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Senate Tax Reform Bill - Initial Observations on Senate Passed Bill

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Introduction

Shortly after 1:30 AM on December 2, the Senate passed its version of tax reform legislation (H.R. 1, the “Tax Cuts and Jobs Act”) by a vote of 51 to 49. All but one Senate Republican (Sen. Bob Corker, R-TN) voted for the bill, while all Democrats voted against it.

Background

On November 9, Senate Finance Committee Chairman Orrin Hatch (R-UT) released a “Chairman’s mark” of his proposed tax reform legislation.

The Finance Committee’s markup—formal consideration of the mark—began on November 13 and concluded just a few days later on November 16.

On November 28, the Senate Budget Committee voted by a party-line vote (12-11) to send reconciliation legislation to the Senate floor. The Senate’s reconciliation bill, which was substituted for the version of H.R. 1 the House passed on November 16, included the Finance Committee’s tax reform bill, as well as an additional title addressing an oil and gas program relating to the Arctic National Wildlife Refuge (ANWR) Coastal Plain.

On November 29, the Senate began consideration of the reconciliation legislation. A number of modifications were made during Senate consideration of the legislation. Some of the changes were made for policy reasons and to correct technical issues, while others were made to ensure the bill complied with various procedural requirements relating to the reconciliation process; still others were made to ensure the bill could secure the necessary number of votes for passage.

Most of these changes were made through a manager’s amendment, including the reinstatement of a limited individual itemized deduction for state and local real property taxes and an increase in a new deduction for qualified business income of passthrough entities.

The Senate also approved two additional amendments during debate of the bill — one offered by Sen. Cruz (R-TX) and the other offered by Sen. Merkley (D-OR). The Cruz amendment expanded the uses for section 529 plans, while the Merkley amendment deleted a provision of the manager’s amendment that would have created an exception to the excise tax on university endowments.

Key changes from Finance Committee bill

A revenue table (JCX-62-17) prepared by the Joint Committee on Taxation (JCT) shows changes made to the reconciliation bill by the manager's amendment. These changes included, among other things, the following:

Modifications decreasing federal revenues relative to the reconciliation bill:

- Restore a limited itemized deduction for up to \$10,000 in state and local real property taxes not paid or accrued in a trade or business
- Increase deduction for qualified business income of passthrough entities to 23%
- Restore medical expense deduction for expenses in excess of 7.5% of adjusted gross income
- Extend and phase-down 100% bonus depreciation
- Retain current law treatment of IC-DISCs
- Phase in proposed new rules for certain excess indebtedness of U.S. groups
- Provide an exception for floor plan indebtedness in the proposed net interest expense limitation rules
- Modify the recovery period for real property
- Modify certain aspects of the AFS conformity rules
- Increase maximum overall domestic loss recapture
- Modify treatment of S-to-C corporation conversions

Modifications increasing federal revenues relative to the reconciliation bill:

- Reinstate the individual alternative minimum tax (AMT), with increased exemption amounts and phase-out thresholds
- Reinstate the corporate AMT
- Increase the repatriation rates to 7.5% and 14.5% for non-cash and cash amounts, respectively
- Repeal deduction for income attributable to domestic production activities of non-corporate taxpayers
- Exclude specified payments from the base erosion and anti-abuse tax (BEAT) and increase BEAT rate by 1% for certain financial institutions
- Modify the age parameters of the child tax credit for 2025.

Provisions deleted from reconciliation bill

- Repeal of tax-exempt status for professional sports leagues
- Treatment of name and logo royalties as unrelated business taxable income (UBTI)
- Modification of taxes on excess benefit transactions
- Uniform treatment of expenses in contingency fee cases
- Certain provisions relating to Alaska Native Corporations and Settlement Trusts

- Repeal of the exclusion applicable to certain passenger aircraft operated by a foreign corporation
- 0% (zero) dividends paid deduction and reporting requirement provision
- Rules that would have repealed certain prospective revenue-raising provisions if the Secretary of the Treasury determined that aggregate on-budget federal revenues for all sources for fiscal years 2018 through 2026 exceed a certain dollar figure by a certain amount.

Other

Other changes were also made to reconciliation bill by the manager's agreement, including significant changes to insurance provisions and a technical change governing the application of the net business interest limitation to partnerships.

KPMG observation

Some of the provisions in the reconciliation bill that were stricken from the Senate bill likely were removed because of procedural requirements relating to budget reconciliation legislation (the vehicle for the tax reform bill). See discussion of budget reconciliation later in this introduction.

Highlights of Senate bill, as approved

Business provisions

Like the House bill, the Senate bill includes a permanent reduction in the corporate income tax rate from 35% to 20%. However, unlike the 2018 effective date in the House bill, the 20% rate in the Senate bill is not scheduled to become effective until 2019. Like the House bill, the full list of proposed changes for businesses in the Senate bill is extensive, including both additional tax benefits and offsetting tax increases.

Notably, both the Senate bill and the House bill would temporarily introduce "expensing" as the principal capital cost recovery regime, by increasing the 168(k) first-year "bonus" depreciation deduction to 100%— therefore allowing taxpayers to write off the costs of equipment acquisitions as made. The Senate bill, however, would generally apply only to *new* property, while the House bill would apply to both new and used property. The Senate bill also would phase down the percent expensed by 20% per calendar year beginning in 2023 (2024 for certain longer production period property and certain aircraft).

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

- Repeal the section 199 domestic manufacturing deduction (beginning in 2019 for C corporations, 2018 for all other taxpayers)

- Limit the deductibility of net business interest expense to 30% of adjusted taxable income
- Limit the carryover of net operating losses to 90% of taxable income and eliminate the carryback (with special rules for certain farms)
- 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 2026

Multinational entity taxation

In reforming the taxation of multinational businesses, the Senate bill adopts the same general framework as the House bill. Yet, significant technical differences will need to be reconciled with the House bill.

Like the House bill, the Senate bill 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 Senate bill would adopt several features, including:

- A 100% exemption for dividends received from 10% or greater-owned foreign corporations
- A minimum tax on “global intangible low taxed income” (GILTI), and
- A transition to the new regime through mandatory repatriation of previously untaxed “old earnings.” A 14.5% rate would apply to cash and cash equivalents and a 7.5% rate would apply to illiquid assets (rates that have been increased since the introduction of the Senate bill).

Also, like the House bill, the Senate bill would adopt additional anti-base erosion measures. Both the Senate and House bills are similar in intent, they differ in approach. The Senate bill eschews the House bill’s controversial excise tax on related-party transactions. Instead, the Senate bill 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, but unlike the House bill, the tax would not also apply to cost of goods sold.

Both the House bill and the Senate bill include an additional limitation on the deduction for net interest based on the U.S. corporation’s proportionate share of the external debt of a corporate group of which it is a member. However, the House bill looks at the external debt of an international financial reporting group, while the Senate bill adds an additional limitation based, instead, on the external debt of a worldwide affiliated group.

The Senate bill also includes several international provisions not found in the House bill. These include revised treatment of hybrids, a deduction for certain foreign derived intangible income, and rules for both inbound and outbound transfers of intangibles.

These differences between the Senate bill and the House bill may not be irreconcilable, but they are not insignificant and would have to be resolved in any final tax bill.

Individual provisions—subject to sunset after 2025

KPMG observation

Many of the changes affecting individual taxpayers would cease to apply after December 31, 2025, and 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 bill's repeal of the Affordable Care Act's individual shared responsibility payment (the individual mandate) or to the substitution of a new, lower inflation index for individual rate brackets (discussed below).

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

The bill would retain seven tax brackets but would modify the "breakpoints" for the brackets. The temporary new brackets would be 10%, 12%, 22%, 24%, 32%, 35%, and 38.5%. The top rate would apply to single filers with income of \$500,000 and married joint filers with income of \$1,000,000.

The Senate bill also includes another temporary provision that generally would allow an individual taxpayer a deduction for 23% of the individual's "qualified business income" from a partnership, S corporation, or sole proprietorship. This proposed deduction is not in the House bill, which instead would adopt a reduced tax rate for business income of individuals from partnerships, S corporations, and sole proprietorships.

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 elimination of deductions for home equity loan interest and state and local income taxes, capping the deduction for state and local real property taxes not derived in a trade or business, and modifying the exclusion of gain from the sale of a principal residence. 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.

Affordable Care Act modifications – “individual mandate”

The bill contains a provision that 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. This provision is not in the House bill.

Taxation of investment income

There would be no significant changes to the capital gains and dividends tax rate. The Senate bill also does not include repeal of the net investment income tax.

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 Senate bill proposes several changes that are specifically relevant to exempt organizations. In particular, the Senate bill 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

The Senate bill does not include a number of notable provisions 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

The bill was not subject to filibuster in the Senate, and thus could pass with a simple majority vote of 51-49, because of a special process called “budget reconciliation”. The proposals contained in the bill have been at least partially shaped by the numerous requirements of that process.

Budget reconciliation is a process 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 Senate bill appears to have been structured with this revenue target in mind; the JCT has estimated that, taking into account the manager’s amendment (but not the Cruz or Merkley amendments), the Senate bill would lose approximately \$1.448 trillion over the 10-year period, not taking into account possible macroeconomic effects. (JCT also issued a separate table showing the expected macroeconomic effect of the reconciliation bill.)

To retain the protection from a Senate filibuster that the reconciliation rules provides, provisions in tax legislation being considered under the budget resolution, such as H.R. 1, must meet a number of complex requirements.

For tax legislation, one of the most relevant requirements is one intended to prevent an increase in the long-term deficit of the United States. Even though the FY 2018 budget resolution allowed a net tax cut of up to \$1.5 trillion **within** the 10-year window, no title of the bill could result in a net tax cut in any year **beyond** the 10-year budget window unless offset by an equivalent reduction in spending. The JCT revenue table does not show the estimated revenue effects of the Senate bill in years outside this budget window, but the Congressional Budget Office analysis of the bill found that it met the requirement.

KPMG observation

The requirements put forth by these budget rules affected some details of this legislation. For example, decisions to delay enactment dates or to include sunset dates for the individual tax changes and the passthrough deduction likely were at least partially related to the need to fulfill the reconciliation-imposed rules regarding long-term deficits or to avoid increasing the short-term deficit by more than the allowable \$1.5 trillion. In addition, some of the provisions that were stricken from the Finance Committee bill in the manager’s amendment likely were removed because of a requirement that provisions in the reconciliation legislation have more than an incidental effect on revenue.

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). The Senate bill does not repeal or modify section 15, but it does include a few provisions explicitly indicating how section 15 would apply. In the case of other provisions involving “rate changes,” section 15 presumably would apply without modification.

Section 15 generally applies if any rate of tax imposed by chapter 1 of the Code¹ 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).²

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.

KPMG observation

Unlike the Senate bill, the House bill would modify section 15 to narrow its scope. Specifically, section 1001(c) of the House bill would amend section 15 so that it would apply only to rates under (or determined by reference to) section 11. In this same connection, the House bill also explicitly provides that section 15 would not apply to any change in a rate of tax imposed by Code chapter 1 that occurs by reason of any amendment made by the House bill, other than the amendments made by section 3001 (relating to the reduction in the corporate tax rate).

¹ Chapter 1 includes sections 1 through 1400.

