the tax beginning October 1, 2018).

### *Add deduction for foreign-derived intangible income*

In conjunction with the new minimum tax regime on excess returns earned by a CFC, the conference agreement would provide a 13.125% effective tax rate on excess returns earned directly by a U.S. corporation from foreign sales (including licenses and leases) or services, which would increase to 16.406% starting in 2026. Specifically, for tax years 2018-2025, the conference agreement would allow a U.S. corporation a deduction equal to 37.5% of its "foreign-derived intangible income" ("FDII"). Starting in 2026, the deduction percentage would be reduced to 21.875%. The total deduction for FDII, GILTI, and the section 78 gross up for foreign taxes attributable to GILTI cannot exceed a corporation's taxable income, determined without regard to this provision. The deduction is not available for S corporations or domestic corporations that are RICs or REITs.

The conference agreement contains a complex set of definitional rules for determining the amount of a U.S. corporation's FDII. At a high level, a U.S. corporation's FDII is the amount of its "deemed intangible income" that is attributable to sales of property (including licenses and leases) to foreign persons for use outside the United States or the performance of services for foreign persons or with respect to property outside the United States. A U.S. corporation's deemed intangible income generally is its gross income that is not attributable to a CFC, a foreign branch, or to domestic oil and gas income, reduced by related deductions (including taxes) and an amount equal to 10% of the aggregate adjusted basis of its U.S. depreciable assets.

The net result of the calculation is that a domestic corporation would be subject to the standard 21% tax rate on its fixed 10% return on its U.S. depreciable assets and a 13.125% (increased to 16.406% as of 2026) tax rate on any excess return that is attributable to exports of goods or services.

The conference agreement also includes special rules for foreign related-party transactions. A sale of property to a foreign related person will not qualify for FDII benefits unless the property is ultimately sold by a related person, or used by a related person in connection with sales of property or the provision of services to an unrelated foreign person for use outside the United States. A sale of property is treated as a sale of each

of the components thereof. The provision of services to a foreign related person will not qualify for FDII benefits if the services are substantially similar to the services provided by the foreign related person to persons located in the United States.

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

### **KPMG observation**

The conference agreement follows the Senate bill with relatively minor amendments. The preferential rate on deemed intangible income attributable to export activities presumably is intended to encourage U.S. corporations to keep (or relocate) production activities in the United States. Interestingly, under the conference agreement, income earned from an active business conducted overseas will generally be taxed at full U.S. rates if undertaken in the form of a branch, while if conducted through a CFC the majority of the income will still be taken into account currently in the U.S. via the GILTI regime but will be eligible for tax at a reduced rate. It is not entirely clear why the proposal creates such incongruous treatment for activities conducted through a foreign branch as opposed to a CFC.

### **Other modifications of subpart F provisions**

#### *Eliminate inclusion of foreign base company oil related income*

A provision (section 14211 of the conference agreement) would repeal section 954(g) of the Code. As a result, there would no longer be full U.S. tax currently imposed on 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, the income may be subject to current U.S. taxation under the new “global intangible low-taxed income” (GILTI) rules described in the conference agreement, which effectively impose a minimum tax based, in part, on a CFC’s gross income, subject to certain exceptions. Although “foreign oil and gas extraction income” is excluded from GILTI, there is no similar exclusion for “foreign oil related income.”

This provision would be effective 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.

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

*Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment*

A provision (section 14212 of the conference agreement) 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 provision 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 less than \$50 million over 10 years.

*Modification of stock attribution rules for determining status as a controlled foreign corporation*

A provision (section 14213 of the conference agreement) 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 provision would apply to the last tax year of foreign corporations beginning before January 1, 2018, and all subsequent tax years of a foreign corporation, and for the 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 the deduction for dividends received, would reduce revenues by approximately \$223.6 billion over 2018-2027. This provision alone, though, 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 provision would be to cause minority U.S. owners of foreign subsidiaries in an inverted group to be treated as U.S. 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 GILTI rules. Nonetheless the downward attribution of ownership from foreign persons can have broader implications than the decontrolling transactions that the provision aims to render ineffective. For example, the foreign subsidiary of a foreign corporation that also owns a U.S. subsidiary could be treated as a CFC solely as a result of downward attribution from the foreign parent corporation to the U.S. subsidiary. In that case, a 10% U.S. owner of the foreign parent

corporation could be treated as the owner of the foreign subsidiary CFC. This provision would apply to the last tax year beginning before January 1, 2018, and thus would apply for purposes of the mandatory repatriation provision.

#### *Modification of definition of U.S. shareholder*

A provision (section 14214 of the conference agreement) would revise the definition of U.S. shareholder in section 951(b) of the Code to include a U.S. person who owns at least 10% of the value of the shares of the foreign corporation. As a result of this provision, a U.S. person would be treated as a U.S. shareholder of a foreign corporation for subpart F purposes when the person owns at least 10% of either the voting power or the value of the foreign corporation.

The provision would be effective for the 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.

According to JCT, this provision would increase revenues by approximately \$1.3 billion over 10 years.

#### **KPMG observation**

This provision would increase the scope of U.S. persons who are required to include amounts in income under the subpart F rules, and potentially increase the amount of subpart F income that current U.S. shareholders would be required to include in income, when the value of a shareholder's stock in a foreign corporation exceeds the voting power of the stock.

#### *Elimination of requirement that corporation must be controlled for 30 days before subpart F inclusions apply*

A provision (section 14215 of the conference agreement) 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 provision would be effective 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.

According to JCT, this provision would increase revenues by approximately \$600 million over 10 years.

## Prevention of base erosion

### *Adds limitations on income shifting through intangible property transfers*

The conference agreement would amend the definition of intangible property in section 936(h)(3)(B) (which applies for purposes of sections 367(d) and 482) to include workforce in place, goodwill, going-concern value, and “any other item” the value or potential value of which is not attributable to tangible property or the services of an individual. The conference agreement also would remove the flush language of section 936(h)(3)(B), which limits section 936(h)(3)(B) to intangibles that have substantial value independent of the services of any individuals, to make clear that the source or amount of value of an intangible is not relevant to whether that type of intangible is within the scope of section 936(h)(3)(B).

Additionally, the proposal clarifies the authority of the Commissioner to specify the method used to value intangible property for purposes of both the section 367(d) outbound transfer rules and the section 482 intercompany pricing rules. Specifically, when multiple intangible properties are transferred in one or more transaction, the IRS may value the intangible properties on an aggregate basis when that achieves a more reliable result. The proposal also would codify the realistic alternative principle, which generally looks to the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

The provision would apply to transfers in tax years beginning after December 31, 2017. Additionally, the conference agreement states that no inference is intended with respect to the application of section 936(h)(3)(B) or the authority of the Secretary to provide by regulation for such application with respect to tax years beginning before January 1, 2018.

### **KPMG observation**

The conference agreement provision is identical to the provision in the Senate bill. By expanding the scope of section 936(h)(3)(B), this provision would make it more difficult for a U.S. person to transfer intangible property outbound without incurring tax. The provision also would resolve prospectively long-standing uncertainties regarding the scope of section 936(h)(3)(B) and, in particular, the application of section 367(d) to outbound transfers of goodwill, going concern value, and workforce in place. Although recent regulations under section 367 required that outbound transfers of goodwill and going concern value are taxable under section 367(a) or (d), the IRS expressly declined to address whether goodwill, going concern value, and work force in place are section 936(h)(3)(B) intangibles.

*Limit deduction of certain related-party amounts paid or accrued in hybrid transactions or with hybrid entities*

The conference agreement would disallow a deduction for any disqualified related-party amount paid or accrued pursuant to a hybrid transaction, or by, or to, a hybrid entity.

A disqualified related-party amount is any interest or royalty paid or accrued to a related party if (i) there is no corresponding income inclusion to the related party under local tax law or (ii) such related party is allowed a deduction with respect to the payment under local tax law. A disqualified related-party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under section 951(a) (i.e., a “subpart F” inclusion). A related party for these purposes is determined by applying the rules of section 954(d)(3) to the payor (as opposed to the CFC referred to in such section).

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

A hybrid entity is one that is treated as fiscally transparent for federal income tax purposes (e.g., a disregarded entity or partnership) but not for purposes of the foreign country of which the entity is resident or is subject to tax (hybrid entity), or an entity that is treated as fiscally transparent for foreign tax law purposes but not for federal income tax purposes (reverse hybrid entity).

The conference agreement also would grant the Secretary authority to issue regulations or other guidance necessary or appropriate to carry out the purposes of the proposal and sets forth a broad list of issues such guidance may address. Such guidance may provide rules for the following: (1) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity; (2) applying the proposal to branches or domestic entities; (3) applying the proposal to certain structured transactions; (4) denying some or all a deduction claimed for an interest or a royalty payment that, as a result of the hybrid transaction or entity, is included in the recipient’s income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country’s generally applicable statutory tax rate by at least 25%; (5) denying a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system that provides for the exclusion of a substantial portion of such amount; (6) determining the tax residence of a foreign entity if the entity is otherwise considered a resident of more than one country or of no country; (7) exceptions to the proposal’s general rule to (a) cases in which the disqualified related-party amount is taxed under the laws of a foreign country other than the country of which the related party is a resident for tax purposes, and (b) other cases that the Secretary determines do not present a risk of eroding the U.S. income tax base; and (8) requirements for record keeping and information reporting in addition to any requirements imposed by section 6038A.

The provision would be effective for tax years beginning after December 31, 2017 and does not appear to contain grandfathering rules.

### **KPMG observation**

The conference agreement attempts to neutralize the effects of hybrid mismatch arrangements by denying deductions for interest and royalty payments made to related parties under hybrid arrangements that give rise to income that is not taxed in any jurisdiction (stateless income). Similar proposals have been included as part of President Obama's FY 2017 Budget Proposal and in the recommendations issued pursuant to Action 2 of the OECD BEPS project (Recommendations).

The conference agreement's provision is written broadly and would appear to apply to many of the transactions and structures addressed by the Recommendations, including the use of hybrid instruments and payments to and from reverse hybrids and disregarded payors. For example, an interest payment made with respect to a hybrid financial instrument held by a related party could be affected if there is no corresponding income inclusion by the related party.

The conference agreement does not appear to be limited to interest or royalties paid by a U.S. payor and may apply to such payments made by a U.S. person or a non-U.S. person, including payments between foreign related parties.

Other portions of the Recommendations may be implemented through Treasury Regulations. These provisions could include rules that apply to imported mismatch arrangements, branch structures or domestic entities, and deductible dividends that are excluded pursuant to a participation exemption. The explanatory statement accompanying the conference agreement anticipates that the Treasury will issue regulations that apply the provision to branches (domestic or foreign) and domestic entities even if such entities do not meet the statutory definition of a hybrid entity. As a result, interest or royalty payments by a U.S. LLC that has elected corporate status for U.S. tax purposes to its foreign parent could be affected under regulations if the foreign parent does not have an income inclusion as a result of the U.S. LLC being treated as disregarded under the tax laws of the country of the foreign parent.

Hybrid entities also potentially implicate the dual consolidated loss rules. Specifically, a domestic corporate owner of a foreign hybrid entity is subject to the dual consolidated loss rules, if the foreign hybrid entity incurs a loss for U.S. tax purposes. The conference agreement does not alter the dual consolidated loss rules.

### *Surrogate foreign corporations not eligible for reduced rate on dividends*

The conference agreement's anti-base erosion provisions include a rule that prevents dividends from surrogate foreign corporations to individuals from qualifying for the reduced tax rate applicable to qualified dividends. This rule only applies to corporations



that first become surrogate foreign corporations after the bill is enacted and are not treated as a domestic corporation under section 7874(b).

This rule would be effective for dividends received after the bill is enacted.

### **Modifications related to foreign tax credit system**

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

The conference agreement 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 foreign income taxes when it receives or is deemed to receive a dividend from that foreign corporation. Section 960 of the Code provides a similar deemed paid credit for subpart F inclusions. Under the conference agreement, the allowable credit under section 960 of the Code would be based on current-year taxes attributable to subpart F income rather than the "pooling" approach that applies currently under sections 902 and 960.

The conference agreement would also provide rules applicable to foreign taxes attributable to distributions of previously taxed income (PTI), including from a lower-tier to an upper-tier CFC. These rules are not explained in any further detail, but appear to allow foreign taxes as credits under section 960 in the year the PTI is distributed. The conference agreement grants the Secretary authority to promulgate regulations and guidance such that the amended section 960 credit would, as under current law, be computed separately for each category or "basket" of income under Code section 904(d).

The conference agreement 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 a dividend.

The amendments are effective for tax years of foreign corporations beginning after 2017 and to tax years of United States shareholders with or within which such tax years of foreign corporations end.

#### **KPMG observation**

The repeal of section 902 of the Code would have significant consequences for domestic corporations currently eligible to claim section 902 deemed-paid credits with respect to dividends from 10%-owned foreign corporations that are not CFCs because foreign income taxes paid or accrued by such corporations could no longer be claimed as FTCs. Moreover, the change from the current pooling regime to a current-year foreign tax regime could also significantly affect the foreign tax credit calculation, as the pooling regime

serves to blend effective foreign tax rates that may differ from year to year due to U.S. and foreign timing differences and rate changes.

### *Separate foreign tax credit limitation basket for foreign branch income*

The conference agreement would create a new foreign tax credit limitation basket for foreign branch income. Under the provision, foreign branch income is a U.S. person's business profits attributable to one or more qualified business units (QBUs) in one or more countries. Generally, a QBU is defined in section 989 of the Code as "any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records." The conference agreement grants the Secretary the authority to establish rules for determining what constitutes "business profits"; however, the proposal explicitly excludes passive income from the definition.

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

#### **KPMG observation**

Similar to creating a separate basket for GILTI, as discussed below, this proposal would operate to prevent cross-crediting of foreign taxes attributable to low-tax subpart F income with those attributable to high-tax branch income. It apparently would also prevent general limitation foreign tax credit carryforwards from pre-effective date years from offsetting the U.S. tax on such branch income.

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

The conference agreement 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 revised provision, 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.

According to the JCT, this provision would increase revenues by approximately \$500 million over 10 years.

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

#### **KPMG observation**

The change eliminates the beneficial title passage rule of current law and replaces it with a rule that is meant to reflect solely the economics of production. The provision would eliminate a significant means under current law for generating general limitation foreign

source income. It could also have the unintended result of encouraging companies to expand foreign production.

### *Amend section 904(g) to allow increased overall domestic loss (ODL) recapture*

The conference agreement would modify the ODL recapture rules of section 904(g) to allow taxpayers to elect to recapture a pre-2018 unused ODL for any “applicable tax year” by substituting a percentage greater than 50% (but not greater than 100%) in section 904(g)(1). An applicable tax year is any tax year of the taxpayer beginning after December 31, 2017 and before January 1, 2028. Under section 904(g)(1), a taxpayer with an ODL account recaptures an amount not greater than 50% of its U.S. source taxable income for a tax year (limited to the amount of its ODL account) and treats such income as foreign source income for foreign tax credit purposes. The election would thus allow taxpayers to recapture their ODL accounts, and recharacterize U.S. source income as foreign source income, more rapidly than under current law.

According to JCT, this provision would decrease revenues by approximately \$2.3 billion over 10 years.

### **KPMG observation**

It will be more challenging under the conference agreement for taxpayers with foreign tax credit carryovers from pre-effective date years to utilize those credits given the creation of new foreign tax credit limitation baskets for GILTI and branch income, as described above. The ODL election will allow taxpayers to accelerate the use of those credits in years subsequent to enactment of the conference agreement by recharacterizing a greater amount of U.S. source income as foreign source (and typically general limitation) income for foreign tax credit purposes.

### *Limit foreign tax credits for global intangible low-taxed income*

The conference agreement would add a new FTC basket for taxes associated with “global intangible low-taxed income.” For more details regarding those rules, see the discussion of regarding global intangible low-taxed income in the “Prevention of Base Erosion” section above.

### **Inbound provisions**

#### *Add base erosion and anti-abuse tax (BEAT)*

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.” The conference agreement implements this principle by creating a new base-erosion-focused minimum tax (the “base erosion and anti-abuse

tax” or “BEAT”) that in many cases will significantly curtail the U.S. tax benefit of cross-border related-party payments made by large multinationals.

### **Scope—Applicable taxpayers making base erosion payments**

The BEAT applies to domestic corporations that are not taxed on a flow-through basis (that is, not S Corps, RICs, or REITs), are part of a group with at least \$500 million of annual domestic (including effectively connected amounts earned by foreign affiliates) gross receipts (over a three-year averaging period), and which have a “base erosion percentage” (discussed below) of 3% or higher for the tax year (or 2% for certain banks and securities dealers, which are also subject to a higher BEAT rate, as discussed below). The provision also applies to foreign corporations engaged in a U.S. trade or business for purposes of determining their effectively connected income tax liability.

The targeted base erosion payments generally are amounts paid or incurred by the taxpayer to foreign related parties for which a *deduction is allowable*, and also include amounts paid in connection with the acquisition of *depreciable or amortizable* property from the foreign related party. The conference agreement also specifically includes cross-border reinsurance payments as base erosion payments. This category includes any premium or other consideration paid that is taken into account as a reduction in either life insurance gross income under section 803(a)(1)(B) or insurance company taxable income under section 832(b)(4)(A). Finally, for taxpayers that after November 9, 2017, become part of an “inverted” group, determined by reference to section 7874, base erosion payments also include “any amount that constitutes reductions in gross receipts” of the taxpayer when paid to the surrogate foreign corporation or any member of its expanded affiliated group.

There are two main exceptions to the provision’s scope for otherwise deductible payments. The first is for any “amount” paid or incurred for services that qualify “for use of the services cost method under section 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure)” and that reflects the total cost of the services without markup. The second is for “qualified derivative payments” for taxpayers that annually recognize ordinary gain or loss (e.g., mark to market) on such instruments, and subject to several exceptions.

The definition of a foreign related party is drawn from current section 6038A and includes any 25% foreign shareholder of the taxpayer, related persons thereto, and any other person related to the taxpayer under the section 482 rules.

### **KPMG observation**

The BEAT includes within its scope almost every outbound payment made by corporations subject to the rule, except for payments treated as COGS or otherwise as otherwise as reductions to gross receipts (subject to regulatory authority for the Secretary to write anti-avoidance regulations). This limited exception is unavailable for taxpayer groups that “invert” after November 9, 2017. Other than for such inverted groups, the

BEAT therefore does not apply, for example, to payments for inventory manufactured outside the United States.

Payments that are treated as full inclusion subpart F income or as GILTI may also be fully subject to the BEAT, even though there may be no net tax benefit for payments subject to full inclusion and only a reduced tax benefit for payments included in GILTI. Although the threshold of deductible payments to foreign affiliates that is necessary for the BEAT to become a positive tax liability may not be met for many U.S.-headquartered companies, the provision will require careful maintenance and may affect companies that, e.g., subcontract to or otherwise make significant deductible services payments to their foreign subsidiaries.

The provision is expected to affect certain industries disproportionately. In particular, with the explicit inclusion of related-party cross border reinsurance, which is very common within the insurance industry, large segments of the insurance market could be very significantly impacted.

The exception for services that qualify for the services cost method is ambiguous. The services cost method is entirely a product of regulations (Reg. section 1.482-9) and other administrative guidance, and includes a number of requirements. In addition to a general exclusion for services that contribute significantly to the risks of business success or failure, which the conference agreement explicitly turns off, the guidance includes a number of additional requirements, including numerous categories of services that are ineligible as “excluded activities.” It is unclear whether Congress intends for these additional regulatory exclusions to apply. It is also unclear what effect future regulatory changes may have on the availability of the exception, though providing a reference to the existing services cost method may indicate that only the current rules are intended to apply for purposes of the exception. In practice, many services contracts that could otherwise qualify for the services cost method nevertheless include a mark-up, which is often required by the transfer pricing rules in the foreign recipient’s jurisdiction. It appears based on a Senate floor colloquy that it may be intended that taxpayers can implement “self-help” in these cases by restructuring the contracts into separate “cost” and “profit” component payments and qualify the cost portion for the exception.<sup>8</sup> Whether this option is confirmed in future guidance, or whether Treasury interprets the rule to provide for this economic result without requiring taxpayers to alter their business affairs to achieve it (which would be an easier solution but has not been foreshadowed), will significantly impact the utility of the exception.

The exception for qualified derivative payments was reported as a significant concession to the financial services industry. Banks and securities dealers are otherwise treated less favorably in that they are subject to higher BEAT tax rates and a lower base erosion percentage *de minimis* threshold.

---

<sup>8</sup> Congressional debate: 163 Cong. Rec. S7697 (daily ed. December 1, 2017) (statements of Sen. Portman (OH) and Sen. Hatch (UT)).

Base erosion payments are subject to the provision when they give rise to a “base erosion tax benefit,” meaning the tax year in which a deduction for the payment is allowed. If base erosion payments form part of a net operating loss (“NOL”), the base erosion tax benefit is taken into account as part of the section 172 deduction in the carryback or carryover year.

For base erosion payments that are subject to Chapter 3 withholding, the payment is not subject to the rule (that is, it is not added back to modified taxable income, as discussed below). For payments that are subject to a reduced rate of withholding under a Treaty, the exclusion is done proportionately in comparison to the statutory withholding rate.

The base erosion percentage used for the 3% (or 2%) threshold requirement, and for the portion of an NOL deduction that is taken into account, is determined by dividing the aggregate amount of base erosion tax benefits of the taxpayer for the tax year by the aggregate amount of the deductions allowable to the taxpayer for the year, but excluding NOLs, the participation exemption, the deduction allowed under new section 250 for foreign intangible income, and also any payments that qualify for the services cost method or qualified derivative exceptions discussed above.

#### **KPMG observation**

The addback for the BEAT occurs in the year the deduction is allowed. As a result, base erosion payments that are capitalized into depreciable or amortizable basis are taken into account as the capitalized costs are recovered.

Furthermore, the focus on allowed deductions indicates that an amount must otherwise be deductible after the application of other limitations before it is taken into account as a base erosion tax benefit. For interest expense, the conference agreement confirms this point but also includes an unfavorable “stacking” rule for taxpayers that pay both unrelated and related-party interest in a given year. The stacking rule requires taxpayers to treat the limitation imposed under section 163(j) attributable entirely to unrelated party interest to the extent thereof. Thus, for example, if a taxpayer has \$100 of interest expense in a given year, \$60 of which is paid to related parties and \$40 to unrelated parties, and the taxpayer is allowed to deduct only \$70 under section 163(j), the entire \$60, rather than only a proportionate amount (e.g., 70%), is subject to the BEAT.

The general effective date provisions (*see infra*) apply to base erosion payments that are *paid or accrued* in tax years beginning after December 31, 2017. Plainly, no part of an NOL arising in a year *prior* to that effective date could arise from an amount paid or accrued *after* the effective date. Thus, unless a retroactive effect was intended, the base erosion percentage of any pre-effective date NOL ought to be zero when absorbed in post-enactment years. Nevertheless, the provision’s use of “any tax year” in defining the base erosion percentage and the definition of modified taxable income could be interpreted to mean that pre-effective year NOL deductions are subject to the BEAT as “add-backs” when absorbed in post-enactment years. That the provision does not clearly address whether the base erosion percentage for an NOL carryover deduction is

determined in the year the NOL arises, or when absorbed, contributes to the ambiguity. These are among the many points that await confirmation in future developments.

### **BEAT computation**

The tax liability increase is determined through a multi-step formula used to derive the base erosion minimum tax amount. This amount equals the excess of 10% of the taxpayer's modified taxable income ("MTI") for the year (5% for 2018), over an amount equal to the pre-credit regular income tax liability reduced (but not below zero) by any credits, other than the research credit and a certain amount of "applicable section 38 credits" that include the low-income housing credit, renewable energy production credit, and energy credits allowed in that year. Applicable section 38 credits are only included to the extent of 80% of the lesser of the credits or the base erosion tax amount otherwise computed.

MTI is the taxpayer's taxable income, with the base erosion tax benefit amount (including the base erosion percentage of an NOL deduction) added back.

### **KPMG observation**

The BEAT formula allows taxpayers to retain, at least initially, the benefit of the research credit and some benefit for the three categories of applicable section 38 credits. The latter category appears responsive to reports that the BEAT could have disrupted financing of development in certain markets, such as renewable energy and low-cost housing, which depend on the availability of such credits to attract investors. The following example may help illustrate the formula's application using the 10% BEAT rate.