² 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.

What is next?

The House approved its version of the Tax Cuts and Jobs Act, H.R. 1, on November 16. Read [KPMG's report](#) [PDF 1.8 MB] providing observations and analysis on H.R. 1, as approved by the House.

As noted, the House bill and the Senate bill differ in many respects. There are different approaches by which these differences could be reconciled in a bill that can pass both houses. A formal conference committee could be convened to reconcile the differences between the two bills (as was done in the 1986 Act). It also is possible for the House simply to pass the Senate bill without change. Or the House could make minor modifications to the Senate bill and send it back to the Senate.

KPMG observation

Congressional Republicans desire to enact tax reform as soon as possible. Negotiation of House-Senate differences could take place either in a conference comprised of representatives of both houses and parties, or, quite possibly, outside the conference itself between House and Senate leaders of the party responsible for the legislation.

Due to the need for the bill to comply with budget reconciliation procedural requirements in the Senate, and given the challenges already evident in obtaining the votes of at least 50 of the 52 Republican senators in the face of united Democratic opposition, negotiators may as a practical matter have to hew more closely to the shape and substance of the Senate bill.

Documents

- [Bill text](#) [PDF 730 KB] (468 pages)
- [Cruz amendment](#)
- [Merkley amendment \[no link available\]](#)
- [JCX-62-17](#): JCT estimate of changes made by manager's amendment
- [JCX-59-17](#): JCT revenue table for Finance Committee bill
- [JCX-61-17](#): JCT macroeconomic of the Finance Committee bill
- [Explanation of Finance Committee bill](#) [PDF 2.6 MB] posted on Budget Committee website (406 pages)

- [**Manager's amendment adopted in Finance Committee**](#) [PDF 104 KB]
- [**Correction to Chairman's modified mark**](#) [PDF 51 KB] - Corrected table for description of modification to mark, JCX-56R-17 (2 pages)
- [**Chairman's modified mark**](#) [PDF 633 KB] - "Description of modification to mark" JCX-56-17 (103 pages)
- [**Chairman's mark**](#) [PDF 877 KB] - "Description of the mark" document prepared by JCT (253 pages)
- [**Section-by-section summary**](#) [PDF 759 KB] of the Chairman's mark prepared by the Finance Committee (48 pages)
- [**Policy Highlights**](#) [PDF 127 KB] of the Chairman's mark prepared by the Finance Committee

This report

This report provides KPMG's preliminary analysis and observations regarding the Senate bill **based on documents available as of December 3, 2017**. 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	17
Treatment of business income of individuals	19
Deduction of 23% for certain passthrough income	19
Loss limitation rules for taxpayers other than C corporations	22
Filing status, standard deductions, and personal exemptions.....	24
New indexing method	25
Tax rates on capital gains and dividends	25
Reform of the child tax and qualifying dependents credits.....	26
Suspension of certain itemized deductions and income exclusions.....	27
Deduction for taxes (including SALT) not paid or accrued in a trade or business...	27
Modify deduction for home mortgage interest.....	28
Increased limitation for certain charitable contributions	28
Modify deduction for personal casualty and theft losses.....	28
Suspension of deduction for tax preparation expenses	29
Suspension of miscellaneous itemized deductions subject to the 2% floor	29
Suspension of overall limitation on itemized deductions (“Pease” limitation).....	29
Temporary reduction in medical expense deduction floor.....	30
Modification of exclusion of gain from sale of a principal residence.....	30
Suspension of exclusion for qualified moving expense reimbursements	31
Suspension of deduction for moving expenses	31
Suspension of exclusion for qualified bicycle commuting reimbursement	32
Modification to the limitation on wagering losses	32
Modification to individual AMT	33
Estate, gift and generation-skipping transfer tax	33
Other.....	33
Exclude income from the discharge of student debt	33
Modification of the deduction for certain educator expenses	34
Allow increased contributions to ABLE accounts, and allow contributions to be eligible for saver’s credit	34

Rollovers between qualified tuition programs and qualified ABLE programs	35
Relief for 2016 disaster areas	35
Exclusion from gross income of certain amounts received by wrongly incarcerated individuals	36
Combat zone tax benefits to Armed Forces in Sinai Peninsula of Egypt	36
Affordable Care Act—Healthcare	37
Reduce Affordable Care Act individual shared responsibility payment to zero	37
Business—In general	37
Generally applicable C corporation provisions	37
Reductions in corporate tax rate reduction and dividends received deduction	39
Modify net operating loss (NOL) deduction	41
Cost recovery	43
Modification of rules for expensing depreciable business assets	43
Temporary 100% expensing for certain business assets	43
Modifications to depreciation limitations on luxury automobiles and personal use property	45
Modifications of treatment of certain farm property	45
Applicable recovery period for real property	46
Requirement to capitalize section 174 research and experimental expenditures ..	46
Expensing certain citrus replanting costs	48
Business-related deductions, exclusions, etc	48
Limitation on the deduction of net business interest expense	48
Repeal deduction for income attributable to domestic production activities	53
Limitation of deduction by employers of expenses for certain fringe benefits	53
Modification of rules for length of service award plans	54
Limits on like-kind exchange rules	54
Accounting methods	55
Certain special rules for tax year of inclusion	55
Small business accounting	57
Business credits	59
Low-income housing credit	59

Modification of credit for clinical testing expenses for certain drugs for rare diseases or conditions	59
Modification of rehabilitation credit.....	60
Employer credit for paid family and medical leave.....	60
Miscellaneous business provisions	61
Qualified opportunity zones	61
Alaskan Native Corporation payments and contributions to settlement trusts	62
Aircraft management services	63
Deny deduction for settlements subject to a nondisclosure agreement paid in connection with sexual harassment or sexual abuse.....	64
Expand non-deductibility of certain fines and penalties	64
Repeal deduction for local lobbying activities	65
Compensation	65
Treatment of qualified equity grants	65
Modification of limitation on excessive employee remuneration.....	67
Excise tax on excess tax-exempt organization executive compensation	68
Retirement savings.....	69
Repeal of special rule permitting recharacterization of IRA contributions	69
Extended rollover period for the rollover of plan loan offset amounts	70
Passthrough entities.....	70
Tax gain on the sale of a partnership interest on look-through basis	70
Modification of the definition of substantial built-in loss in the case of transfer of partnership interest	73
Partnership charitable contributions and foreign taxes taken into account in determining partner loss limitation under section 704(d).....	74
Short-term capital gain with respect to applicable partnership interests	75
Provisions applicable to “eligible terminated S corporations”	78
Expansion of qualifying beneficiaries of electing small business trust	79
Charitable contribution deduction for electing small business trusts	80
Other proposals relevant to passthrough entities.....	80
Banks and financial institutions	81
Deduction limits for FDIC premiums	81

Repeal of advance refunding bonds	81
Cost basis of specified securities determined without regard to identification.....	82
Insurance	83
Net operations loss deductions of life insurance companies.....	83
Net operations loss deductions of property and casualty insurance companies	84
Repeal small life insurance company deduction	85
Repeal Code section 807(f) spread—Adjustment for change in computing reserves	85
Repeal special rule for distributions to shareholders from pre-1984 policyholders surplus accounts	86
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	88
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
Tax-exempt organizations	94
Excise tax based on investment income of private colleges and universities	95
Unrelated business taxable income separately computed for each trade or business activity.....	95
Repeal of deduction for amounts paid in exchange for college athletic event seating rights	96
Repeal of substantiation exception in case of contributions reported by donee.....	96
International	97
Establishment of participation exemption system for taxation of foreign income	97
Add U.S. participation exemption.....	97
Add special rules relating to sales or transfers involving specified 10% owned foreign corporations	99
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.....	114
Add special rules for transfers of intangible property from controlled foreign corporations to U.S. shareholders	115
Other modifications of subpart F provisions.....	116
Eliminate inclusion of foreign base company oil related income.....	116
Inflation adjustment of de minimis exception for foreign base company income ..	117
Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment.....	117
Modification of stock attribution rules for determining status as a controlled foreign corporation.....	117
Modification of definition of United States shareholder.....	118
Elimination of requirement that corporation must be controlled for 30 days before subpart F inclusions apply	119
Look-thru rule for related controlled foreign corporations made permanent	119
Corporations eligible for deductions for dividends exempted from subpart F inclusions for increased investments in United States property.....	120
Prevention of base erosion	121
Deny deduction for interest expense of United States shareholders which are members of worldwide affiliated groups with excess domestic interest	121
Adds limitations on income shifting through intangible property transfers	125
Limit deduction of certain related-party amounts paid or accrued in hybrid transactions or with hybrid entities.....	126
Preserve special rules for domestic international sales corporations.....	128
Surrogate foreign corporations not eligible for reduced rate on dividends	129
Modifications related to foreign tax credit system	129
Repeal section 902 indirect foreign tax credits; determination of section 960 credit on a current-year basis	129
Separate foreign tax credit limitation basket for foreign branch income.....	130
Acceleration of election to allocate interest on a worldwide basis.....	131
Determine source of income from sales of inventory solely on basis of production activities	132

Amend overall foreign loss ("ODL") rules to allow increased ODL recapture.....	132
Inbound provisions.....	133
Add base erosion and anti-abuse tax	133
Other provisions.....	138
Modify insurance exception to the passive foreign investment company rules	138
Repeal fair market value method of interest expense apportionment.....	140
Modify source rules involving possessions	140
Modify Code section 4985 excise tax	141
CRAFT beverages/excise taxes on beer, wine, and distilled spirits	141
Exempt the aging period of beer, wine and spirits from UNICAP rules related to interest	141
Reduced rate of excise tax on beer	142
Transfers of beer in bond.....	143
Reduced rate of tax on certain wine.....	143
Adjust alcohol content level of wine for application of excise taxes	144
Reduced rate of tax on mead and certain carbonated wines	144
Reduced excise tax rates on distilled spirits.....	145
Allow transfer of bonded spirits in bottles.....	145
Procedural provisions.....	146
Uniform tax treatment of attorney fees and court costs in connection with whistleblower awards.....	146
Improvement of the IRS whistleblower program	147
Modification to user fee requirements for installment agreements	148
Extension of period for contesting IRS levy	148
REITs	149
RICs	154
State and local tax implications	157
Impact of tax reform on accounting for income taxes	168
KPMG contacts	171

Individuals

The modified mark that was adopted during the Finance Committee markup added an expiration date to the provisions contained in Title I (relating to tax reform for individuals) of the initial Chairman's mark. The Senate bill would retain the expiration date for affected provisions. As a result, except where noted, the changes described below would cease to apply after December 31, 2025. At that time, these tax provisions generally would revert to their pre-2018 form. Future legislation would be required to make the provisions effective beyond 2025.

Note that the expiration date does not apply to the provision requiring the use of "chained CPI" to index tax parameters.

Ordinary income tax rates—In general

The Senate bill would modify the current income rate structure under which individuals are taxed, but not as drastically as the modifications contained in the House bill. The current rate structure has seven rates: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. The Senate bill would maintain the seven-rate structure, but would tax a taxpayer's income at modified rates: 10%, 12%, 22%, 24%, 32%, 35%, and 38.5%.

The Senate bill 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 business rate below.

KPMG observation

The Senate bill's seven-rate structure does not propose to alter current law as significantly as the four-rate structure proposed in the House bill.