Assume the ABC U.S. Consolidated Group ("ABC") has pre-credit regular tax liability of \$20,000 (corresponding to \$100,000 of taxable income after the 20% corporate income tax rate takes effect). ABC claims \$5,000 of tax credits overall, of which \$2,000 constitute research credits and \$1,000 are applicable section 38 credits. Thus, the "floor" that the BEAT must cross is  $\$20,000 - (\$5,000 - \$2,800 (\$2,000 \text{ plus } 0.8 * \$1,000)) = \$17,800$ . For companies that are taxpayers, this formula thus effectively adds back the research credit [\$2,000] and 80% of the [\$1,000] of applicable section 38 credits to the otherwise final tax liability [\$15,000].

The BEAT would be owed to the extent that ABC's MTI equaled more than \$178,000 (that is,  $\$17,800 \times 10$ , or  $\times 1.1$ ). Stated differently, ABC would have to deduct more than \$78,000 of base erosion tax benefits for the year to be subject to the BEAT.

The BEAT computation is modified to raise additional revenue for tax years beginning after December 31, 2025 through the following changes which take effect in such years: (i) the 10% of MTI input will increase to 12.5% of MTI; and (ii) the tax liability against which 12.5% of MTI is compared is simply regular income tax liability minus all credits, which appears to remove the previously retained benefit of the research credit and qualifying section 38 credits.

Banks and registered securities dealers are subject to a one percentage point higher BEAT rate in every year: 6% for 2018, 11% for 2019-2025, and 13.5% thereafter.

### Reporting and penalties

The conference agreement would introduce new reporting requirements under the existing Code section 6038A regime (Form 5472) to collect information regarding applicable taxpayers' base erosion payments. The provision would also increase that reporting regime's existing \$10,000 penalty to \$25,000.

The provision applies to payments paid or accrued in tax years beginning after December 31, 2017. It is estimated to increase revenues by approximately \$149.6 billion over 10 years.

### KPMG observation

The BEAT is a significant new proposal and revenue raiser among the conference agreement's international proposals. Once enacted, it will operate in tandem with the new interest deduction limitations, and the disallowance for payments involving hybrid transactions and hybrid entities, to significantly curtail the tax benefit of deductible payments made by U.S. groups to their foreign affiliates. The provision is partially phased in through the lower tax rate in 2018, and then will ramp up in post-2025 years. The JCT scoring line for the provision commensurately projects that nearly a third of the projected revenue will arise in 2026 and 2027.

The provision's status under the United States' income tax treaties and trade agreements has already been questioned by U.S. trading partners in news reports. In particular, the BEAT raises issues regarding the non-discrimination clauses contained in most U.S. tax treaties. For example, Paragraph 24(4) of the U.S. Model Tax Treaty is implicated because the provision effectively denies a portion of the deductions for payments made to foreign entities where payments made to similarly-situated domestic entities remain fully deductible. While the conference agreement does not include any statement indicating whether Congress specifically intended to override tax treaties in this regard, the scope of the BEAT would be significantly reduced if it were to be made subject to existing tax treaties, which would be hard to reconcile with the sizable revenue estimate by the JCT. As a general matter, legislation and treaties are on equal footing for U.S. purposes, with the result that the later in time prevails in case of clear conflict, suggesting that the conference agreement, when enacted, would be likely to apply even if it would result in overriding existing tax treaties.

### Other provisions

#### *Modify insurance exception to the passive foreign investment company rules*

The conference agreement modifies a current law exception from passive income that prevents certain investment income derived from the active conduct of an insurance



business from causing a foreign corporation to be a passive foreign investment company (PFIC). Section 14501 of the conference agreement would amend this exception in the PFIC rules to apply only to a foreign corporation whose applicable insurance liabilities constitute more than 25% of its total assets as reported on the corporation's applicable financial statement for the last year ending with or within the tax year. Applicable liabilities of any property and casualty or life insurance business include loss and loss adjustment expenses and certain reserves, but do not include unearned premium reserves.

An applicable financial statement is a statement for financial reporting purposes that is 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. Unless otherwise provided in regulations, GAAP means U.S. GAAP.

Section 14501 of the conference agreement 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.

Section 14501 of the conference agreement would apply to tax years (presumably of foreign corporations being tested for PFIC status) beginning after December 31, 2017.

The JCT has estimated that this provision also would increase revenues by approximately \$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 an impact 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 14501 of the conference agreement 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 new 25% test.

The text of this provision of the conference agreement is materially the same as section 14501 of the Senate bill and section 4501 of the House bill, and has the same effective date and revenue effect.

### *Repeal fair market value method of interest expense apportionment*

The conference agreement would require taxpayers to allocate and apportion interest expense of members of an affiliated group using the adjusted basis of assets and would prohibit the use of the fair market value method.

According to the JCT, this provision would increase revenues by approximately \$600 million over 10 years.

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

### **KPMG observation**

Taxpayers that currently use the fair market value method to value assets when allocating interest expense will be required to switch to the adjusted basis or “tax book value” method. Such a switch could have a dramatic effect on the foreign source income calculation for certain taxpayers.

### *Modify Code section 4985 excise tax*

The conference agreement would increase the section 4985 excise tax rate from 15% to 20%. This tax is imposed on certain stock-based compensation of corporate “insiders” when a domestic corporation becomes an “expatriated corporation” through an inversion transaction in which a shareholder of the domestic corporation recognizes gain.

The provision would be effective upon date of enactment. The JCT has estimated that this provision would increase revenues by approximately \$100 million over 10 years.

## **Procedural provisions**

### **Extension of time limit for contesting IRS levy**

The conference agreement would extend the time period from nine month to two years for returning the monetary proceeds from the sale of property that the IRS has wrongful levied. The conference agreement would also extend from nine month to two year the period for bringing civil suit for wrongful levy.

The proposal would be effective with respect to: (1) levies made after the date of enactment; and (2) levies made on or before the date of enactment provided that the nine-month period has not expired as of the date of enactment.

The JCT has estimated that this provision would lose less than \$50 million over a 10-year period.

### **KPMG observation**

This provision was based on the Senate bill and was adopted without modification. The following procedural provisions that were in the Senate bill were not included in the conference agreement:

- Modifications to the user fee requirements for installment agreements authorized under current Code section 6159.
- New above-the-line deduction for attorney fees and courts costs to whistleblowers under a broader category of laws.
- Amendment to current Code section 7623(b) broadening the scope of collected proceeds eligible for awards to whistleblowers.

## **CRAFT beverages**

The conference agreement would make numerous temporary changes to the taxes imposed on beer, wine, and distilled spirits. The JCT has estimated that these provisions would decrease revenues by approximately \$4.2 billion over 10 years. These provisions would sunset after 2019.

### **Exempt the aging period of beer, wine and spirits from UNICAP rules related to interest**

The Uniform Capitalization (“UNICAP”) rules under section 263A require certain direct and indirect costs allocable to real or tangible personal property produced (or acquired for resale) to be included in inventory or capitalized into the basis of the related property. In the case of interest expense, the UNICAP rules apply only to interest paid or incurred during the property’s production period, and that is allocable to property which either 1) is real property or property with a class life of at least 20 years, 2) has an estimated production period exceeding two years, or 3) has an estimated production period exceed one year and a cost exceeding \$1,000,000.

In the case of property that is customarily aged (e.g., tobacco, wine, and whiskey) before it is sold, the production period includes the aging period. The conference agreement would exclude the aging periods for beer, wine, and distilled spirits from the production period for purposes of the UNICAP interest capitalization rules. Thus, under the provision,

producers of beer, wine, and distilled spirits would be able to deduct interest expense (subject to any other applicable limitation) attributable to a shorter production period.

This provision would be effective for interest costs paid or incurred after December 31, 2017 and would sunset for interest costs paid or accrued after December 31, 2019.

#### **KPMG observation**

The conference agreement follows the Senate bill, without modifications.

#### **Reduced rate of excise tax on beer**

Section 13802 of the conference agreement would amend section 5051 to reduce the amount of federal excise tax imposed on brewers and importers of beer. The conference agreement would reduce the tax on beer from \$18 per barrel to \$16 per barrel on the first six million barrels brewed by the brewer or imported by the importer. Beer brewed or imported in excess of the six million barrels would be taxed at \$18 per barrel.

For small brewers producing less than 2 million barrels of beer, tax would be reduced from \$7 per barrel to \$3.50 per barrel for the first 60,000 barrels. The additional barrels would be taxed at \$16 per barrel.

Special rules apply for determining controlled groups and allocation of the reduced tax rates among members of the controlled group. Moreover, it provides that two or more entities (whether or not under common control) that produce beer under a similar brand, license, franchise, or other arrangement are to be treated as a single taxpayer for the reduced rates.

Moreover, the conference agreement discusses additional rules related to foreign brewers and the assignment of the reduced rate of tax to importers of foreign brewed beer.

This provision would apply to beer removed after December 31, 2017 and would expire for tax years beginning after December 31, 2019.

#### **KPMG observation**

The conference agreement would provide a two-year reduced rate of tax for both small and large brewers and would allow foreign brewers to assign such credit to importers if conditions are met.

#### **Transfers of beer in bond**

Section 13803 of the conference agreement would amend section 5414 to allow for more situations in which beer may be transferred tax free under bond by modifying the rules of

section 5414. Under the provision, brewers would be able to transfer beer from one brewery to another under any of the following situations:

- The breweries are owned by the same person (existing law)
- One brewery owns a controlling interest in the other (new)
- The same person or persons have a controlling interest in both breweries (new)
- The proprietors of the transferring and receiving premises are independent of each other, and the transferor has divested itself of all interest in the beer so transferred, and the transferee has accepted responsibility for payment of tax (new)

This provision would apply to calendar quarters beginning after December 31, 2017 and expires for tax years beginning after December 31, 2019.

#### **KPMG observation**

The conference agreement would allow more types of tax-free transfers of beer under bond between breweries for a two-year period, essentially providing for a deferral of tax due if conditions are met. Most importantly, it would allow for a transfer under bond of beer between unrelated proprietors.

#### **Reduced rate of tax on certain wine**

Section 13804 of the conference agreement would modify the section 5041(c) credit for small domestic producers of wine. The conference agreement would allow the credit to be claimed by foreign and domestic producers of wine, regardless of the gallons of wine produced. The conference agreement would also allow the credit for sparkling wine producers.

Under the conference agreement, the credit for wine produced in, or imported into, the United States during the calendar year would be:

- \$1.00 per wine gallon for the first 30,000 wine gallons of wine; plus
- \$0.90 per wine gallon for the next 100,000 wine gallons of wine; plus
- \$0.535 per wine gallon on the next 620,000 wine gallons of wine.

The conference agreement also provides special credit rates for hard cider, as well as rules for allowing foreign producers of wine to assign the credit to importers of the wine.

The provision would apply to wine removed after December 31, 2017 and would expire for tax years beginning after December 31, 2019.

**KPMG observation**

The conference agreement would essentially provide a two-year rate reduction for all foreign and domestic producers of wine, including sparkling wine, regardless of the number of wine gallons produced. Moreover, it would allow foreign producers to assign such credit to importers if conditions are met.

**Adjust alcohol content level of wine for application of excise taxes**

Section 13805 of the conference agreement would amend section 5041 to modify the alcohol-by-volume levels of the first two tiers of federal excise tax on wine. Generally, under section 5041, wine with an alcohol content of not more than 14% alcohol is taxed at a rate of \$1.07 per wine gallon and wine more than 14% but not more than 21% alcohol is taxed at a rate of \$1.57 per gallon. The conference agreement would change section 5041 such that wine with an alcohol content of not more than 16% alcohol would be taxed at the \$1.07 per wine gallon rate.

This provision would apply to wine removed after December 31, 2017 and expires for tax years beginning after December 31, 2019.

**KPMG observation**

The conference agreement would provide a two-year, \$.50 per wine gallon rate reduction for still wines with an alcohol content of more than 14% but less than 16% alcohol.

**Reduced rate of tax on mead and certain carbonated wines**

Section 13806 of the conference agreement would amend section 5041 to reduce the rate of tax for mead and certain sparkling wine. Currently sparkling wines are generally taxed at a rate of \$3.40 per wine gallon and artificially carbonated wines are taxed at a rate of \$3.30 per wine gallon. Under the conference agreement, mead and certain sparkling wine would be taxed at the lowest rate applicable to “still wine” which is currently a rate of \$1.07 per wine gallon of wine.

“Mead” is defined as a wine that contains not more than 0.64 grams of carbon dioxide per hundred milliliters of wine, which is derived solely from honey and water, contains no fruit product or fruit flavoring, and contains less than 8.5% alcohol-by-volume.

The sparkling wines eligible to be taxed at the preferential rate are wines that contain no more than 0.64 grams of carbon dioxide per hundred milliliters of wine, which are derived primarily from grapes or grape juice concentrate and water, which contain no fruit flavoring other than grape and which contain less than 8.5% alcohol-by-volume.

This provision would apply to wine removed after December 31, 2017 and would expire for tax years beginning after December 31, 2019.

**KPMG observation**

The conference agreement would provide a two-year significant rate reduction for mead and certain sparkling wines that contain an alcohol content of less than 8.5% alcohol-by-volume.

**Reduced excise tax rates on distilled spirits**

Under existing Code section 5001, all distilled spirits are taxed at a rate of \$13.50 per proof gallon. Section 13807 of the conference agreement would institute a tiered rate for distilled spirits. The conference agreement would amend section 5001 to tax the first 100,000 proof gallons of distilled spirits at a rate of \$2.70 per proof gallon. The tax rate for proof gallons greater than 100,000 but less than 22,130,000 proof gallons would be \$13.34 per proof gallon, and the rate for 22,130,000 proof gallons or more would be \$13.50 per proof gallon.

Special rules apply for determining controlled groups and allocation of the reduced tax rates among members of the controlled group. Moreover, the conference agreement provides that two or more entities (whether or not under common control) that produce distilled spirits under a similar brand, license, franchise, or other arrangement are to be treated as a single taxpayer for the reduced rates.

Moreover, the conference agreement discusses additional rules related to foreign producers and the assignment of the reduced rate of tax to importers of foreign produced spirits.

This provision would apply to distilled spirits removed after December 31, 2017 and would expire for tax years beginning after December 31, 2019.

**KPMG observation**

The conference agreement would provide a two-year significant rate reduction for distilled spirit producers and importers.

**Allow transfer of bonded spirits in bottles**

Section 13808 of the conference agreement would amend section 5212 to expand allowable tax-free transfers in bond of distilled spirits to distilled spirits that are not packaged in bulk containers.

Generally under current law, tax is imposed on distilled spirits upon removal from the distilled spirits plant. An exception is that bulk distilled spirits may be transferred without payment of tax if the transfer is under bond between bonded premises and in containers that are at least one gallon; that is, a bulk container.

This provision would apply to distilled spirits removed after December 31, 2017 and expires for tax years beginning after December 31, 2019.

### **KPMG observation**

The conference agreement would allow transfers of distilled spirits in bottles to be made tax-free under bond for two years.

## **REITs**

### **KPMG observation**

The conference agreement would provide a deduction to noncorporate taxpayers (individuals, trusts, and estates) of 20% on dividends paid by a REIT that are neither capital gain dividends nor are eligible for treatment as “qualified dividend income.” This would provide parity between the treatment under the conference agreement of ordinary REIT dividends and “qualified business income” (setting aside the wage/capital limitation, which would not apply to limit the deduction applicable to ordinary REIT dividends). The conference agreement would also provide for a maximum marginal tax rate on ordinary income, without regard to the effect of this deduction, of 37%. For noncorporate taxpayers, this would reduce the maximum marginal tax rate on ordinary REIT dividends to 33.4% (including the 3.8% Medicare tax, which is seemingly applied before application of the 20% deduction).

The conference agreement would reduce the effective tax rate on dividends paid by a domestic C corporation to noncorporate domestic taxpayers to approximately 39.8%, including 21% at the corporate level. As indicated above, the effective tax rate under the conference agreement on ordinary dividends paid by REITs to individual taxpayers would appear to decrease from 43.4% to approximately 33.4%. This is a smaller disparity than under current law. Under the conference agreement, the disparity in tax rate for these taxpayers for distributions attributable to net capital gain generally would be approximately 16% (approximately 39.8% for C corporations, and 23.8% for REITs).

A noncorporate taxpayer invested in or considering investments in partnerships whose equity is linked to the share value of a REIT (i.e., UPREIT and DownREIT partnerships) should consider that, through 2025, it may be subject to a higher rate of tax on ordinary income allocated to it by the partnership than would be the case if the investor were to receive the same income via a dividend from the REIT, given that the wage/capital limitation on the 20%-deduction does not apply to REIT dividends. That the deduction is limited either by a wage factor or by a combination of wage factor and a capital factor, as opposed to merely a wage factor, may be effective in reducing or eliminating this disparity, depending upon the circumstances.



Importantly, the conference agreement's reduction in corporate tax rate would apply to tax years beginning after 2017, and would be permanent. Both the 20% deduction and the proposed rate structure for noncorporate taxpayers (which, among other things, would reduce the maximum income tax rate to them from 39.6% to 37%, not taking into account the 3.8% Medicare tax) would sunset for tax years beginning after 2025. Under the conference agreement, therefore, for tax years beginning after 2025, absent further legislation, the effective tax rate for ordinary dividend income of individual taxpayers from C corporations would remain approximately 39%, while the effective tax rate for dividend income of noncorporate taxpayers from REITs would increase to 43.4%; the effective rates for capital gain income generally would not change as a result of the sunset.

### *Foreign income*

As described elsewhere, the changes proposed by the conference agreement to the taxation of U.S. taxpayers' foreign income would be substantial, and would have an effect on REITs that invest overseas. Domestic corporate taxpayers generally would be able to fully deduct the "foreign-source portion" of dividends from foreign corporations (other than certain passive foreign investment corporations) in which they are "United States shareholders" (i.e., they hold a 10%-or-greater voting interest, determined taking into account applicable attribution rules). REITs would be ineligible for this deduction. While those dividends also would seem to continue to be qualifying income for purposes of the 95% gross income test applicable to REITs, under the conference agreement they also would be taken into account in calculating a REIT's taxable income and, therefore, its distribution requirement.

As a transition to a territorial system which incorporates the dividends-received deduction for foreign-corporate dividends described above, the conference agreement includes provisions treating certain accumulated earnings of certain foreign corporations as being repatriated; a portion of the amount is deductible, generally so as to result in a specific rate of tax (with a higher rate applying where the deferred earnings are treated as held as cash assets). REITs generally would be entitled to this deduction. The conference agreement treats the accumulated deferred foreign income that would be treated as repatriated in the last tax year of such foreign corporation that begins before January 1, 2018 as (or as if it were) Subpart F income. The conference agreement, following the Senate bill, explicitly disregards the repatriation inclusions for REIT gross income test purposes. Under current law, Subpart F income is not explicitly treated as qualifying income for either gross income test, though the IRS has issued a number of private letter rulings concluding, under its authority provided in section 856(c)(5)(J), that the specific Subpart F income earned by the REIT and described in the ruling would be treated as qualifying income for purposes of the 95% gross income test (though not the 75% gross income test). The approach included in the conference agreement would allow REITs to avoid this uncertainty.

Moreover, the conference agreement, again following the Senate bill, would permit REITs to elect to satisfy their distribution requirement with respect to the repatriation inclusion over an eight-year period, using the same installment percentages that apply to other

U.S. taxpayers, and generally eligible for the partial dividends-received deduction described above. This takes the form of the relevant installment being included in the REIT's "REIT taxable income" for the relevant year subject to acceleration in connection with certain events (e.g., a liquidation or sale of substantially all of REIT's assets).

### *Other Important Items*

Several other points are worth mentioning:

- First, REITs would in many cases (or with respect to large portions of their businesses) appear to be able to elect out of the proposed limitation on the deductibility of net business interest expense 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; those businesses are not covered by this new limitation if the taxpayer so elects. Mortgage REITs presumably are more likely to be subject to such a limitation, though the overall effect of the limitation on a mortgage REIT might not be significant given that the limitation applies to *net* business interest expense, and mortgage REITs typically expect to have substantial interest income. The breadth of the definition of a "real property trade or business" might, though, allow REITs investing in "nontraditional" REIT asset-classes to avoid this limitation. For purposes of the conference agreement, a "real property trade or business" is defined by reference to the passive-loss rules and includes "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." The explanation by the Senate Finance Committee of its proposed bill, which is reproduced in the conference report's explanatory statement, indicates that the definition of a "real property trade or business" is intended to be interpreted to include the operation or management of a lodging facility. Further, while not entirely clear and presumably dependent on the specific nature of a given business, this definition might be sufficiently broad to cover certain businesses that have been treated for REIT purposes as involving the rental of real property, such as the operation by a REIT of data centers.

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 could be carried to future tax years indefinitely.

In computing the taxpayer's "adjusted taxable income," the conference agreement excludes deductions for depreciation, amortization, and depletion, but only for tax years beginning before 2022. For tax years beginning after 2021, depreciation, amortization and depletion would be taken into account in determining adjusted taxable income, resulting in a potentially more restrictive net interest limitation. For a

REIT engaged in a “real property trade or business,” the amount of its cost recovery deductions would presumably influence its decision to elect out this net interest limitation. Such election, once made, would be irrevocable.

This provision would apply to tax years beginning after 2017, and would replace the current earnings-stripping rules under Code section 163(j).

The conference agreement includes other provisions intended to combat “base erosion.” Specifically, the conference agreement would impose a tax generally equal to the amount by which a specified percentage (5% for tax years beginning in 2018), 10% for tax years beginning after 2018 and before 2026, and 12.5% for tax years after 2025) of the “modified taxable income” of an “applicable taxpayer” for a year exceeds its “regular tax liability” (reduced by certain credits) for the year. Modified taxable income would be determined by excluding tax benefits associated with certain payments made to foreign affiliates. The conference agreement would exempt certain payments to the extent that they are subject to FDAP withholding; to the extent that FDAP withholding on the payment is less than 30%, only a corresponding portion of the payment is exempt. The purpose of this rule is to limit “base erosion” resulting from payments by U.S. (and certain foreign) corporations to foreign affiliates that are not subject to an appropriate level of U.S. federal income tax. Importantly, though, REITs themselves would not seem to be affected – the definition of “applicable taxpayer” excludes REITs.

- Second, taxpayers electing out of the interest limitations under new section 163(j) would be required to use the alternative depreciation system (ADS). The conference agreement, however, would reduce the ADS recovery period for residential real property from 40 years to 30 years. The MACRS periods for nonresidential and residential real property under current law would not be modified by the conference agreement; the conference agreement provides a 15-year MACRS period for qualified improvement property.

The conference agreement allows for immediate expensing, on temporary basis, of certain types of business assets placed in service after September 27, 2017, including property to which MACRS applies with an applicable recovery period of 20 years or less, including qualified improvement property. REITs do not appear to be generally ineligible for these benefits.

- Third, the conference agreement would limit the utilization of NOL carryovers to 80% for NOLs arising after 2017. For purposes of these limitations, a REIT’s taxable income would be the REIT’s “REIT taxable income” without taking into account the dividends paid deduction (DPD). Given that a REIT ordinarily determines its utilization of NOL carryovers after its DPD, this is necessary to avoid causing a REIT to fail the minimum distribution requirement, incurring a corporate-level tax, or forgoing the utilization of NOL carryovers. Furthermore, if enacted, such a proposal 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 20% of pre-DPD REIT taxable income.

The conference agreement would repeal the corporate AMT effective for tax years beginning after 2017; under current law, 10% of the amount offset by the utilization of an NOL carryover as an AMT preference item.

- Fourth, the conference agreement would appear to 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 relaxed or even repealed entirely so as to incentivize foreign investment in U.S. real estate and infrastructure assets.
- Lastly, the conference agreement would eliminate tax-free like-kind exchanges for all property other than real property not held primarily for sale, effective for exchanges completed after 2017. REITs often use like-kind exchanges to defer gain while disposing of their real property holdings.

## RICs

### **KPMG observation**

If enacted, the conference agreement might have significant consequences for RICs, including business development companies (BDCs), from potentially limiting RIC expenses to accelerating RIC income from investments. In addition, global asset managers of RICs might be significantly affected by the international tax reform provisions of the proposal.

#### *Potential acceleration of RIC income and gain*

The conference agreement would revise certain rules associated with the recognition of income by requiring that taxpayers recognize income no later than the tax year in which such income is taken into account on an applicable financial statement. Certain fees that are treated as original issue discount (OID) on a debt instrument may be required to be included in income for financial statement purposes when received, whereas they are accrued into income over the term of the debt instrument under current law. These fees would be accelerated into income upon receipt under the proposal. While this change would have relevance to all RICs, it could have especially significant consequences to RICs that are BDCs due to the substantial debt holdings of many BDCs, much of which is originated by such BDCs and involves payments of upfront fees. The accelerated inclusion of OID would apply to tax years beginning after December 31, 2018.