For married taxpayers filing a joint return (or for a surviving spouse): The 10% rate would apply to all income in excess of the standard deduction (see discussion below) up to \$19,050; the 12% rate would apply to all income over \$19,050, up to \$77,400; the 22% rate would apply to all income over \$77,400, up to \$140,000; the 24% rate would apply to all income over \$140,000, up to \$320,000; the 32% rate would apply to all income over \$320,000, up to \$400,000; the 35% rate would apply to all income over \$400,000, up to \$1,000,000; the 38.5% rate would apply to all income over \$1,000,000.

For married taxpayers filing a separate return: The 10% rate would apply to all income in excess of the standard deduction up to \$9,525; the 12% rate would apply to all income over \$9,525, up to \$38,700; the 22% rate would apply to all income over \$38,700, up to \$70,000; the 24% rate would apply to all income over \$70,000, up to \$160,000; the 32% rate would apply to all income over \$160,000, up to \$200,000; the 35% rate would apply to all income over \$200,000, up to \$500,000; the 38.5% rate would apply to all income over \$500,000.

KPMG observation

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

Under the Senate bill, the marriage penalty would be eliminated for married individuals at all levels of income – unless subject to AMT (see discussion below).

For taxpayers filing as head of household: The 10% rate would apply to all income in excess of the standard deduction up to \$13,600; the 12% rate would apply to all income over \$13,600, up to \$51,800; the 22% rate would apply to all income over \$51,800, up to \$70,000; the 24% rate would apply to all income over \$70,000, up to \$160,000; the 32% rate would apply to all income over \$160,000, up to \$200,000; the 35% rate would apply to all income over \$200,000, up to \$500,000; the 38.5% rate would apply to all income over \$500,000.

KPMG observation

Absent the possible mitigating impact of the increased standard deduction and the increased child and dependent tax credits, the Senate bill would eliminate 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 Senate bill 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 all income in excess of the standard deduction up to \$9,525; the 12% rate would apply to all income over \$9,525, up to \$38,700; the 22% rate would apply to all income over \$38,700, up to \$70,000; the 24% rate would apply to all income over \$70,000, up to \$160,000; the 32% rate would apply to all income over \$160,000, up to \$200,000; the 35% rate would apply to all income over \$200,000, up to \$500,000; the 38.5% rate would apply to all income over \$500,000.

KPMG observation

Unlike the House bill, the Senate bill does not include a phase-out of the lowest rate (12% in the House bill) for high income taxpayers.

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 Senate bill 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 a 10-year period.

Treatment of business income of individuals

Deduction of 23% for certain passthrough income

The Senate bill includes a provision that generally would allow an individual taxpayer a deduction for 23% of the individual's domestic qualified business income from a partnership, S corporation, or sole proprietorship. However, the deduction generally would be limited to 50% of the sole proprietorship's W-2 wages or 50% of the taxpayer's allocable or pro rata share of W-2 wages of the partnership or S corporation. For this purpose, the taxpayer's "W-2 wages" would 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. The 50% of wages limitation would not apply in the case of a taxpayer with income of \$500,000 or less for married individuals filing jointly (\$250,000 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, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business the principal asset of which is the reputation or skill of one or more of its employees. However, the deduction may apply to

income from a specified service trade or business if the taxpayer's taxable income does not exceed \$500,000 (for married individuals filing jointly or \$250,000 for other individuals). Under the Senate bill, this benefit would be phased out over the next \$100,000 of taxable income for married individuals filing jointly (\$250,000 for other individuals).

Twenty-three percent (23%) 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 23% 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 Senate bill provides a similar deduction for specified agricultural or horticultural cooperatives.

The Senate bill specifically provides that the deduction is not available to any trust or estate.

The proposal would be effective for tax years beginning after December 31, 2017. However, the 23% deduction would expire after December 31, 2025.

Effective

The JCT's revenue tables indicate that the 23% deduction would decrease revenue by approximately \$476 billion over a 10-year period.

KPMG observation

The 23% deduction in the Senate bill is not in the House bill. However, the 23% deduction would effectively reduce the tax rate applicable to domestic qualified business income. The House bill attempts to accomplish a similar result through an actual reduction in the applicable tax rate to business income of individuals from partnerships, S corporations, and sole proprietorships. The tax rate on income to which the Ways and Means provision would apply would generally be 25% (although it could be as low as 9% in certain situations). Under the House bill, the new rate generally would apply to all net business income from passive business activities and to the "capital percentage" of net business income from active business activities. Net business income is generally defined to include any wages, guaranteed payments, or non-partner capacity payments. The Senate

bill also appears to relate solely to “domestic” qualified businesses, whereas the House bill does not appear to distinguish between foreign and domestic activities. Although the income of a trust or estate is generally computed in the same manner as an individual, the Senate bill does not apply to any trust or estate; on the other hand, the House bill does generally apply to such taxpayers.

If the House bill and the Senate bill applied to identical amounts of income from partnerships, S corporations, and sole proprietorships, then taxpayers would generally pay less tax under the House bill than under the Senate bill. In simplistic terms, under the House bill, an individual with \$100 of business income to which the 25% rate applied would pay just \$25 of tax on that income. If that same \$100 of income were qualified business income eligible for the 23% deduction in the Senate bill, then the net effect would be that the taxpayer would pay its ordinary tax rate on \$77 of income. If the taxpayer were in the highest rate bracket (which, under the Senate bill, would be 38.5%), the taxpayer would pay almost \$30 of tax on the same income. Thus, if the amount of income subject to the House bill and the Senate bill were identical, a taxpayer would pay almost \$5 more in tax on the same income under the Senate bill.

However, there may be significant differences in the amount of income subject to the 23% deduction and the 25% rate that might amplify the impact of this issue. Moreover, limiting the available deduction to 50% of a taxpayer’s wage income allocable to qualified business income would reduce the net impact of the deduction.

The definition of “W-2 wages” in the Senate bill 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. If wages (or their equivalents) paid to an owner of a business are intended to be included in W-2 wages, the definition of W-2 wages would need to be expanded to encompass wage-like payments made to sole proprietors or partners (which may receive guaranteed payments or non-partner capacity payments). If wages paid to an owner of a business are *not* intended to be included as W-2 wages, then legislative language may be required with regard to W-2 wages paid to S corporation shareholders.

The 23% deduction proposed in the Senate bill would not apply to any trust or estate. As the taxable income of trusts and estates is generally computed in the same manner as in the case of an individual, this disparate treatment would be unusual and would put trust and estate owners of passthrough entities at a disadvantage when compared to individual owners of passthrough entities. Many interests in family and other closely-held businesses are owned by trusts with a view to passing the business on to the next generation, or will be held for some period of time by the estates of the owners before being distributed to such heirs. For passthrough entities owned by trusts, the Senate approach could add to the choice of entity considerations favoring converting to a C corporation. In contrast to the Senate’s approach, the House bill’s reduced rates for

certain income from passthrough entities would generally apply to trusts and estates, in addition to individuals.

A modification made prior to the Senate bill's passage significantly increased the income limitation with respect to the 23% deduction relating to a specified service trade or business. This change significantly increased the number of taxpayers in a specified service trade or business that may take advantage of the deduction.

The inclusion of publicly traded partnership income came in on the Senate floor in a provision in the manager's amendment that would treat income of publicly traded partnerships similar to dividends from a real estate investment trust. Notably, 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, under the current language of the bill, it is unclear whether that would be the case if a taxpayer sells an interest in a non-publicly traded partnership.

The Senate bill directs the Treasury to provide regulations 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.

Perhaps most importantly, the 23% deduction in the Senate bill 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

The Senate bill includes provisions that would expand certain limitations on losses for non-corporate taxpayers. 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 Senate bill contains two provisions affecting the loss limitation rules. First, the Senate bill 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 Senate bill contains a significant change to the treatment of non-passive losses of taxpayers other than C corporations. Under the Senate bill, 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.

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

The JCT has estimated that the proposed changes to the loss limitation rules would increase revenue by approximately \$176 billion over a 10-year period.

KPMG observation

The Senate bill effectively would deny business deductions for taxpayers (other than C corporations) for any net business losses in excess of \$500,000 (or \$250,000 as

relevant). 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 Senate bill 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.

Filing status, standard deductions, and personal exemptions

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

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

The Senate bill 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.

Similar to the House bill, the Senate bill would significantly increase the standard deduction for all taxpayers for tax years beginning after December 31, 2017. Under current law, the standard deduction for 2018 is \$6,500 for a taxpayer filing as single or married filing separately, \$9,550 for a taxpayer filing as head of household, and \$13,000 for taxpayers filing as married filing jointly. Under the Senate bill, 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.

Unlike the House bill, the Senate bill would not repeal 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 Senate bill 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 \$737 billion over a 10-year period and the proposed repeal of deductions of personal exemptions (subject to a December 31, 2025 sunset) would increase revenues by approximately \$1.22 trillion over a 10-year period.

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 Senate bill. However, personal exemptions are subject to phase-outs under current law and the Senate bill proposes an expanded child tax credit (discussed below) that could provide a greater tax benefit compared with 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.

New indexing method

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

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

Chained CPI would generally result in smaller annual increases to indexed amounts and is estimated by JCT to increase revenues by approximately \$134 billion over a 10-year period.

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.

Tax rates on capital gains and dividends

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

The Senate bill also would leave in place the current 3.8% net investment income tax (consistent with the House bill).

Reform of the child tax and qualifying dependents credits

Through tax year 2024, the Senate bill would increase the child tax credit to \$2,000 per qualifying child from the current credit of \$1,000 per qualifying child, and would increase the age limit for a qualifying child by one year with the result that the credit can be claimed for any qualifying child under the age of 18. For tax year 2025, the age limit for a qualifying child would revert to less than 17 years of age, as under current law. The Senate bill would also provide a \$500 nonrefundable credit for qualifying dependents other than qualifying children.

KPMG observation

The House bill would provide a similar credit for qualifying dependents other than qualifying children. The \$300 credit proposed in the House bill would sunset in 2023, whereas the \$500 credit contained in the Senate bill would sunset in 2025. Additionally, the Senate bill does not include the temporary \$300 “family flexibility credit” proposed in the House bill.

Similar to current law, \$1,000 of the child tax credit would be refundable. The refundable portion would be indexed for inflation in future years. The income levels at which this credit is subject to phase-out would increase from \$110,000 to \$500,000 for joint filers, and from \$75,000 to \$500,000 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 Senate bill 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.

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 \$580 billion over a 10-year period and the SSN requirement (subject to a December 31, 2025 sunset) would increase revenues by approximately \$24 billion over a 10-year period.

Suspension of certain itemized deductions and income exclusions

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

Combined, the JCT estimates that the following provisions related to certain taxes, home equity debt, charitable contributions, casualty losses, tax preparation expenses, miscellaneous expenses, and the overall limitation on itemized deductions (all subject to a December 31, 2025 sunset) would increase revenue by approximately \$830 billion over 10 years.

KPMG observation

The Senate bill does not modify a number of itemized deductions and exclusions that were modified by the House bill such as contributions to medical savings accounts, alimony payments, adoption assistance programs and employer-provided dependent care assistance programs.