### *Specific provisions for REITs (but not RICs)*

- The agreement deduction of 20% for certain passthrough income treated as qualified business income would specifically treat dividends from a REIT (other than any portion that is a capital gain dividend or qualified dividend income) and certain income from publicly traded partnerships as qualified business income. However, the agreement would not extend similar treatment to ordinary dividends paid by RICs. This change could create an “unlevel” playing field for RIC investors in two key respects. First, for RICs investing in REITs, RIC dividends are not provided comparable treatment to the extent such dividends are attributable to REIT distributions treated as qualified business income. Second, although BDCs may be taxed like other RICs, they historically have been taxed similarly to other types of passthrough entities, such as REITs, MLPs, and publicly traded partnerships, which also may engage in activities other than investment in securities. By definition, a BDC electing to be treated as such under the Investment Company Act of 1940 is required to make available “significant managerial assistance” to certain of the portfolio companies in which the BDC invests. The BDC industry sought (albeit unsuccessfully) to expand qualified business income under the conference agreement to include “qualified BDC dividends.”<sup>9</sup>
- The conference agreement also includes specific provisions for REITs subject to mandatory repatriation of foreign earnings. Comparable treatment is not provided for RICs subject to mandatory repatriation inclusions, including with respect to the determination of a RIC’s gross income and distribution requirements.

### *Municipal lending*

RICs that invest in advance refunding bonds should be aware that the conference agreement would repeal the exclusion from gross income for interest on such bonds issued after December 31, 2017. The conference agreement also would repeal the authority to issue tax credit bonds and direct pay bonds after December 31, 2017.

### *Reduction in dividends received deduction percentages*

For tax years beginning after December 31, 2017, the conference agreement would reduce the 80% dividends received deduction to 65% and the 70% dividends received deduction to 50% to preserve the current law effective tax rates on income from such dividends. Corporate shareholders in a RIC could be affected by this change as a RIC is permitted to treat its dividends as qualifying for the dividends received deduction.

### *Limitation on business interest*

As drafted, it appears that RICs would be subject to the proposed limitation on the deductibility of business interest. Under the conference agreement, the amount allowed

---

<sup>9</sup> See proposed Senate amendment number 1829 introduced by Senator Jim Risch (R-ID); <https://www.congress.gov/amendment/115th-congress/senate-amendment/1829/text>.

as a deduction for business interest cannot exceed the sum of a taxpayer's business interest income, 30% of the taxpayer's adjusted taxable income, and the taxpayer's floor plan financing interest. Business interest expense is defined as interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest does not include investment interest within the meaning of Code section 163(d) which applies to taxpayers other than corporations. Since RICs are corporations, it appears that the investment activities of RICs would be treated as giving rise to "business interest expense" which is properly allocable to a trade or business and, thus, subject to the limitation. While relevant for all RICs, this change could be particularly significant for BDCs which may have material leverage in their portfolios. This proposed change would apply to tax years beginning after December 31, 2017. For a RIC that is a partner in a partnership, the RIC should consider the implications of any carryforward of excess business interest from the partnership.

### *Other Significant Issues*

- RICs, REITs and S Corporations would be specifically excluded from application of the base erosion minimum tax provisions. Also, the deduction for foreign-derived intangible income and global intangible low-taxed income would be available only to C corporations that are not RICs or REITs.
- For a RIC acquiring an interest in a partnership, the RIC should consider the implications of the requirement that the transferee of a partnership interest withhold 10% of the amount realized on the sale or exchange of the interest unless the transferor certifies that it is not a nonresident alien individual or a foreign corporation and provides a U.S. taxpayer identification number.
- A RIC should consider whether the conference agreement's elimination of the constructive ownership rule in section 958(b)(4) could cause the RIC to be treated as a U.S. shareholder in a CFC due to downward attribution of stock owned by a foreign person to a U.S. person.
- The suspension of the ability of individual taxpayers to deduct miscellaneous itemized deductions for tax years beginning after December 31, 2017 and before January 1, 2026, would not affect the ability of publicly offered RICs to deduct expenses under section 67(c)(2). The agreement would add a new section 67(g) to the Code which would apply to individuals and would not alter the RIC rule.

## **Natural resources**

### **KPMG observations**

For natural resources, in general, special rules would continue to apply with respect to:

- 1) oil and gas geological and geophysical costs (section 167(h), qualified tertiary injectant expenses (section 193), intangible drilling costs (section 263(c), as limited for integrated corporations by section 291(b), and section 263(i)), depletion (sections 611, 612 and 613A), ordinary income recapture potential (section 1254);
- 2) mining exploration and development costs (sections 616 and 617, as limited for corporations by 291(b)), depletion (sections 611, 612 and 613 as limited for corporations by 291(a)(2) for percentage depletion in excess of tax basis on iron ore and coal), the disposal of coal or domestic iron ore with a retained economic interest as capital gain (section 631(c)), and ordinary income recapture potential (section 1254); and
- 3) timber reimbursements of certain government reforestation costs (section 126(a)(8) and (9)) and amortization of certain reforestation expenditures (section 194), election to consider cutting timber or the disposal of timber with a retained economic interest as a sale (section 631(a) and (b)).

The conference agreement would not repeal either the section 43 enhanced oil recovery credit or the section 45I credit for producing oil and gas from marginal wells for taxable years beginning after December 31, 2017. However, section 199 would be repealed for tax years beginning after December 31, 2017.

In addition, a new section 199A would provide a 20% deduction for qualified business income for certain noncorporate taxpayers (including income from publicly traded partnerships) for tax years beginning after December 31, 2017. For example, a small individual oil and gas working interest owner could qualify for the section 199A deduction, and pay the section 1401 self-employment of 3.8% (deductible for income taxes) instead of the section 1411 3.8% net investment income tax.

The AMT would be repealed for corporations for tax years beginning after December 31, 2017. Taxpayers other than corporations would continue to be subject to the alternative minimum tax and may need to make adjustments for mine exploration and development costs (section 56(a)(2)(A)); mine depletion (sections 56(g)(F)(i) and 57(a)(1)); and the oil and gas and geothermal intangible drilling and development costs preference (section 57(a)(2)). Section 59(f) (which coordinates section 59(e) with a corporate section 291) is being repealed. It appears that Congress did not expect corporations to use 59(e) after 2017. A corporation with domestic NOLs and foreign source income covered by foreign tax credits may want to consider using section 59(e) to eliminate the domestic NOL.

Mineral streaming agreements (advance sale of future severed minerals, i.e., personal property) would be subject to the conference agreement's amendment to section 451, requiring an accrual method taxpayer receiving an advance payment for an item of gross income to recognize such income no later than the tax year in which such income is taken into account as revenue is recognized in an applicable income statement, or another financial statement under the rules specified by the Secretary, but with an exception requiring the remaining portion of the advance payment to be included in income in the

tax year following the tax year in which the payment is received. However, the language of this provision seems to equate gross receipts with gross income (i.e., gross receipts minus cost of goods sold). Note that the 16th Amendment to the Constitution allows the federal government to lay and collect taxes on incomes, not receipts. The conference agreement's amendment to section 451 would not apply to production payments (transfer of minerals in the ground, i.e., real property) subject to section 636.

Under the conference agreement, section 1031 like-kind exchanges would be limited to real property for tax years beginning after December 31, 2017. Mineral interests and standing timber are real property and ought to continue to qualify as like kind exchanges (e.g., unitizations and poolings). Also, certain permanent structures may be treated as real property, for example, offshore production platforms. Personal depreciable property in a like-kind exchange may generate a taxable event but may also qualify for 100% expense treatment under section 168(k).

## State and local tax implications

### KPMG observations

#### *Background*

Nearly every state corporate and personal income tax conforms in some manner to the federal Code. Conformity between state and federal taxes simplifies 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. Static conformity states generally update their conformity annually or at least regularly; California tends to be an exception and is somewhat irregular in its conformity updates for various reasons.

#### *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.

Regardless of whether they use rolling or static conformity, states tend to pick and choose the federal 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 from 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 seven states 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 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 federal 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 contained in the conference agreement are reviewed below. Many of these provisions, particularly the individual provisions and the business tax provisions, are similar to those in the Senate and House bills. Certain of the international provisions in the agreement largely follow the model used in the Senate bill.

### *Individual provisions*

- **Tax rates:** The conference agreement would retain seven individual income tax rate brackets with a maximum rate of 37%, compared to 39.6% under current law. The maximum is applicable at \$500,000 taxable income for single filers and \$600,000 for those filing joint returns. As in the Senate bill, these rates and most of the individual income tax provisions in the agreement would expire after December 31, 2025. At that point, the law would revert to the law as in effect before January 1, 2018. The revision of tax rates and brackets proposed in the agreement would not directly affect state taxes as states establish their own individual tax rate structures.

- **Passthrough deduction:** The conference agreement would allow an individual taxpayer to deduct 20% of domestic qualified business income from a partnership, S corporation, or sole proprietorship. This deduction, similar to the other provisions affecting individual taxpayers, sunsets after 2025. The deduction generally would be limited to the greater of: (a) 50% of the W-2 wages paid with respect to the trade or business; or (b) 25% of the W-2 wages paid with respect to the trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property. The limitation described in the preceding sentence does not apply in the case of a taxpayer with income of \$315,000 or less for married individuals filing jointly (\$157,500 for other individuals), with a phase-out over the next \$100,000 of taxable income for married individuals filing jointly (\$50,000 for other individuals). (See discussion above under section dealing with deduction of passthrough business income for further details on computing the deduction.) Qualified income is defined generally to include income arising from the conduct of a trade or business, other than specified service trades or businesses (e.g. health, law, accounting, but specifically excluding engineering and architecture). There is an exception allowing the 20% deduction in the case of certain taxpayers with income from a specified service business whose taxable income does not exceed \$315,000 for married individuals filing jointly or \$157,500 for other individuals with a phase-out of this benefit over the next \$100,000 of taxable income for married individuals filing jointly (\$50,000 for other individuals).

The passthrough deduction is structured as a new Code section 199A. In a change from the Senate bill, the conference agreement specifies that the deduction would not be taken into account in computing AGI for individual income tax purposes. Instead, it would be treated as a deduction from taxable income. However, the deduction would be available both to taxpayers that itemize their deductions and those that do not. As such, the impact at the state level would depend on the manner in which a state conforms to itemized deductions. As noted, most states currently conform to federal itemized deductions with the exception of the deduction for state income taxes paid. There are 11 states that do not allow itemized deductions. The impact of the provision on states could be substantial. The JCT estimated that the federal revenue impact of the provision is about \$415 billion over the eight years it is in place.

- **Standard deduction, personal exemption allowance, and child credit:** The provisions in the conference agreement would effectively double the standard deduction for all tax filers, repeal the personal exemption allowances, and enhance the child tax credit. These changes would sunset at the end of 2025. 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 repeal of personal exemptions would be incorporated into the state individual income tax, presuming continued conformity. There are five additional states that have adopted the federal standard deduction levels under

current law. There are ten states that do not utilize a standard deduction in their personal income tax.

- **Itemized deductions:** The conference agreement proposes to repeal or revise many federal itemized deductions, including deductions for state and local property, income and sales taxes, personal casualty losses, mortgage interest, and a variety of miscellaneous deductions. Specifically, the changes to itemized deductions contained in the conference agreement (all of which apply to tax years beginning after December 31, 2017 and before January 1, 2026 unless otherwise noted) include:
  - The deduction for mortgage interest would be limited to the interest on \$750,000 of acquisition indebtedness for debt incurred after December 15, 2017. The limit on deducting interest on acquisition indebtedness for debt incurred prior to December 15, 2017 remains at \$1,000,000. The agreement would repeal the deduction related to interest incurred on home equity debt.
  - In the case of an individual, the conference agreement limits the deduction for state, local and foreign property taxes and state and local sales taxes, as a general matter, only to such taxes when they are paid or accrued in carrying on a trade or business. State and local income taxes, war profits taxes and excess profits taxes are not allowed as a deduction for an individual taxpayer. The conference agreement contains an exception to this general rule allowing an individual taxpayer to claim an itemized deduction of up to \$10,000 (in the aggregate) for state and local property taxes not incurred in carrying on a trade or business and state and local income, war profits and excess profits taxes (or sales taxes in lieu of income taxes). Foreign real property taxes would not be deductible under the exception.
  - The personal casualty loss deduction is retained in the conference agreement, but only for losses incurred in a federally declared disaster area.
  - The conference agreement provides an itemized deduction for unreimbursed medical expenses in excess of 7.5% of AGI for tax years 2017 and 2018.
  - Miscellaneous itemized deductions subject to the 2% of AGI floor (e.g., tax preparation expenses, work clothing, hobby expenses, and unreimbursed business expenses) are repealed under the conference agreement.
  - The conference agreement also repeals the overall limitation on itemized deductions.

With respect to the deduction of state and local income, property, and sales taxes, the explanatory statement makes clear that, in the case of an individual, the state and local income taxes imposed on individual owners or partners in the passthrough entity would not be deductible. However, state and local income taxes imposed at the entity level that are reflected in computing the owner's or partner's distributive share of income from the passthrough would remain deductible. Also, property taxes and sales and use taxes paid by the passthrough entity would remain deductible as under current law.

The conference agreement also addresses an issue that arose as a result of the anticipated loss of the state and local tax deduction. That issue is whether 2018 state income and property taxes can be prepaid in 2017 and deducted on the 2017 federal return. The conference agreement provides that in the case of an amount paid in a tax year beginning before January 1, 2018 with respect to a state or local income tax imposed for a tax year beginning after December 31, 2017, the payment will be treated as being made on the last day of the tax year for which such tax is imposed for purposes of applying the limit to the amount of the deduction. Thus, under the agreement, an individual may not claim an itemized deduction in 2017 on a prepayment of income tax for a future tax year to avoid the limitation on such deductions in tax years beginning after 2017.

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 and local tax income deduction, which is not allowed in the vast majority of states that allow itemized deductions. Property taxes are, however, generally allowed as a state itemized deduction. To the extent a state retains itemized deductions not allowed at the federal level, there could be challenges in documentation and compliance.

- **Repeal of the so-called “individual mandate”:** Under the conference agreement, the amount of the individual shared responsibility payment enacted as part of the Affordable Care Act would be reduced to zero. Repeal of the individual mandate would not directly affect an individual’s state tax liability.
- **Alternative minimum tax:** The conference agreement retains the individual AMT with an increased exemption amount for tax years 2018 through 2025. Beginning in tax year 2026, the exemption amount would revert to its current law level. A few states impose an AMT. State alternative minimum taxes are generally modeled after the federal tax, but they are not computed as a percentage of federal AMT liability. Therefore, the retention of the federal AMT should have little to no effect for state purposes.

### *Business provisions*

- **Tax rates:** The proposed corporate tax rate reduction to 21% beginning in 2018 would not have a direct impact on state taxation as states establish their own rate structures. 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. Due to the lower federal rate, the federal 80% dividends received deduction would be reduced to 65% and the federal 70% dividends received deduction would be reduced to 50%. These federal changes would potentially affect the state tax base in those states that conform to the federal dividends-received deduction amounts.

- **Expensing certain assets:** The conference agreement would increase the current 50% bonus depreciation regime under Code section 168(k) to 100% expensing for qualified assets placed in service after September 27, 2017 and before December 31, 2022. For assets placed in service after that date, the amount of expensing allowed would decline by 20 percentage points each year, until it phased out for property placed in service after December 31, 2026. In terms of property qualifying for the 100% expensing, the agreement continues to apply the expensing to most assets that are currently covered by bonus depreciation and expands that coverage to include used assets that are acquired by a taxpayer for the first time. The expensing provisions of the conference agreement would not apply to certain property of regulated utilities or to property financed by floor financing indebtedness. The conference agreement also increases the availability of expensing for certain small businesses under Code section 179. The increased expensing allowance would flow through to the state tax base in rolling conformity states unless the state acts to decouple or has already decoupled from bonus depreciation. 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 and the enhanced deductions allowed during the phase-out would be substantial both for states that currently conform to bonus depreciation and those that do not currently conform. In other words, certain states that currently conform to 50% bonus depreciation may not be able to absorb the cost of immediate expensing. Because the full expensing system is accomplished by amending Code section 168(k), there are likely to be a minimum of compliance-related issues emanating from the change beyond those experienced currently in states that do not conform to bonus depreciation.

- **Interest deductibility:** The conference agreement would disallow the deduction of net interest expense (excluding floor plan financing interest) to the extent it exceeds 30% of a taxpayer's adjusted taxable income (ATI), with an exception for taxpayers with an average of \$25 million or less in gross receipts over the three prior years, certain real property businesses, farming businesses, regulated public utilities, and electric cooperatives. Unused amounts could be carried forward indefinitely. ATI is defined in the conference agreement as the taxable income of the taxpayer computed without regard to any business interest or business interest income, the 20% deduction for certain passthrough entities, NOLs, and for tax years beginning before January 1, 2022, any deduction for depreciation, amortization or depletion.

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 (even though it is a permanent change and the 100% expensing starts to phase out after five years). Whether that policy carries over to states that choose not to conform to the expensing

is an open question. The JCT estimated that the federal revenue impact of the interest limitation is approximately \$250 billion over 10 years.

If a state chooses to conform to the interest limitation, there would be certain complexities because of the different filing methods at the state and federal level. The federal limitation would be determined at the taxpayer level, which would, in many cases, be the consolidated group. For state purposes, a member of the federal consolidated group may be required to file a separate return or as a member of a unitary combined group. To deal with the different composition of the “taxpayer” at the state level, states often require individual consolidated group members to re-compute federal taxable income as if the member had filed separately, rather than consolidated, at the federal level. In addition, over 20 states currently have rules that disallow the deduction of interest or intangible-related interest paid to related parties. Coordinating the state and federal rules in these states could also present complications. For example, because the federal limit applies to all interest, and money is fungible, it may not be clear whether the character of the interest that is allowed to be deducted is “related party” interest for state purposes.

- **Net operating loss limitations:** The conference agreement, much like the House and Senate bills, would restrict the use of net operating losses (NOLs) by taxpayers (other than property and casualty insurance companies). Effective for losses arising in tax years beginning after December 31, 2017, the bill would eliminate the current law carryback provisions in most cases, allow NOLs to be carried forward indefinitely, and limit the amount of NOL deduction used to 80% of the taxpayer’s taxable income determined without regard to the deduction. Many states start their computation of state taxable income with Line 28 of the federal form 1120, which is federal taxable income before NOLs and special deductions. Other states that start the computation of taxable income with Line 30 require an addback of the federal NOL and then require computation of a state specific NOL. There are only a handful of states that directly incorporate the federal NOL. However, a number of states reference Code section 172 in the statutes providing for the state-specific NOL (e.g., stating that the state NOL should be treated in the same manner as for federal purposes). Because the new 80% federal NOL limitation would be added to Code section 172, it is unclear how that limitation will interact with those state NOL provisions that reference section 172. States also vary significantly in their allowance of NOL carryforwards and carrybacks. Most states do not allow a carryback, and there are varying (but always specified) carryforward periods. In addition, several states have their own limitations (e.g., Louisiana and Pennsylvania) on the extent to which NOLs may offset taxable income. States seem likely to continue to choose their own approach to NOLs, resulting in continued complexity.
- **Repeal of other deductions and modification of certain credits:** The conference agreement proposes to repeal or limit certain other business deductions (e.g., certain meals and entertainment expenses, transportation fringe benefits, and expenses for lobbying before local governments). To the extent a state currently conforms to a deduction, limiting or repealing the deduction would broaden the state tax base

(assuming continued conformity). One of the most significant deductions proposed for repeal is the Code section 199 deduction (effective for tax years beginning after December 31, 2018 for C corporations) to which about one-half of the states currently conform. Interestingly, in a fixed-date state that currently allows the section 199 deduction, there would appear to continue to be a state-only section 199 deduction until the state updated its IRC conformity. The agreement proposes some modifications to existing corporation tax credits, but the modifications would not have a significant impact on state taxes.

- **Contributions to capital:** The conference agreement revives a modified version of a provision that originated in the House bill, but was not in the Senate bill, related to the treatment of grants and contributions to private entities for economic development purposes. The conference agreement would require any contribution in aid of construction or other contribution by a customer or potential customer and any contribution by a governmental entity or civic group (other than a contribution by a shareholder as such) to be included in the income of the receiving entity. In addition, the explanatory statement expresses the conferees' intent that section 118 "continue to apply only to corporations." The explanatory document accompanying the original House bill indicated that the section would affect only grants made by governmental entities and would not affect tax abatements. This is not explicitly noted in the explanation of the conference agreement. The provision applies to contributions made after the date of enactment unless the contribution is made pursuant to a master development plan approved by the governmental entity prior to the date of enactment. The conference agreement would also eliminate the tax exemption for advanced refunding bonds and the authority to issue tax credit bonds. It would retain the exemption for qualified private activity bonds, including those issued to finance professional sports stadiums.
- **Alternative minimum tax:** The conference agreement would repeal the corporate AMT effective December 31, 2017. Eight states currently have an alternative minimum tax on corporations: Alaska, California, Florida, Iowa, Kentucky, Maine, Minnesota, and New Hampshire. However, the state alternative tax is not computed as a percentage of the federal tax and ultimately any changes (or not) to the federal AMT may not affect the states.

### *International provisions*

From the start, one of the stated goals of tax reform was to revise the way multinational businesses are taxed. The conference report accomplishes three objectives with respect to the treatment of foreign income and international tax reform: (a) shift the United States from a worldwide system of taxation closer to a system of territorial taxation; (b) transition to the new quasi-territorial system by requiring an immediate repatriation of certain foreign entity earnings and profits that have heretofore been deferred from U.S. taxation; and (c) establish measures to prevent the diversion of income to foreign jurisdictions once the United States moves to the territorial regime, colloquially referred to as "base erosion provisions."

Collectively, these provisions represent a significant shift in the taxation of multinational businesses; they also create some interesting state issues. Unlike the federal system, which has historically taxed multinational businesses on a worldwide basis, states have largely used a territorial approach, including income from wherever earned in the tax base, then attributing income to an individual state through the use of formulary apportionment. In addition, states often take additional steps to deal with foreign-source income, including the use of dividends received deductions for dividends paid by foreign subsidiaries to U.S. parent corporations, subtractions from the tax base for subpart F income, or general exclusions from the tax base for foreign-source income.

There is substantial variation across the states with respect to how foreign income generally, and subpart F income specifically, is handled. As noted in more detail below, the repatriation inclusion amounts under the conference agreement are treated for federal purposes as an addition to subpart F income. The state treatment of subpart F income is far from consistent across states. Certain states provide a specific exclusion from the state tax base for subpart F income. Other states administratively extend their foreign dividends-received deduction to subpart F income. A number of states simply do not address subpart F income. Additionally, many states disallow expenses associated with any subpart F income not taxed by the state. These issues are not new, but will likely require closer examination due to the magnitude of the amounts required to be repatriated and included in federal taxable income under provisions of the conference agreement.

For states, the dormant foreign commerce clause arising under the U.S. constitution inserts another layer of complexity to the analysis of state taxation of foreign-source income. Unlike the federal government, states are prohibited from taxing foreign income or entities engaged in foreign commerce less favorably than domestic counterparts. The essential principle applicable here was provided by the U.S. Supreme Court in *Kraft General Foods v. Iowa Department of Revenue*, in which the Court determined that Iowa's conformity to federal tax law was an unconstitutional violation of the foreign commerce clause because it resulted in discriminatory treatment of dividends received from foreign affiliates as compared to domestic affiliates. This mandate to avoid discriminating against foreign commerce requires an examination of any state inclusion of foreign-source income (remaining in the state tax base after the application of state-specific subtraction rules) to ensure the foreign income is not taxed more heavily than similarly situated income from domestic sources. To complicate matters further, the application of this principle may differ depending on whether the state is a separate filing state or a state in which a corporate taxpayer files its returns on a combined or consolidated basis.

### **Establish a territorial tax system**

- **Deduction for foreign-source dividends received.** The territorial system encompassed in the conference agreement would allow a dividends received deduction (DRD) for 100% of the foreign-source portion of dividends received from a foreign corporation in which the U.S. recipient owns 10% or more of the voting stock (subject to certain holding period requirements). A "hybrid" dividend would not be



eligible for this deduction. A hybrid dividend is a dividend paid by the foreign subsidiary for which it received a deduction or other tax benefit in a foreign country. Instead, any hybrid dividend received by a CFC from another CFC would be treated as subpart F income for the U.S. shareholders.