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

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

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

KPMG observation

An amendment approved by the Senate conforms the Senate bill to the House bill which would allow a deduction for up to \$10,000 (\$5,000 for a married taxpayer filing a separate return) in state and local real property taxes not paid or accrued in a trade or business. However, the House proposal is not subject to a sunset provision. Under the prior version of the Senate bill (as approved by the Senate Finance Committee), state and local real property taxes would be allowed as a deduction only when paid or accrued in carrying on a trade or business or an activity described in section 212 (relating to expenses for the production of income).

Modify deduction for home mortgage interest

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 Senate bill would suspend the deduction for interest on home equity indebtedness for tax years 2018 through 2025.

In contrast to the House bill, the Senate bill would not reduce the amount of debt that can be treated as acquisition indebtedness from the current level of \$1 million or modify the treatment of interest attributable to mortgages secured by a second home (e.g. vacation homes).

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

Increased limitation for certain charitable contributions

The Senate bill would increase the adjusted gross income limitation for charitable contributions of cash made by individuals to public charities and certain private foundations to 60% (from the current 50% limitation). This proposal would apply to contributions made in tax years beginning after December 31, 2017 and before January 1, 2026.

KPMG observation

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

The House bill includes a similar provision; however, it does not sunset in tax years beginning after December 31, 2025. In addition, the Senate bill does not mirror the House bill's proposal to adjust the charitable mileage rate for inflation.

Modify deduction for personal casualty and theft losses

The Senate bill would 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.

KPMG observation

The House bill would repeal the deduction for personal casualty and theft losses in all situations, with the exception of those incurred with respect to certain events specifically enumerated in the bill. Unlike the Senate bill, the House bill does not apply a sunset provision to this proposal.

Suspension of deduction for tax preparation expenses

The Senate bill would suspend the deduction for tax preparation expenses for years 2018 through 2025. The House bill would repeal the deduction.

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

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 Senate bill 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.

KPMG observation

The House bill would introduce new section 262A that would disallow deductions for expenses attributable to the trade or business of performing services as an employee, except for above-the-line deductions allowable in determining adjusted gross income.

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 Senate bill 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.

Temporary reduction in medical expense deduction floor

Under the Senate bill, 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. 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 estimates the provision would decrease revenue by approximately \$5 billion for tax years 2017 and 2018.

KPMG observation

The House bill would eliminate the itemized deduction for medical expenses for tax years beginning after December 31, 2017.

Modification of exclusion of gain from 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.

Similar to the House bill, the Senate bill would extend the length of time a taxpayer must own and use a residence to qualify for the exclusion from two of the previous five years to five of the previous eight years. In addition, the exclusion would be available only once every five years. The House bill, however, does not include the sunset provision applicable to the Senate proposals.

KPMG observation

The Senate bill does not include a provision similar to the House proposal that would subject the exclusion to phase-out for individuals whose average modified AGI over the year of sale and the two preceding tax years exceeds \$250,000 (or \$500,000 for joint filers).

The provision would be effective for sales and exchanges after 2017 (subject to a December 31, 2025 sunset) and is estimated by the JCT to increase revenues by approximately \$800 million over 10 years.

Suspension of exclusion for qualified moving expense reimbursements

Under current law, qualified moving expense reimbursements are excludable 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 Senate bill 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 estimates 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 Senate bill 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 House bill would generally repeal the deduction for moving expenses other than for members of the armed services.

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

The JCT estimates 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.

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 Senate bill 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.

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

KPMG observation

There is no similar provision in the House bill.

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

Modification to individual AMT

Unlike the House bill, the Senate bill does not repeal the alternative minimum tax (AMT) for individuals. Instead, the Senate bill temporarily increases the AMT exemption amounts and phase out thresholds for individuals.

For married taxpayers filing a joint return (or for a surviving spouse): The AMT exemption amount would be increased from \$78,750 to \$109,400. The phase out threshold would be increased from \$150,000 to \$208,400.

For married taxpayers filing a separate return: The AMT exemption amount would be increased from \$39,375 to \$54,700. The phase out threshold would be increased from \$75,000 to \$104,200.

For all other individual taxpayers: The exemption amount would be increased from \$50,600 to \$70,300. The phase out threshold would be increased from \$112,500 to \$156,300.

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 \$636 billion over a 10-year period.

Estate, gift and generation-skipping transfer tax

The Senate bill would double the basic exclusion amount from \$5,000,000 to \$10,000,000 (as indexed for inflation for years after 2011) per individual. This enhanced exclusion would apply to estates of decedents dying, generation-skipping transfers, and gifts made after 2017, but would sunset after December 31, 2025.

Unlike the House bill, the Senate bill would not provide for future elimination of the estate and generation-skipping transfer taxes.

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

Other

Exclude income from the discharge of student debt

Similar to the House bill, the Senate bill 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. The Senate version of this exclusion would sunset after 2025.

The JCT estimates that the proposal would decrease revenues by approximately \$100 million over a 10-year period.

Modification of the deduction for certain educator expenses

Under current law, certain expenses of eligible educators may be taken as a deduction in determining adjusted gross income. The deduction may not exceed \$250 (for 2018) in expenses, indexed for inflation.

The Senate bill would increase the deduction limit to \$500 for tax years beginning after December 31, 2017. The increased deduction would sunset after 2025.

The JCT estimates that the proposal would decrease revenues by approximately \$1.5 billion through 2025.

KPMG observation

The House bill takes a different approach to the provision – it would repeal the deduction for educator expenses.

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

The Senate bill 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.

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

KPMG observation

A similar provision is not in the House bill.

Rollovers between qualified tuition programs and qualified ABLE programs

The Senate bill would provide that amounts from qualified tuition programs under section 529 could be rollover 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.

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

KPMG observation

The House bill contains a similar provision.

Relief for 2016 disaster areas

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

The Senate bill 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 Senate bill 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.

The proposal would be effective on the date of enactment.

JCT has estimated the proposal would decrease revenues by approximately \$5 billion over 10 years.

KPMG observation

As initially drafted, this provision applied to the Mississippi River Delta Flood disaster area but was expanded to include relief for any area for which a disaster was declared by the President during 2016.

Exclusion from gross income of certain amounts received by wrongfully incarcerated individuals

Under current law, a wrongfully incarcerated individual is not required to include in gross income any civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal matter) relating to the wrongful incarceration.

The Senate bill would extend the waiver on the statute of limitations for filing a claim for credit or refund resulting from the exclusion for an additional year. Under the proposal, the claim for credit or refund must be filed before December 18, 2017.

The provision would be effective on the date of enactment.

The JCT estimates the proposal would decrease revenues by less than \$50 million over a 10-year period.

KPMG observation

The House bill does not contain a similar provision.

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

The Senate bill 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 lose less than \$50 million over a 10-year period.

KPMG observation

There is no similar provision in the House bill.

Affordable Care Act—Healthcare

The Senate bill 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 Senate bill, 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 proposal, 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 estimates that reducing the individual shared responsibility payment to zero would increase revenues by approximately \$318.4 billion over 10 years.

KPMG observation

The House bill does not contain a similar provision. This proposal, because of its significance in the Affordable Care Act, is somewhat controversial and could impact efforts to build consensus between the House and the Senate in conference. It has been reported that Senator Collins (R-ME) supported the Senate bill with the understanding that the Senate would bring to the floor a bipartisan bill intended to stabilize the individual health insurance market, but such legislation might be met with objections from those who do not favor funding cost-sharing reductions payable to health insurers.

Business—In general

Generally applicable C corporation provisions

The Senate bill includes a permanent reduction in the regular tax corporate rate and the dividends received deduction, as well as changes to the net operating loss rules.

Retention of AMT

The Senate bill would not repeal the corporate AMT. This contrasts with the House bill and the Senate Finance Committee bill, both of which would have repealed the corporate AMT.

KPMG observation

The retention of the corporate AMT (at its current 20% rate) could have significant and potentially unanticipated consequences when combined with the reduction in the corporate regular tax rate and the modification of the NOL provisions, as described in further detail below. Also, because the House bill and the Finance Committee bill would have repealed the corporate AMT, there was no need to draft legislative language to coordinate other provisions in those bills with the corporate AMT when those bills were being put together. The AMT was added back to the reconciliation bill late in the Senate floor process. This increases the risk that there may not have been sufficient time to address ancillary issues and draft appropriate coordinating language.

In addition, the retention of the corporate AMT could have a significant effect on corporations that have often been subject to the corporate AMT or that have significant inventories of minimum tax credit carryovers. First, the retention of corporate AMT could eliminate much of the benefit the corporate rate reduction otherwise might have provided to taxpayers with this profile. Second, corporate taxpayers with substantial minimum tax credit carryovers might be unable to utilize these credits, given the removal of the accelerated and enhanced credit utilization provisions that had been in earlier versions of the Senate bill combined with the proposed alignment of the regular tax and corporate AMT rates. These taxpayers could face the prospect of possibly having to reevaluate valuation allowances for these items for financial statement purposes.

Other provisions not included in House bill

The Senate bill also does not contain any provision corresponding to the provision in the House bill that would repeal Code sections 118 and 108(e)(6), which currently provides that a corporation does not recognize income on its receipt of a capital contribution.

KPMG observation

The capital contribution repeal provision in the House bill is not limited to non-shareholder contributions. The House bill provision raises a number of apparently unintended and unexpected consequences, and could have a particularly destabilizing effect on workouts and efforts to rehabilitate troubled companies.

Additionally, the Senate bill does not include the provision in the House bill that would repeal a taxpayer's ability 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 earlier Finance Committee bill included a 0% dividends paid deduction and certain additional reporting requirements for dividend payments. These items were removed in the manager’s amendment that was adopted by the full Senate, and are not in the Senate bill.

KPMG observation

Although not clear, there was speculation that the reference to a 0% dividends-paid deduction in the Senate Finance Committee bill might have been intended to facilitate, from a procedural perspective, the possible addition of a dividends paid deduction in a conference committee bill (assuming a formal conference is used to reconcile differences between House and Senate bills). A dividends paid deduction is one of the potential ways to implement a “corporate integration” mechanism (i.e., mitigating the effect of taxing corporate income at the entity level when recognized and again at the shareholder level when distributed). The deletion of the 0% dividends paid deduction provision might have been deleted due to procedural considerations associated with the use of the budget reconciliation process. (See discussion of budget reconciliation in the introduction.)

Reductions in corporate tax rate reduction and dividends received deduction

The Senate bill would eliminate the progressive corporate tax rate structure, currently imposing a maximum U.S. corporate tax rate of 35%, and replace it with a flat tax rate of 20% (and make various corresponding changes throughout the Code). Further, it would eliminate the special U.S. corporate tax rate on personal service corporations (PSCs). The new rates would be effective for tax years beginning after 2018. In addition, the Senate bill 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 2018.

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

The JCT estimates that the rate reduction would decrease revenues by approximately \$1.329 trillion over 10 years, while the dividends received deduction haircut would raise revenues by approximately \$5.1 billion over the same period.

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 Senate bill, this provision would lower tax rates in exchange for the elimination of certain tax benefits. The Senate bill would apply the rate for tax years beginning after 2018, one year later than the House bill, presumably due to revenue considerations. At the same time, various other items in the Senate bill, such as the temporary expensing provisions, would be effective with respect to property placed in service as early as September 27, 2017. This may create opportunities for tax rate arbitrage, an issue the drafters are surely aware of given some of the commentary on this issue that was first presented in the Senate Finance Committee Chairman's mark.

As noted above, the Senate bill retains the current corporate AMT. The corporate AMT is calculated as the excess of the tentative minimum tax (a tax imposed at a flat 20% rate on taxable income as modified for AMT purposes) over the corporation's regular tax liability. Accordingly, the reduction in the regular tax rate would significantly increase the number of corporations subject to the AMT (which applies to some corporations even at the current 35% maximum rate), and may make the AMT the more prevalent corporate tax regime. Additionally, the retention of the AMT would greatly limit the ability of many corporations to utilize certain credits – for example, the new markets tax credit and the research credit for taxpayers other than eligible small businesses. Given that the House bill and the Finance Committee bill would repeal the AMT, it was not expected that the Senate bill would instead supercharge the AMT by increasing the number of affected corporations. This would represent a significant change to the corporate tax system, likely with unanticipated consequences that may not be appreciated until well after enactment. 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, 2018).

The corporate rate reduction proposed by the Senate bill could affect choice-of-entity decisions for some business entities. The proposed flat 20% 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 23% deduction discussed elsewhere in this document. Also as described elsewhere in this document, certain income from business activities of passthrough entities would still be taxed at the individual rates, for which the Senate bill would provide a maximum tax rate of 38.5%.

The Senate bill does not distinguish between investment income and business income earned by corporations for purposes of applying the 20% tax rate. In addition, even though Chairman Hatch had been exploring integrating the corporate and individual income taxes, the Senate bill does not contain a corporate integration proposal, meaning that corporate income subject to a 20% rate could be subject to a further tax in the hands of shareholders when distributed to them as dividends. Regardless, taxpayers should

consider the impact of other changes to the Code proposed under the Senate bill (as well as current law provisions such as the accumulated earnings and personal holding company taxes), and choice-of-entity decisions still would depend on individual facts and circumstances.

The Senate bill 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. The Senate bill thus differs from the House bill, which would reduce the tax rate on PSCs to 25%.

The Senate bill's proposed flat 20% corporate tax rate matches the 20% rate in the House bill.

Modify net operating loss (NOL) deduction

The Senate bill would limit the NOL deduction for a given year to 90% of taxable income, effective with respect to losses arising in tax years beginning after 2017. This limitation is similar to the current limitation of NOLs in the corporate AMT regime. The Senate bill would further limit the NOL deduction with respect to post-2017 NOLs to 80% of taxable income in tax years beginning after 2022.

The Senate bill also would repeal carrybacks of post-2017 NOLs, although it also would permit a new two-year carryback for certain farming losses, and it would retain present law for NOLs of property and casualty insurance companies. Current law generally provides a two-year carryback and twenty-year carry forward 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 Senate bill would provide for the indefinite carryforward of a post-2017 NOL as opposed to the current 20-year carryforward. Unlike the House bill, the Senate bill would not provide for an annual increase of NOL carryovers by an interest factor.

The JCT has estimated that the proposal would increase revenue by approximately \$157.8 billion over 10 years.

KPMG observation

The Senate bill does not appear to limit the three-year capital loss carryback allowed for corporations or impose a limitation on the utilization of capital loss carryovers.

The Senate bill 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 90%/80% limitation.

In the House bill and the Finance Committee bill, the 90% limitation appeared to represent the preservation of an aspect of the to-be repealed corporate AMT regime. However, as the Senate bill would retain the corporate AMT regime and its 90% limitation on NOL deductions, arguably the imposition of a similar 90% limitation for regular tax purposes is redundant and potentially unnecessary. Further, the Senate bill's imposition of a 80% limitation for regular tax purposes for tax years beginning after 2022, which would be more restrictive than the 90% limitation under the AMT, would add further complexity and could potentially push certain taxpayers that had been subject to the AMT as a result of the lower corporate tax rates back into the regular tax regime.

The regular tax 90% 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 90% 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 90% 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.

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 Senate bill differs from the House bill in several ways: (1) the House bill applies the 90% limit to all NOLs carryovers after December 31, 2017 while the Senate bill would apply the limit to NOLs arising after that date; (2) the House bill does not contain the Senate bill's post-2022 80% limitation; (3) the House bill would apply a one-year carryback for certain casualty losses for small businesses and farming businesses while the Senate bill would permit a two-year carryback for certain farming losses and would preserve the present law rules for NOLs of property and casualty insurance companies; and (4) the House bill provides a formula to increase NOLs by an interest factor over time, while the Senate bill does not.

Cost recovery

Modification of rules for expensing depreciable business assets

Under the Senate bill, 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 the 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 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 bill would adjust this limitation annually for inflation.

In addition, the bill would expand the availability of the expensing election to depreciable 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 tax years beginning after 2017.

The JCT estimated that the provision would decrease revenues by approximately \$24 billion over 10 years.

KPMG observation

The bill would provide a significantly less generous expansion of the dollar limit and phase-out amount than would be provided by the House bill, which would allow a \$5 million dollar limit and a \$20 million phase-out amount. This is counterbalanced by adding more property to the definition of property eligible for the election and by making the expansion permanent. 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 Senate bill would extend and modify the additional first-year depreciation deduction (“bonus depreciation”).

Under the Senate bill, generally, the bonus depreciation percentage would be increased from 50% to 100% for property 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.

The Senate bill would change the definition of qualified property (i.e., property eligible for bonus depreciation) by excluding qualified improvement property, which is generally defined as certain interior improvements to nonresidential real property that are placed in service after the building's original placed in service date. In addition, the bill 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 bill, the Senate bill 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 bill 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).

In addition, the Senate bill 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 bill, 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 Senate bill would permit the taxpayer to elect to apply a 50% allowance in lieu of 100%.

The JCT estimated that the provision in the Finance Committee bill expanding qualified property to include qualified film, television and live theatrical productions would decrease revenues by \$1.7 billion over 10 years. The JCT estimated that all other aspects of the Finance Committee bill (with the December 31, 2027, sunset date) would decrease revenues by approximately \$61.3 billion over 10 years, but then increased its estimate of the extension and phase-down of bonus depreciation by \$34 billion in its estimate of the manager's amendment that was approved on the Senate floor.

KPMG observation

The Senate bill differs significantly from the House bill by not expanding the availability of bonus depreciation to non-original use property, by excluding qualified improvement property, and by not excluding property used in a real property trade or business.

Modifications to depreciation limitations on luxury automobiles and personal use property

The Senate bill 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 Senate bill 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 Senate bill would repeal this requirement for property placed in service after 2017.

The Senate bill 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 Senate bill would shorten to 25 years the depreciation recovery period for residential rental property and nonresidential real property from 27.5 years and 39 years, respectively. The ADS recovery period for residential rental property would be shortened from 40 years to 30 years.

The Senate bill also would eliminate the special 15-year recovery period for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property; instead, it would provide a 10-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, and a 25-year recovery period for restaurant building property (i.e., restaurant property that does not meet the definition of qualified improvement property).

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

The Senate bill 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 30 years 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 \$11.5 billion over 10 years.

KPMG observation

As described above, the Senate bill 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, 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.

Requirement to capitalize section 174 research and experimental expenditures

Under the Senate bill, amounts defined as research or experimental (R&E) under section 174 paid or incurred in tax years *beginning after December 31, 2025* would be required to 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 research or experimental 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 required to 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 research or experimental 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 apply on a cutoff basis to R&E expenditures paid or incurred in tax years beginning after December 31, 2025 (hence there is no adjustment under section 481(a) for R&E expenditures paid or incurred in tax years beginning before January 1, 2026).

The JCT has estimated that this provision would raise approximately \$62.1 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). Reg. section 1.174-2 provides a general definition of research and experimental 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. There are also a number of procedural issues concerning tax accounting method changes for section 174 and software development expenses that would need to be resolved under the revised statute.

Expensing certain citrus replanting costs

The Senate bill 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.

KPMG observation

This provision is not in the House bill.

Business-related deductions, exclusions, etc.

Limitation on the deduction of net business interest expense

The Senate bill would amend section 163(j) to disallow a deduction for net business interest expense of any taxpayer in excess of 30% of a business's adjusted taxable income plus floor plan financing interest. 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 \$15 million under section 13102 of the Senate Bill) for any tax year.

For this purpose, 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 23% deduction for certain passthrough income, and (4) the amount of any net operating loss deduction. The trade or business of performing services as an employee would not be treated as a trade or business for purposes of the limitation. 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 financing the acquisition of motor vehicles (including boats and farm machinery or equipment) held for sale or lease.

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 file a consolidated return, it applies at the consolidated tax return filing level. 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.

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 subject to certain cost recovery requirements. In addition, the limitation would not apply to certain regulated public utilities and electric cooperatives.

The proposed legislation 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 explanation posted on the Budget Committee website 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 proposed legislation 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 explanation 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 * \$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 net interest deduction limitation would not apply to certain regulated public utilities or any taxpayer with average gross receipts of \$15 million or less. Also, at the election of a

taxpayer, the provision would not apply to any farming business or any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. A real property trade or business electing out of the limitation on the deduction for interest would have to use the alternative depreciation system (ADS) to depreciate its nonresidential real property, residential rental property, and qualified improvement property.

The proposal coordinates with the rules limiting interest deductions of members of worldwide affiliated groups in new proposed section 163(n). The Senate bill would disallow interest deductions pursuant to whichever provision would deny a greater amount of interest deductions.

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

The JCT estimates the provision would increase revenues by approximately \$307.5 billion over 10 years, after accounting for the exception for floor plan financing.

KPMG observation

The House bill contains a similar proposal, but there are several notable differences. For example, unlike the House bill, the Senate bill would determine adjusted taxable income by including certain deductions allocable to the trade or business such as depreciation, amortization, and depletion. In addition, any disallowed interest would be carried forward indefinitely (as opposed to the 5-year carryover in the House bill). The Senate bill would permit a real property trade or business to elect out of the net interest disallowance regime but it would be required to use ADS to depreciate any nonresidential real property, residential real property, and qualified improvement property. The House bill contains a similar carve out for real property trades or businesses, but is mandatory rather than elective.

Under the Senate bill, adjusted taxable income would be determined without regard to the 23% deduction for certain passthrough income. While this provision was not in the House bill, the 23% deduction was also not in the House bill. Accordingly, this definitional revision represents a conforming change that more closely aligns the Senate bill with the House bill. The Senate bill is otherwise similar to the House bill in most respects.

Under the Senate bill, 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 House bill would exclude a partner's distributive share of a partnership's non-separately stated taxable income or loss (but not its share of separately stated income or loss, such as section 1231 gain or loss). The Senate bill excludes a partner's distributive share of all partnership items.

Unlike the House bill, the Senate bill 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. The Senate bill 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.

It is unclear how the proposed rule interacts with other interest disallowance and deferral provisions other than the limitation on deduction of interest by domestic corporations which are members of worldwide affiliated groups with excess domestic indebtedness. Because business interest is defined as any interest paid or accrued, it is unclear if the business interest amount would be computed taking into account interest the deduction for which is deferred or disallowed under some other provision of the Code. For example, if a corporation issues an applicable high yield discount obligation, the deduction for some or all of the original issue discount may be disallowed or deferred under section 163(e)(5). Other provisions that limit the deduction for interest paid or accrued on certain debt instruments include (but are not limited to) sections 163(f), 163(l), 163(m), and 279.