States often do not conform to the federal tax treatment of foreign affiliate dividends. Many states apply their DRDs in the same manner to both foreign and domestic dividends to avoid unconstitutionally discriminating against foreign dividends in violation of the foreign commerce clause. A number of states, but certainly not all, already allow a 100% DRD for dividends from foreign corporations. Some allow only a partial DRD, but tax an equal portion of domestic and foreign dividends. Many states also provide a subtraction from taxable income for subpart F income, either in the form of a specific exclusion of some or all subpart F income or a DRD that includes subpart F income. If the conference agreement becomes law, taxpayers will need to evaluate how a state conforms to the federal DRD as well as its treatment of subpart F income, thus determining whether the dividends qualify for deduction or exclusion under state law.

### **Transition to the territorial system**

- To transition to the territorial system, the conference agreement would require a deemed repatriation of post-1986 earnings and profits (E&P) of certain foreign corporations and would subject those amounts to reduced federal tax rates depending on whether the E&P relates to cash and cash equivalents or other assets. This is accomplished by adding the post-1986 E&P to the U.S. shareholders' subpart F income and then allowing a partial deduction of those included amounts to effectively arrive at the applicable preferential tax rates. The effective preferential rates on repatriated earnings in the agreement are 15.5% for cash and cash equivalents and 8% for other amounts. The bill would require this income inclusion in "the last tax year beginning before January 1, 2018." The conference agreement would allow taxpayers the option of preserving NOLs, rather than using such NOLs to offset the deemed repatriated E&P.

Certain state issues would flow from this mandatory repatriation. Those issues include the interaction between the mechanics of the way deemed repatriated amounts would be included in a U.S. taxpayer's federal gross income and the state modifications to federal taxable income that generally apply to subpart F income and foreign dividends. For example, the repatriated amount does not fall within the Code section 952 definition of subpart F income in the Code, but is an amount added to a taxpayer's subpart F income to be included in federal gross income. That raises questions of whether a state's subpart F modification provision would apply to the repatriated amount. Even where the state's subpart F modification would include the repatriated amount, the reduction in some states is less than 100% of that income, resulting in the potential for some residual state taxable income resulting from the repatriation. Further, the foreign commerce clause could be implicated if the undistributed earnings of similarly situated domestic subsidiaries are not similarly subject to tax. In states

that automatically conform to the Code, confusion could arise when computing the amount of income to be included on the state return due to the overlapping limitations provided in the conference agreement and a state's DRD (or the subpart F exclusion that would otherwise apply).

The conference agreement would allow the federal tax on repatriated earnings to be paid over eight years, a provision that would not likely be picked up by a state without legislative action (state conformity to the Code generally applies to the calculation of taxable income and not to the tax on that income). As a result, the full amount of any state tax attributable to the repatriation would need to be paid in a single year rather than spread over the eight-year federal installment period. Paying the federal tax on repatriated income in installments would also affect the timing of any deductions for federal income tax paid in the handful of states that permit a deduction for federal taxes.

### **Establish measures to prevent base erosion**

The conference agreement includes several sections that, if enacted, would address potential base erosion on both outbound and inbound transactions. A number of state issues would flow from these new rules. Of critical importance is the foreign commerce clause prohibition against discriminating against foreign commerce, even if the differential treatment is the result of conformity to the federal income tax code.

- **Rules related to passive and mobile income.** To address possible abuses related to certain types of income, the agreement contains a provision that requires current recognition of a portion of certain income. The provision has potential consequences for state corporate income taxpayers.

Under the agreement, a U.S. parent of a foreign subsidiary would include in gross income what is referred to as the global intangible low-taxed income (GILTI) of the foreign subsidiary. The calculation of this income amount is complicated and would be made based on certain enumerated attributes of the domestic corporation's foreign subsidiary. Regardless of whether the foreign subsidiary actually distributes this GILTI income, it must be included in the gross income of the U.S. parent. This income inclusion would be required through the enactment of a new Code section (section 951A). The income included under this provision by the domestic parent would be eligible for a potential deduction equal to 50% (37.5% for years beginning after December 31, 2025) of the foreign subsidiary's GILTI (subject to limitation when GILTI exceeds taxable income). This deduction would also be added as a new Code section (section 250).

While this provision would require GILTI to be treated as subpart F income for a number of purposes, it would not be included in the definition of "subpart F income" under Code section 952. In addition, the explanatory statement accompanying the conference report specifically states that "GILTI inclusions do not constitute subpart F" income. Because the state exclusions from income (or qualification for a DRD)

often refer to subpart F income or to a specific definition of subpart F income (e.g., Code section 952), the exclusion or DRD provisions may not encompass this new income amount or the related deduction of a portion of the income amount. That raises the issue of a potential foreign commerce clause violation if this income earned by foreign affiliates would be taxed less favorably than similar income of domestic affiliates. For rolling conformity states with existing subpart F subtractions that might apply to GILTI, the addition of the 50% deduction for that income in a new Code section could create confusion as to how the state subtraction and federal deduction would interact.

- **Base erosion minimum tax.** The proposed base erosion provisions also include a “base erosion minimum tax” for certain inbound transactions. The tax would be applicable to certain enterprises with average annual gross receipts in the preceding three years of at least \$500 million. The tax would be based on the excess income that would have been reported by the domestic corporation without taking into account certain amounts paid to foreign affiliates. Given that this is a new, separate tax calculation, it is possible there would be no state tax effect because the tax would not cause a change to the taxable income of the corporation.

The above discussion has focused on whether certain foreign-source income would be included in the state income tax base and made note of the U.S. constitutional requirement for its treatment. Beyond this, there would be a host of additional considerations that need to be taken into account in cases where some or all of the income gets included in the state tax base. For the most part, these considerations are not new. They include considerations of whether the income is unitary and subject to apportionment or non-unitary and subject to allocation. If subject to apportionment, taxpayers would need to consider the method used by individual states to source that type of income for apportionment factor purposes, which can differ depending on whether the income is from dividends, interest, capital gains, inventory sales, and the like. While not new, they will require careful analysis.

### *Closing thoughts*

The enactment of substantial federal tax changes appears imminent. Based on the conference agreement, three general observations relative to the potential impact on state taxes seem in order. First, from a structural standpoint, the changes envisioned in the individual income tax would seem likely to have a greater impact on the states. The repeal of personal exemptions and use of an enhanced child credit as the primary family size adjustment, the modifications to itemized deductions, and the proposed deduction for owners of passthrough entities could each have a significant impact on the yield and distribution of the personal income tax, depending on how the state responds. As it relates to purely domestic businesses, the impact would seem to be more modest given that the focal point of the federal reform is substantially reducing the corporate tax rate. There is likely to be additional complexity as states and taxpayers try to coordinate different filing methods and current state law provisions in such areas as interest limitations, expensing and the like. Finally, the international provisions proposed in the conference agreement

are far-reaching and will pose substantial challenges in evaluating whether certain types of income are included in a state return, how it should be sourced or allocated if it is included and whether the proposed treatment presents any potential constitutional challenges. The international changes are ones of kind rather than degree, and they may well overwhelm current state structures for taxing foreign-source income.

In evaluating how states might respond to the proposed changes, state taxpayers would be well-advised to keep a few fundamentals in mind. First, the reaction to federal tax reform by individual states is likely to be driven, to a considerable extent, by the fiscal impact of conformity to a 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. While the additional complexity and compliance challenges associated with nonconformity will be evaluated, the fiscal concerns are likely to be paramount.

Second, there would likely be indirect effects as a result of federal tax reform that states would consider. Certain of the proposed changes, such as curtailing the state and local income and sales tax deduction for individuals, would 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 the conference agreement, which is effective for the 2018 tax year, is signed into law before January 1, states will have an extremely limited time to assess the fiscal and tax effect of the federal changes before state legislatures convene in early 2018. The first priority of the states is likely to be fashioning a response to the personal income tax changes. 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. The complexity of the proposed legislation and the short response time left to states would seem to place a priority on closely monitoring state legislation updating conformity statutes in 2018.

Finally, there is no “one size fits all” state or state taxpayer response to federal tax reform. The proposed federal changes 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**

Potential tax reform may significantly impact an organization’s accounting for income taxes process and measurement of income taxes related balances, beginning with the

date of enactment. As entities assess the impact of the potential new legislation, there may be elements 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 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.

This discussion highlights selected areas of accounting for income taxes that may be impacted by changes in tax laws or rates included in the conference agreement, but it is not all inclusive.

### **Corporate tax rate reduction**

The conference agreement reduces the corporate tax rate to 21% effective January 1, 2018. In accordance with Section 15, a fiscal year-end entity would utilize a blended rate for its fiscal 2018 tax year by applying a prorated percentage of the number of days prior to and subsequent to the January 1, 2018 effective date.

The tax effect of changes in tax laws or rates on income taxes receivable (payable) for the current year is recognized in the estimated annual effective tax rate beginning in the interim period which includes the latter of the date the legislation is enacted or effective. To the extent income taxes receivable (payable) of prior years are adjusted, such impacts are recognized in income tax expense (benefit) from continuing operations as of the date of enactment.

Deferred tax assets (liabilities) are remeasured to reflect the effects of enacted changes in tax laws or rates at the date of enactment, even though the changes may not be effective until future periods. The impact of the remeasurement is reflected entirely in the interim period that includes the enactment date and allocated directly to income tax expense (benefit) from continuing operations.

### **KPMG observation**

Companies will need to consider the timing of reversal of temporary differences that exist as of the enactment date. In measuring deferred tax assets (liabilities), existing tax laws and rates should continue to be utilized for temporary differences expected 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 such effective date. Despite the fact that deferred taxes are not generally determined on a daily basis, reasonable effort should be made to estimate such balances at the enactment date.

Fiscal year-end entities, as a result of the blended rate application for the fiscal 2018 tax year, may need to schedule the reversal of enactment date temporary differences to determine which will reverse under the blended rate in fiscal 2018 and which temporary differences will reverse once the 21% is fully effective.

The allocation of income tax expense (benefit) directly to continuing operations may result in residual tax effects within other comprehensive income. Residual tax effects are generally released when the item giving rise to the tax effect is disposed, liquidated or terminated.

### Excessive executive compensation

In accordance with the conference agreement, the covered employees subject to the excessive executive compensation limitation will be the principal executive officer, principal financial officer and three other highest paid employees. Once an employee is a covered person for a tax year beginning after December 31, 2016, the employee will remain classified as such for all future years. The proposed guidance eliminates the exceptions for commissions and performance-based compensation. The effective date of such provisions are for tax years beginning after December 31, 2017 but will not apply to certain compensation under pre-November 2, 2017 written binding contracts.

#### KPMG observation

At the date of enactment, entities may need to remeasure deferred tax assets associated with share-based compensation or other compensation related deferred tax assets to the extent the compensation does not meet the written binding contract exception and is not anticipated to be deductible in the future. Further, entities may need to consider existing policies on the determination of the portion of compensation related temporary differences that will be deductible in the future noting that the two most common methods used in practice are pro rata (between cash and non-cash compensation) or stock compensation last.

Due to the anticipated increase in future nondeductible compensation expense, entities will need to consider the potential reduction in deferred tax assets and increase in future taxable income on its valuation allowance judgment.

### Interest expense limitation

Interest expense, net of interest income, is proposed to be permitted as a deduction to the extent it does not exceed 30% of adjusted taxable income for tax years beginning after December 31, 2017. Adjusted taxable income is computed without regard to deductions allowable for interest, depreciation, amortization or depletion for tax years beginning after December 31, 2017 and before January 1, 2022. Subsequent to such date, adjusted taxable income is computed without regard to deductions allowable for interest. Any disallowed interest expense is carried forward indefinitely.

#### KPMG observation

The incorporation of a limitation on the deductibility of interest expense may result in an increase in future taxable income and the effective tax rate. If an entity anticipates

increases in future taxable income as a result of the limitation, existing valuation allowance judgments should be reassessed to determine if a change in judgment on the realizability of non-interest related federal deferred tax assets occurs. Further, entities may need to consider the limitation on the utilization of disallowed interest expense carryforwards in scheduling the reversal of deferred tax assets on a go forward basis.

### Net operating losses

The conference agreement provides that net operating losses (NOLs) arising in tax years beginning after December 31, 2017 will be limited to 80% of taxable income. While no carryback is permitted, those NOLs will be permitted to be carried forward indefinitely. Existing NOL carryforwards arising in tax years beginning before January 1, 2018 are not subject to the 80% limitation; however, such carryforwards remain subject to the 20 year carryforward period.