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

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

Repeal deduction for income attributable to domestic production activities

Under section 13305 of the Senate bill, the deduction for domestic production activities provided under section 199 would be repealed for tax years beginning after December 31, 2017 for taxpayers other than C corporations. Section 199 would be repealed for C Corporations in years beginning after December 31, 2018.

JCT has estimated that repealing section 199 would increase revenues by approximately \$84.4 billion from 2018-2027.

KPMG observation

The original intent of the section 199 deduction was to provide a targeted corporate rate reduction that would allow U.S. companies to compete against international tax systems, while also drawing international companies to the United States and its tax structure. While this provision would eliminate the rate reduction created by section 199, a separate provision of the Senate bill proposes a much larger overall corporate rate reduction, as discussed above.

The House bill also included a provision to repeal the deduction for income attributable to domestic production activities. However, the effective date of the repeal under that bill is tax years beginning after December 31, 2017 for all entity types. A separate provision of the House bill extended the section 199 deduction for income attributable to qualifying activities performed in Puerto Rico from tax years beginning before January 1, 2017 to tax years before January 1, 2018 (a one-year extension). The Senate bill does not include any specific provisions related to Puerto Rico.

Limitation of deduction by employers of expenses for certain fringe benefits

The Senate bill proposes to repeal deductions for entertainment, amusement, and recreation when directly related to the conduct of a taxpayer's trade or business. The Senate bill 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 Senate bill 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.

However, the bill would eliminate the deduction for meals provided to employees for the convenience of the employer on the business premise, or through an employer-operated eating facility that qualifies as a de minimis fringe benefit. The Senate bill provides that this rule would not apply, however, until tax years beginning after 2025.

The Senate bill 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).

JCT estimates this provision would increase revenue over 10 years by approximately \$22.9 billion for meals and entertainment expenses and \$17.4 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.

There is a similar provision in the House bill.

Modification of rules for length of service award plans

The Senate bill provides 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.

Limits on like-kind exchange rules

Section 13303 of the Senate Bill 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 are proposed to apply to exchanges completed after December 31, 2017. A transition rule is included under which the new section 1031 rules would not apply to any exchange in which the taxpayer disposed of relinquished property, or received replacement property, on or before December 31, 2017.

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

KPMG observation

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

Economic interests in unsevered oil and gas, minerals and timber are real property that would remain eligible for like kind exchange treatment (e.g., poolings and unitizations). In addition, under the Senate bill, 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.

An earlier version of the Senate bill would have retained an exception 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. Consistent with the House bill, the Senate bill would eliminate that special rule. Accordingly, under the Senate Bill, stock in a mutual ditch, reservoir, or irrigation company may be considered property ineligible for deferral under section 1031.

Accounting methods

Certain special rules for tax year of inclusion

Under section 13221 of the Senate bill, accrual method taxpayers would be required 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, section 13221 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 proposal 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 includable 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 section 13221.

Other than the OID provisions, section 13221 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.

JCT estimates indicate that the special rules for tax year of inclusion would increase revenues by approximately \$13 billion from 2018-2027 (taking into account changes made on the Senate floor).

KPMG observation

The special rules for tax year of inclusion provided for in the Senate bill will 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.

The House bill does not include any proposals similar to the special rules for tax year of inclusion provided for in the Senate bill.

Small business accounting

The Senate bill 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.

JCT estimates that the combined effect of these provisions would be a reduction in revenues of approximately \$27.6 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 UNICAP rules and the percentage of completion method.

The House bill also includes similar provisions but proposes a higher threshold of \$25 million for the gross receipts test compared to the proposed \$15 million threshold provided by the Senate bill (described below).

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 its gross receipts do not exceed \$1 million (\$25 million for certain family farm corporations).

Under the Senate bill, the threshold under the three-year average annual gross receipts test would be increased to \$15 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 \$25 million dollar gross receipts test threshold for family farming corporations would remain (and be indexed for inflation for tax years beginning after 2018), but the three-year average gross receipts test would apply. 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 Senate bill would allow additional businesses with inventories to use the cash method by increasing this threshold to \$15 million. Under the provision, businesses with average annual gross receipts of \$15 million or less would be permitted to use the cash method of accounting even if the business has inventories. Under the provision, a business with inventories that otherwise qualifies for and uses the cash method of accounting would be able to treat inventory as non- incidental materials and supplies or 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 Senate bill, producers or resellers with average annual gross receipts for the prior three tax years of \$15 million or less would be fully exempt from the UNICAP rules. This exemption would apply to real and personal property for both resellers and manufacturers. 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 Senate bill, the \$10 million average annual gross receipts exception to the percentage-of-completion method would be increased to \$15 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

Low-income housing credit

Amendments approved on the Senate floor removed all of the low-income housing credit provisions that had been included in the Finance Committee bill and added two new amendments.

General public use requirement

The Senate bill would clarify that a LIHTC project does not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants who are veterans of the Armed Forces.

This provision would be effective for buildings placed in service before, on, or after the date of the enactment of this Act.

Increase in LIHTC for high cost areas

The Senate bill would allow a building which is located in a rural area (as defined in section 520 of the Housing Act of 1949) to be treated in the same manner as a new building located in a difficult development area, but would reduce the eligible basis increase to 125% from 130% for all building costs for new construction and qualified rehabilitations expenditures in difficult development areas and qualified census tracts.

This provisions would apply to buildings placed in service after the date of the enactment of this Act.

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

The Senate bill would limit the "orphan drug credit" to 27.50% of qualified clinical testing expenses for the tax year.

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 \$29.7 billion over 10 years. A repeal under the House bill would increase revenue by \$54 billion over 10 years.

KPMG observation

Unlike the House bill (section 3401) that proposes to repeal the orphan drug credit, the Senate bill would amend the credit by reducing the credit rate to 27.50%. The manager's amendment approved on the Senate floor removed the public disclosure requirement that had been included in the Finance Committee bill.

Modification of rehabilitation credit

The Senate bill 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, as added in the manager's amendment, the "historic" credit 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.

A transition rule provides that, for buildings owned or leased at all times after 2017, the 24-month period for making qualified rehabilitation expenditures begins no later than 180 days after the date of enactment, and the modification is effective for such expenditures paid or incurred after the end of the tax year in which such 24-month period ends.

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

KPMG observation

The House bill would repeal the rehabilitation credit for both pre-1936 buildings and historic buildings.

Employer credit for paid family and medical leave

The Senate bill 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 Senate Bill would also add a provision that 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.

KPMG observation

The Senate bill would create a new general business credit for eligible employers. The proposal provides that vacation, personal, or other medical or sick leave, is not eligible for this credit.

Miscellaneous business provisions

Qualified opportunity zones

The Senate bill 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 is 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.

Governors may submit nominations for a limited number of qualified opportunity zones to the Secretary for certification and designation and must consider areas that: (1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity; (2) have demonstrated success in geographically targeted development programs such as promise zones, the new

markets tax credit, empowerment zones, and renewal communities; and (3) have recently experienced significant layoffs due to business closures or relocations.

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

KPMG observation

The amendments made on the Senate floor to the Finance Committee bill removed a provision that would have deemed a population census tract to be a qualified opportunity zone if the Secretary or Governor failed to make certain required designations or nominations; removed detailed guidance to governors when considering nominations for qualified opportunity zones; and removed certain reporting requirements by the Secretary to Congress regarding opportunity zone incentives.

Alaskan Native Corporation payments and contributions to settlement trusts

The Senate bill includes a proposal that 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 proposal 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 Senate bill 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.

KPMG observation

The first, second and third proposed changes were in the Finance Committee bill and the Senate bill. As a result of the manager's amendment on the Senate floor, the proposal in the Finance Committee bill that would have permitted the amendment of Settlement

Trusts agreements to allow such trusts to make an election to defer income recognition was removed from the bill. Also struck was a proposal which would have provided that any ambiguities in the proposal text would be resolved in favor of ANCs attempting to exclude income or claim a deduction thereunder. None of the proposals are included in the House bill.

The explanation of these proposals 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

The Senate bill 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 Senate bill 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.

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. Section 13307 of the Senate bill 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 after the date of enactment.

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

KPMG observation

A similar provision is not in the House bill.

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 Senate bill would further deny any otherwise deductible amounts paid or incurred to or at the direction of a governmental or specific nongovernmental 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. Such exceptions would not apply to reimbursement of government investigative or litigation costs.

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

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

KPMG observation

The provision in the Senate bill would expand the definition of non-deductible fines and penalties to include certain payments for violations not made directly to the government. This provision is described as aiming to protect taxpayers, foster corporate accountability, and discourage future fraud and abuse. The House bill does not include any specific provisions related to the deductibility of fines and penalties.

Repeal deduction for local lobbying activities

Similar to the House bill, the Senate bill 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 \$600 million over a 10-year period.

KPMG observation

Only expenses associated with influencing legislation before local government bodies would be disallowed under both the Senate bill and the House bill. Many lobbying expenses relate to currently non-deductible grassroots lobbying campaigns. 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.

Compensation

The initial mark had included a provision changing the treatment of nonqualified deferred compensation. This provision was stricken from the bill during the Finance Committee's markup.

Treatment of qualified equity grants

The Senate bill 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. 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 at any time during the last 10 years
- An employee who 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 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.

The Senate bill 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.

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

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

Modification of limitation on excessive employee remuneration

The Senate bill would repeal the exceptions to the \$1 million deduction limitation for commissions and performance-based compensation. The bill would clarify that the definition of "covered employee" includes the principal executive officer, principal financial officer, and the three other highest paid employees. The bill 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 after death. Further, the bill would expand the definition of a "publicly held corporation" to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs. The definition may include some corporations that are not publicly traded, such as large private C or S corporations.

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

JCT estimated the provision would increase revenues by approximately \$6.9 billion over 10 years.

KPMG observation

The House bill includes a similar proposal, but does not include the transition rule in the Senate bill.

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 transition rule would apply to existing arrangements that are not fully vested or how the deduction limitation would apply following a corporate transaction (acquisition, merger, etc.).

Excise tax on excess tax-exempt organization executive compensation

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

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

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

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

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

KPMG observation

The Senate bill provides rules for tax-exempt entities that are similar to section 162(m) limits on the deductibility of compensation paid by publicly traded corporations. However, the Senate bill 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 Senate bill 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 proposed legislation related to “excess parachute payments” relies upon section 280G guidance for determining the “base amount” calculation.

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

The proposal would add an additional layer of complexity to the rules governing compensation paid by tax-exempt organizations. Currently, sections 4941 and 4958 impose excise taxes on the recipients of unreasonable or excess compensation paid by certain tax-exempt organizations. In addition, the inurement prohibition that applies to most tax-exempt organizations, 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.

The House bill includes the same provision.

Retirement savings

The Senate bill does not include some retirement savings provisions that were in the Finance Committee bill, including provisions requiring conformity for contribution limits among various retirement plans and holding individuals harmless on improper levies on retirement plans in certain cases.

Repeal of special rule permitting recharacterization of IRA contributions

The Senate bill would repeal the special rule that allows IRA contributions to one type of IRA to be recharacterized as a contribution to the other type of 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. 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.

KPMG observation

The House bill includes a similar (but not identical) provision. The House bill provision is more expansive.

Extended rollover period for the rollover of plan loan offset amounts

The Senate bill 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 a separation from service.

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

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

KPMG observation

The House bill includes a similar provision.

Passthrough entities

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

The Senate bill proposes to treat gain or loss on the 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 an interest, directly or indirectly, in the partnership would have had effectively connected gain or loss had the partnership sold its underlying assets.

In 1991, the IRS issued Rev. Rul. 91-32,³ 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 the sale of the underlying assets by the partnership would have resulted in effectively connected income. Earlier this year, the Tax Court refused to follow the revenue ruling in

³ 1991-1 C.B. 107.

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).⁴

The Senate bill would adopt a look-through rule 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 or exchange 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 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. The provision applies to gain or loss realized and, under appropriate regulations, to sales or exchanges from which gain or loss is not realized.

The Senate bill 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 Senate bill would impose an obligation on the partnership to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold, plus interest.

The Senate bill gives the Service authority to prescribe a reduced amount of withholding in situations where it determines that such reduced amount shall 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 changes would apply to sales or exchanges on or after November 27, 2017.

KPMG observation

This provision was not contained in the House bill. Much like the rules under section

⁴ *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 2017).

897(g), it appears to apply to transactions that otherwise would be subject to a nonrecognition provision. It also authorizes regulations that would cause the recognition of effectively connected gain or loss on the sale or exchange of a partnership interest even when no overall gain or loss is realized. These two provisions of the bill are oddly worded and, when read together, raise the question of the ultimate intent of the provision. It is possible that the bill is intended to apply only to gain or loss realized in a recognition exchange, unless and until the Service provides regulations otherwise with respect to nonrecognition exchanges. Nevertheless, as currently drafted, it appears that the substantive tax applies to gain or loss realized in a nonrecognition exchange, unless and until the Service provides otherwise regulations.

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 withholding provision imposed on transferees applies to transfers of partnership interests where a foreign partner's gain on the disposition of the interest would be effectively connected gain. It also appears that the withholding provisions would apply to nonrecognition exchanges, although it is not clear whether this was intended in the absence of regulations addressing such exchanges. Furthermore, the withholding provisions would apply to transfers that are made on or after November 27, 2017. This retroactive withholding obligation is particularly significant given the potentially broad scope of the substantive taxation and the limited exceptions from withholding, as noted below.

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. 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. The IRS is given latitude to provide for reduced withholding in appropriate circumstances. Without additional exceptions or coordination, duplicative or over-withholding could result.

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 Senate bill does not indicate the applicable rate of interest. This puts an onus on the partnership to determine whether there was sufficient withholding, and in some cases can raise questions as to what the amount

realized on which withholding should have been done was (in cases of nonrecognition transfers, for example).

Finally, 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 Senate bill does not define “nonseparately stated items.” 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. If the intent of the provision is to use the sharing ratios for operating income, 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.

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

The Senate bill 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 was 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 Senate bill 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 proposed to be added looks 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

If enacted, the provision in the Senate bill would 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.

This provision is not in the House bill.

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

The Senate bill provides that a partner's distributive share of a partnership's charitable contributions and foreign taxes paid or accrued is 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 loss 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 explanation of the Senate bill 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 states that the exclusion

of such contributions (and foreign taxes) from the section 704(d) limitation is a flaw in the rule's operation.

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.

The explanation notes that the proposed modification both furthers the interests of accurate income measurement and provides parity between partners in partnerships and S corporation shareholders.

This provision is not in the House bill.

Short-term capital gain with respect to applicable partnership interests

Section 13310 of the Senate bill would add to the Code a new section 1061 addressing the taxation of "applicable partnership interests." This provision is nearly identical to the applicable partnership interest provision contained in the House 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 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 bill take a different approach than the House bill regarding the interaction of section 83 and section 1061. Under the House bill, section 83 would be amended such that it would not apply to the transfer of an applicable partnership interest to which section 1061 applies. The Senate bill merely provides that short-term capital gain treatment will 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 \$1.2 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.

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. Similarly, the 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 were significantly stricter and arguably more clearly defined.

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 implications of the bill language indicating that short-term capital gain treatment will result “notwithstanding section 83 or any election in effect under section 83(b)” are unclear. This language may be intended to indicate that, as with the House bill, section 1061 is to apply to the exclusion of section 83 with respect to an applicable partnership interest. The bill language, however, is different, and the placement of the language implies a potentially narrower scope in providing only that section 83 does not override the recast to short-term capital gain for capital assets held for three years or less. In any event, the bill does not make clear how disregarding section 83 and section 83(b) elections for the stated purpose would otherwise impact the application of section 83 with respect to applicable partnership interests.

Provisions applicable to “eligible terminated S corporations”

The Senate bill contains two generally favorable provisions applicable to “eligible terminated S corporations”; both provisions are also in the House bill. The provisions appear to be based on an expectation that many S corporations may revoke their S corporation status if tax reform based on the House or Senate bill is enacted.

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 the bill’s 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 of the Senate bill relates to accounting method changes required as a result of an S corporation’s conversion to a C corporation. Specifically, the Senate bill provides that, in the case of an eligible terminated S corporation, any increase in tax by reason of a section 481 adjustment arising from a 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 Senate bill 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.

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 may allow the corporation to avoid the resulting strain on its liquidity.

Expansion of qualifying beneficiaries of electing small business trust

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.

The Senate bill would allow nonresident alien individual to be a potential current beneficiary of an ESBT. The proposal would be effective on January 1, 2018.

KPMG observation

The Senate bill would expand the number of corporations that may 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, the proposed change is included as part of a bill that, if enacted, may make operating a business as an S corporation less desirable (and thus may only affect a limited number of corporations).

Charitable contribution deduction for electing small business trusts

As noted above, an ESBT may be a shareholder of an S corporation. If so, the 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 from gross income (without limitation) for amounts 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 Senate bill 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 proposal would apply to tax years beginning after December 31, 2017.

Other proposals relevant to passthrough entities

See discussion of "treatment of business income of individuals" for provisions relating to (1) a deduction for certain passthrough income of owners who are individuals and (2) a limitation on losses for taxpayers other than corporations.

The House bill provided for the repeal of technical terminations of partnerships. The Senate bill does not contain a similar provision.

Banks and financial institutions

Deduction limits for FDIC premiums

The Senate bill would amend 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 estimates the limitation on deduction for FDIC premiums would increase revenues by approximately \$14.5 billion over 10 years.

KPMG observation

A similar provision is in the House bill.

Repeal of advance refunding bonds

The Senate bill 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 estimates the repeal of advance refunding bonds would increase revenues by approximately \$16.8 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.

An identical provision is in the House bill. However, the Senate bill does not include a provision similar to the provision in the House bill that would eliminate the tax-exempt treatment of interest received from “qualified bonds.”

Cost basis of specified securities determined without regard to identification

The Senate bill would change the way in which taxpayers other than regulated investment companies (RICs) may determine the cost basis of specified securities. A specific security includes any stock of a corporation (including stock of a RIC), as well as any debt, commodity or contract or derivative with respect to such commodity (to the extent required by Treasury), and other financial instrument (also to the extent required by Treasury).

Current law generally requires a taxpayer that sells only a portion of its holdings in a specified security which it has acquired in multiple lots over different dates or at different prices, to use a first-in first-out (“FIFO”) method in determining which lot is sold. However, if the taxpayer specifically identifies one or more lots, those lots are treated as the lots that are sold. In addition, Treasury regulations permit a taxpayer that owns shares in a RIC to use an average-cost-basis method to determine the basis of RIC shares sold.

Current law also requires a broker to report to the IRS a customer’s adjusted basis in a specified security that the customer has sold, as well as whether any gain or loss from such sale is long-term or short-term.

The proposal requires the cost of any specified security sold, exchanged or otherwise disposed of on or after January 1, 2018 to be determined on a FIFO basis, except to the extent that the average basis method is otherwise allowed (such as with respect to stock of a RIC). Thus, the proposal eliminates the ability of taxpayers other than RICs to use the specific identification method.

The JCT estimates that this change would increase revenues by approximately \$2.4 billion over 10 years. This change is not in the House bill.

KPMG observation

This change would be unfavorable for taxpayers who currently use the specific identification method, as those taxpayers would no longer have the ability to specifically identify securities to minimize taxable gain on a sale. Instead, taxpayers other than RICs would be limited to using the FIFO method, except for RIC stock with respect to which taxpayers may still elect to use an average-cost-basis method. Preventing taxpayers from using a specific identification method would mean that taxpayers (1) may have gain on a sale that they may not have had if they could have identified higher basis shares as being sold, (2) may have long-term loss on a sale which may have been short-term loss if they could have identified shares held for a shorter timeframe as being sold, or (3) may have loss on a sale subject to the wash sales rules instead of gain on the sale if lower basis shares were specifically identified.

In addition, brokers have invested substantial time and money into their cost basis reporting systems, including to accommodate the specific identification method. While the proposal's elimination of the specific identification method ostensibly simplifies cost basis reporting, it would require efforts by brokers to "turn off" specific identification for "specified securities" as an available method to determine cost basis and to communicate this change to clients. A potential complicating factor worth noting is that not all securities are treated as "specified securities" under current IRS regulations, including debt instruments subject to section 1272(a)(6), short-term obligations described in section 1272(a)(2)(C), and certain derivatives.

Insurance

The Senate bill 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 Senate bill) 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 Senate bill also modifies the carryover and carryback rules for all corporations (other than nonlife insurance companies). All net operating losses 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 90% of the taxpayer's taxable income for the year for tax years beginning before January 1, 2023. For tax years beginning after December 31, 2022, the net operating loss deduction would be 80% of taxable income.

These provisions would be effective for losses arising in tax years beginning after 2017 other than the 80% limitation as described above which begins in tax years after 2022. 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.

The limitation of a life insurance company's operating loss deduction to 90% of the company's taxable income would conform to current law regarding the utilization of losses to compute alternative minimum tax. The 80% limitation beginning in tax years after 2022 would also be applicable to life insurance companies.

The House bill includes a similar provision; however the 80% limitation in tax years beginning after 2022 is specific to the Senate bill.

Net operations loss deductions of property and casualty insurance companies

The Senate bill (section 13302 of the Senate bill) 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 to offset 100% taxable income in such 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 House bill does not include a similar provision. The House bill would repeal all carrybacks and limit non-life insurance company's operating loss to 90% of the company's taxable income. This difference will need to be resolved in the final statute.

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 Senate bill) 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.

This proposal is also in the House bill.

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 Senate bill) 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 \$1.3 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.

The proposal is identical to one in the House bill.

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 Senate bill) 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.

This proposal is identical to one in the House bill.

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 Senate bill) replaces the 15% reduction under present law with a reduction equal to 5.25% divided by the top corporate tax rate. Under the Senate bill, for 2018 the top corporate tax rate is 35%, and the percentage reduction is 15%. For 2019 and thereafter, the corporate tax rate is 20% and the percentage reduction is 26.25% under the proration rule for P&C companies. 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 provision would be effective for tax years beginning after 2017.