#### KPMG observation

The conference report language may result in additional scheduling of the reversal of temporary differences in determining the total amount of deferred tax assets supported by reversing taxable temporary differences. An entity may need to consider the reversal of temporary differences and the offset of taxable and deductible temporary differences prior to the consideration of the availability of NOL carryforwards in order to determine the portion of deferred tax assets for NOLs supported. Further, as NOL carryforwards arising in tax years beginning after December 31, 2017 have an indefinite carryforward period, we believe the deferred tax assets related to such NOLs may be supported by taxable temporary differences associated with indefinite life assets, but remain subject to the 80% limitation imposed under operation of the tax law.

### Alternative minimum tax

The conference agreement repeals the corporate alternative minimum tax regime and permits existing minimum tax credits to offset the regular tax liability for any tax year. Further, the credit is refundable for any tax year beginning after December 31, 2017 and before December 31, 2020 in an amount equal to 50% of the excess of the minimum tax credit over the allowable credit for the year against the regular tax liability. Any unused minimum tax credit carryforward is refundable in the following year.

#### KPMG observation

All or a portion of existing deferred tax assets related to minimum tax credit carryforwards may be reversed and an income taxes receivable recognized. Any income taxes receivable recognized is presented as a current receivable or noncurrent receivable based upon the expected timing of receipt (current if anticipated to be received within 12 months or the operating cycle, otherwise noncurrent). Additionally, we believe companies should consider the effects of discounting in determining the amount of receivable to recognize. Finally, as all minimum tax credit carryforwards will be realized either as a

reduction of income taxes payable or as a refundable amount, entities may need to consider if existing deferred tax assets for minimum tax credit carryforwards, and related valuation allowances, if any, should be reversed.

### **Mandatory repatriation**

The conference agreement provides that the aggregate of post-1986 earnings and profits (E&P) are deemed repatriated for the last tax year of a foreign corporation beginning prior to January 1, 2018 based upon the greater of E&P measured at November 2, 2017 or December 31, 2017. E&P is taxed at a rate of 15.5% and 8% for cash and non-cash earnings, respectively. While the deemed repatriation is included in taxable income in the last tax year beginning prior to January 1, 2018, an election may be made to pay the liability over an eight year period under a prescribed methodology. Future dividends of future earnings generally may be remitted without federal tax consequences.

### **KPMG observation**

The conference agreement will generally result in an entity reflecting an income taxes payable balance associated with the deemed repatriation in the tax year of inclusion. Such amount is anticipated to be classified as a current or noncurrent income taxes payable based upon the expected timing of cash payment (current if anticipated to be paid within 12 months or the operating cycle, otherwise noncurrent). Additionally, companies should consider the effects of potentially discounting any income taxes payable in determining the amount to recognize. This provision will generally require an entity to verify the accuracy of its E&P and related tax pools within the annual or interim period which include the date of enactment.

If the amount is not includable in taxable income of the owner of the foreign corporation in the current tax year, such as when the foreign corporation has a different fiscal year end than its owner, an entity may not have the ability to assert that the unremitted E&P is indefinitely reinvested and may need to recognize a liability associated with the future inclusion. Further, while future dividends are generally not subject to tax consequences upon remittance, entities may still need to consider the applicability of the indefinite reinvestment criteria as it relates to items such as withholding taxes or state income taxes imposed on actual distributions or currency transaction gains (losses) that would result in taxation upon remittance.

Finally, entities may need to consider the realizability of remaining foreign tax credit carryforwards due to the potential limitation associated with the generation of future general basket foreign source income to support utilization.

### **Global intangible low-taxed income**

For tax years of foreign corporations beginning after December 31, 2017, the conference agreement provides a U.S. shareholder of any CFC must include in taxable income its pro rata share of global intangible low-taxed income (GILTI). GILTI is considered the



excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. Additionally, a deduction is permitted for 50% of its GILTI for tax years beginning after December 31, 2017 and before January 1, 2026, with a reduction to 37.5% thereafter (collectively referred to as the Section 250 deduction). Further, for any amount of GILTI included in taxable income, a deemed paid foreign tax credit of 80% is permitted, with a corresponding gross-up at 100%. Any foreign tax credits generated under the GILTI regime represent a separate basket for purposes of determining whether the amounts are creditable with no carryforward or carryback of excess credits permitted.

#### **KPMG observation**

Entities may need an understanding of the tax basis of its CFCs assets and liabilities under U.S. tax principles in order to determine whether GILTI related deferred taxes are required upon enactment. Additionally, entities will need to consider the appropriate tax rate utilized in measuring deferred tax consequences, including taking into account whether the deemed tangible asset return or the Section 250 deduction are viewed as special deductions or measured as part of the statutory tax rate.

#### **Base erosion anti-abuse tax**

Under the conference agreement, an applicable taxpayer is required to pay a base erosion anti-abuse tax (BEAT) equal to the excess of 10% of modified taxable income over the pre-credit regular tax liability, as reduced by certain tax credits. Modified taxable income is generally taxable income excluding any amounts paid or accrued by a taxpayer to a foreign person that is a related party for which a deduction is permitted, collectively base erosion payments, and generally excludes payments for cost of goods sold. The BEAT is applicable for tax years beginning after December 31, 2017.

#### **KPMG observation**

As of the date of enactment, an entity may need to assess whether it anticipates being subject to the regular tax or base erosion anti-abuse tax regimes in order to appropriately measure its deferred tax assets (liabilities) considering the anticipated regime expected to apply in the year of reversal. Practical challenges may exist in determining the base amounts subject to the underlying tax regimes, including the amount subject to expense disallowance under the BEAT.

#### **Foreign derived intangible income**

The conference agreement permits U.S. corporations a deduction for tax years beginning after December 31, 2017 and before January 1, 2026 equal to 37.5% of the lesser of foreign derived intangible income or its taxable income determined without regard to the deduction. Foreign derived intangible income is considered deemed intangible income attributable to income received from a foreign person for sales of property or services for ultimate use outside the U.S. The deduction is reduced to 21.875% for tax years beginning after December 31, 2025.

**KPMG observation**

In assessing the impact of foreign derived intangible income, it must be determined whether the deduction is considered to be similar to a special deduction. While special deductions are not anticipated in measuring deferred tax assets (liabilities), the future tax effects may impact the need for a valuation allowance on deferred tax assets if significant future special deductions are anticipated to reduce taxable income in future periods to a level which will not be sufficient to realize the benefits of existing deferred tax assets.

**Financial statement disclosure****KPMG observation**

Entities may need to consider disclosure of the effects of potential enactment in the footnotes to the financial statements, within management discussion and analysis (MD&A) or within risk factors. Within the footnotes, entities are required to disclose income tax expense (benefit) arising from adjustments of deferred tax assets (liabilities) and income taxes receivable (payable) for enacted changes in tax laws or rates. If the tax law is enacted subsequent to the end of the financial reporting period, entities may need to disclose the nature of the event and an estimate of its financial effect or a statement that such an estimate cannot be made. Further, to the extent estimated amounts have been recognized, entities may need to provide transparency around the nature of the estimates and the reasonably possible adjustments to those amounts.

Within MD&A, entities may consider disclosing expected future effective tax rates as well as future obligations regarding deemed mandatory repatriation if deferred to a future period. Additionally, to the extent future regulatory, administrative or legislative actions could have a materially adverse effect, additional disclosure within risk factors may be necessary.

**Summary**

As noted above, this discussion highlights selective common areas of accounting for income taxes that may be impacted by the conference agreement, but it is not all inclusive. An entity's specific facts and circumstances should be assessed in determining the accounting for income taxes impact upon enactment.

## KPMG contacts

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

<b>Tax technical area</b>	<b>Name</b>	<b>Email</b>	<b>Phone</b>
<b>Passthroughs</b>	Deborah Fields	dafiels@kpmg.com	+1 (202) 533-4580
<b>Global mobility services</b>	Martha Klasing	mklasing@kpmg.com	+1 (202) 533-4206
	Joan Smyth	jsmyth@kpmg.com	+1 (202) 533-4404
<b>Corporate</b>	Mark Hoffenberg	mhoffenberg@kpmg.com	+1 (202) 533-4058
	Rob Liquerman	rliquerman@kpmg.com	+1 (202) 533-3054
<b>Compensation and benefits</b>	Karen Field	kfield@kpmg.com	+1 (202) 533-4234
	Terri Stecher	tstecher@kpmg.com	+1 (202) 533-4830
<b>Estates, gifts, and trusts</b>	Tracy Stone	ttstone@kpmg.com	+1 (202) 533-4186
<b>Insurance</b>	Frederick Campbell-Mohn	fcampbellmohn@kpmg.com	+1 (212) 954-8316
	Sheryl Flum	sflum@kpmg.com	+1 (202) 533-3394
<b>Regulated investment companies</b>	Deanna Flores	djflores@kpmg.com	+1 (858) 342-7661
<b>Banking</b>	Elizabeth L'Hommedieu	elhommedieu@kpmg.com	+1 (614) 249-1849
	Matthew Mosby	mmosby@kpmg.com	+1 (704) 371-5265
<b>Other financial products &amp; debt</b>	Kevin Keyes	kkeyes@kpmg.com	+1 (202) 533-3577
	Jon Zelnik	jzelnik@kpmg.com	+1 (202) 533-4193

<b>Exempt organizations</b>	Greg Goller	greggoller@kpmg.com	+1 (703) 286-8391
	Alexandra Mitchell	aomitchell@kpmg.com	+1 (202) 533-6078
<b>International</b>	Manal Corwin	mcorwin@kpmg.com	+1 (202) 533-3127
	Seth Green	sethgreen@kpmg.com	+1 (202) 533-3022
	Danielle Rolfes	drolfes@kpmg.com	+1 (202) 533-3378
	Devon Bodoh	dbodoh@kpmg.com	+1 (202) 533-5681
	Ron Dabrowski	rdabrowski@kpmg.com	+1 (202) 533-4274
<b>Mergers &amp; acquisitions</b>	Thomas Wessel	twessel@kpmg.com	+1 (202) 533-5700
<b>International M&amp;A</b>	Devon Bodoh	dbodoh@kpmg.com	+1 (202) 533-5681
<b>Income tax accounting</b>	Eric Lucas	ejlucas@kpmg.com	+1 (202) 533-3023
<b>Economic &amp; valuation services</b>	Stephen Blough	sblough@kpmg.com	+1 (202) 533-3108
<b>Energy</b>	Rich Blumenreich	rblumenreich@kpmg.com	+1 (202) 533-3032
	Robert Swiech	rswiech@kpmg.com	+1 (713) 319-3257
<b>Financial institutions and products</b>	Mark Price	mhprice@kpmg.com	+1 (202) 533-4364
<b>Accounting for income taxes</b>	Ashby Corum	acorum@kpmg.com	+1 (313) 230-3361
	Jenna Summer	jsummer@kpmg.com	+1 (202) 533-3614
<b>State and local tax</b>	Harley Duncan	hduncan@kpmg.com	+1 (202) 533-3254
	Ann Holley	aholley@kpmg.com	+1 (202) 533-3248
<b>Excise and credits</b>	Deborah Gordon	dkgordon@kpmg.com	+1 (202) 533-5965
	Taylor Cortright	tcortright@kpmg.com	+1 (202) 533-6188

<b>REITs</b>	David Lee	dwlee@kpmg.com	+1 (202) 533-4071
	Stephen Giordano	stephengiordano@kpmg.com	+1 (202) 533-3535

# Contact us

**For questions on legislative matters, contact a professional in the Federal Legislative and Regulatory Services group of the Washington National Tax office:**

## **John Gimigliano**

**T** +1 (202) 533-4022

**E** [jgimigliano@kpmg.com](mailto:jgimigliano@kpmg.com)

## **Carol Kulish**

**T** +1 (202) 533-5829

**E** [ckulish@kpmg.com](mailto:ckulish@kpmg.com)

## **Tom Stout**

**T** +1 (202) 533-4148

**E** [tstoutjr@kpmg.com](mailto:tstoutjr@kpmg.com)

## **Jennifer Bonar Gray**

**T** +1 (202) 533-3489

**E** [jennifergray@kpmg.com](mailto:jennifergray@kpmg.com)

[kpmg.com/socialmedia](https://kpmg.com/socialmedia)



The information contained herein is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 152 countries and have 145,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

© 2017 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in the U.S.A. The KPMG name and logo are registered trademarks or trademarks of KPMG International. NDPPS 669194