The JCT has estimated that the provision would increase revenues by approximately \$2.2 billion over 10 years.

KPMG observation

The JCT description states 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.

With a permanent corporate tax rate of 20%, both the House bill and the Senate bill would result in a proration rate of 26.25%. However, in contrast to the House bill (which has a fixed rate of 26.25%), the Senate bill's proration rate would automatically adjust based on changes to the corporate tax rate. The effective date for the 20% corporate tax rate (House bill proposes 20% corporate tax rate for tax years starting after December 31, 2017; Senate bill proposes 20% corporate tax rate for tax years starting after December 31, 2018) will need to be resolved in the final statute.

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 Senate bill) 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.

The proposal is identical to one in the House bill.

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 Senate bill) 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) 92.87% of the reserve computed as required by the National Association of Insurance Commissioners (NAIC) at the time the reserve is determined.

Items taken into account in determining life insurance reserves will be the same as in the current law and include (1) reserves as described under section 816(b), (2) the unearned premiums and unpaid losses included in total reserves under section 816(c)(2), (3) the amounts necessary to satisfy the obligations under insurance and annuity contracts, (4) dividend accumulations and other amounts, (5) premiums received in advance and liabilities for premium deposit funds, and (6) reasonable special contingency results under contracts of group term life insurance or group accident and health insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or a combination thereof.

The Senate bill also maintains the requirement that tax reserves cannot be less than the contract's cash surrender value. Additionally, the Senate bill preserves the requirement that the tax reserve cannot be greater than the statutory reserve for the contract. The Senate bill 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 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 provision is proposing to simplify the complex section 807 reserve calculation. The current rules in the Tax Code do not explicitly provide how reserves measured in the new manner (i.e., principle-based reserves) should be taken into account for tax purposes.

Initially, the House had proposed a 23.5% haircut of statutory reserves that would have led to a significant reduction of currently deductible life insurance company reserves. Some life insurance companies may not have had sufficient surplus to absorb this increased tax liability. This provision was subsequently removed from the final House bill, and a placeholder 8% surtax on life insurance company taxable income was added. The proposed provision in the Senate bill uses a 7.13% 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. The initial House proposal also specifically stated that asset adequacy reserves would not be included for tax purposes. This language related to adequacy reserves is not included in the Senate bill.

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 Senate bill) 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. The House bill initially included a similar proposal, but set the company share at 40%. The House bill DRD proration provision was eliminated and the 8% surtax was added. The Senate bill sets the company share at 70%. 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 Senate bill) 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 (2.1%)
- Group life contracts (2.46%)
- All other specified contracts (9.24%)

The proposal would extend the amortization period from a 120-month period to a 180-month period beginning with the first month in the second half of the tax year. 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. The House bill does not currently suggest a change to DAC. Ways and Means Committee Chairman Brady's mark initially increased the DAC capitalization rates, but that proposal was withdrawn during the markup and an 8% surtax on life insurance company taxable income was inserted as a placeholder. The Senate Finance Committee bill initially proposed a significant increase to the amount of DAC capitalized and the amortization period, so the final Senate bill is a more modest change. A reconciliation between the different House and Senate proposals will be necessary.

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

Tax-exempt organizations

The Senate bill includes a number of proposed changes that would affect tax-exempt organizations.

KPMG observation

As a result of amendments approved on the Senate floor, the Senate bill does not include a number of provisions that were in the Finance Committee bill, including:

- Name and logo royalties treated as unrelated business taxable income
- Repeal of tax-exempt status for professional sports leagues
- Modification of taxes on excess benefit transactions
- Exception from private foundation excess business holding tax for independently operated philanthropic business holdings

In addition, the Senate bill does not include certain provisions that are in the House bill, including:

- Termination of private activity bonds
- Unrelated business taxable income increased by amount of certain fringe benefit expenses for which deduction is disallowed
- 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.

Excise tax based on investment income of private colleges and universities

The Senate bill would impose a 1.4% excise tax on the net investment income of private colleges and universities with at least 500 students and non-exempt use assets with a value at the close of the preceding year of at least \$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 \$2.5 billion over 10 years.

KPMG observation

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

The House bill includes a similar provision that would apply at a lower threshold (\$250,000 per student). In addition, although the House bill extends the provision to related organizations of the private college or university, the Senate bill provides additional clarity and limitations on the application of this provision to related organizations.

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

Under the Senate bill, 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.

JCT estimated the provision would increase revenues by approximately \$3.2 billion over 10 years.

KPMG observation

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 Senate bill would prevent organizations from calculating UBTI on an aggregate basis.

Because the proposal would preclude tax-exempt investors from netting income and losses from unrelated activities, it might encourage such investors to use “blocker” corporations when investing in private equity funds organized as partnerships that generate losses from certain underlying investments. Nothing in the Senate bill would prevent a tax-exempt organization’s blocker corporation from investing in a partnership and using the losses derived from an underlying investment of the partnership to offset income derived from other investments of that partnership or from other partnerships in which the blocker is invested. Similarly, tax-exempt organizations with some unrelated business activities that generate losses and others that generate income might seek to move these activities into taxable corporate subsidiaries.

As noted above, the Senate bill contains a welcome clarification that NOL carryovers from years prior to 2018 would continue to be used on an aggregate basis

The House bill does not include a similar provision.

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

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

JCT estimated the provision would increase revenues by approximately \$1.9 billion over 10 years.

KPMG observation

The House bill includes a nearly identical provision.

Repeal of substantiation exception in case of contributions reported by donee

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

JCT estimated the provision would have negligible revenue effects.

KPMG observation

The House bill includes an identical provision.

International

In the context of international tax, the Senate bill follows the approach of the House bill in eliminating any element of deferred taxation on foreign income within a US-parented multinational group—income is taxed as earned or is permanently exempt from U.S. taxation. Also in keeping with the House bill, the Senate bill retains current subpart F to provide full and immediate taxation of the classes of income that are captured by current law, and would subject a new, very broad, class of income (“global intangibles low-taxed income” under the Finance Committee bill, and “foreign high return income” under the House bill) to immediate taxation at a reduced rate. In contrast to the House bill, however, the Finance Committee bill extends the benefit of the reduced rate to a new class of income earned directly by a U.S. corporation (“foreign derived intangibles income”).

In the context of proposals to combat base erosion, the Senate bill goes substantially beyond the House bill. Interest expense limitations are expanded in a variety of ways, and deductions are disallowed for transactions involving related parties and hybrid instruments or transactions. While the excise tax regime of the House bill is not present, a new proposal would impose an alternative minimum tax focused on deductible payments made by U.S. persons to related foreign persons.

As with the House bill, the sum total of these changes would represent 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

Similar to new section 245A of the House bill, the Senate bill would allow a domestic corporation that is a U.S. shareholder (as defined in section 951(b)) of a foreign corporation a 100% dividends received deduction (“DRD”) for the foreign-source portion of dividends received from the foreign corporation (a “100% DRD”).

The foreign-source portion of a dividend would be equal to the same proportion of the dividend as the foreign corporation’s foreign earnings bears to its total undistributed earnings. A foreign corporation’s undistributed foreign earnings would consist of all undistributed earnings except for income effectively connected with the conduct of a trade or business in the United States and dividend income received from an 80%-owned domestic corporation. Total undistributed earnings include all earnings without reduction for any dividends distributed during the tax year.

New section 245A of the House bill would treat a foreign corporation's pre-1987 earnings in the same manner as its post-1986 earnings, but the Senate bill does not expressly address this issue. Similarly, while the House bill makes it clear that nimble dividends (i.e., dividends paid out of current year earnings when there is an overall accumulated deficit at year end) are eligible for the 100% DRD, the Senate bill does not expressly address nimble dividends.

Contrary to the House bill, the Senate bill provides that a DRD is not available for any hybrid dividend, which is generally defined as an amount received from a controlled foreign corporation ("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.

Furthermore, while the House Bill is also silent with respect to passive foreign investment companies ("PFICs"), the Senate bill specifically states that dividends from PFICs may not qualify for the 100% DRD.

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 House bill only required that the domestic corporation be a U.S. shareholder of the foreign corporation for more than 180 days during the 361-day period beginning 180 days before the dividend is paid.

The Senate bill DRD proposal is effective for tax years of foreign corporations beginning after December 31, 2017 and is expected to reduce revenues by approximately \$215.5 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. As noted above, the participation exemption proposal largely follows the participation exemption proposal in the House bill, which was modeled after former House Ways and Means Committee Chairman Dave Camp's 2014 Discussion Draft. For corporations earning only foreign source income, the mechanics of the new participation exemption are largely irrelevant.

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

The Senate bill 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. However, E&P of a selling CFC will not be reduced by any loss from the sale or exchange. The House bill did not address the interaction of Code sections 1248 and 964(e) with the House bill's participation exemption system.

Consistent with the House bill, the Senate bill provides two loss limitation rules.

First, the Senate bill provides that if U.S. shareholder that is domestic corporation receives 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 Senate bill 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.

As with the House bill, the amount of the domestic corporation’s income inclusion under this proposal would be subject to limitations. Furthermore, the Senate bill changes the source of “branch loss recapture” (BLR) income from foreign source to U.S. source.

The Senate Bill also would repeal the active trade or business exception of section 367(a)(3) for transfers after December 31, 2017. The House bill did not contain a similar provision.

The proposal requiring basis adjustments to a foreign corporation’s stock would be effective for dividends received in tax years beginning after December 31, 2017.

The proposal relating to the TLA inclusions would be effective for transfers made after December 31, 2017.

The combined proposals are expected to increase revenues by approximately \$11.3 billion over 10 years.

KPMG observation

The Senate bill proposal is essentially the same as proposed section 4003 of the House bill, with the exception of the repeal of the active trade or business exception of section 367(a)(3), which was not contained in the House bill. The repeal of the active trade or business exception in section 367(a)(3) is consistent with the Senate bill’s theme of disfavoring the use of foreign branches.

The 2014 reform proposal contained a similar loss limitation provision that also required taxpayers also to carry forward and include in future income the portion of the TLA that was subject to a limitation and thus not included in gross income in the year of transfer. While section 91 as proposed by the House bill does not include this carry forward rule, the Senate bill contains a substantial limitation on the gross income inclusion that is tied to the section 245A DRD amount.

Both the House bill and the Senate bill dovetail TLA inclusions with the OFLR provisions and BLR provisions to avoid double inclusions and to provide ordering rules when there are overlapping applications of section 91 and one or both of these provisions. As a general matter, it appears that both proposals are intended to ensure that branch loss

recapture is not limited to built-in gain, which is a limitation on both the OFLR and BLR provisions. The House bill and the Senate bill would apply both to recognition and non-recognition transactions and would not be limited to foreign branch built-in gain. Neither of the new proposals, however, provide a coordination rule with the dual consolidated loss recapture provisions, creating uncertainty in situations in which section 91 and the dual consolidated loss recapture overlap. While both proposals and dual consolidated loss recapture are not the same, the dual consolidated loss recapture provisions apply both to recognition and non-recognition transactions and in many situations require recapture of amounts in excess of foreign branch built-in gain. Thus, the provisions in many situations already achieve the apparent desired result of the new House bill and the Senate bill proposals.

Mandatory repatriation

The Senate bill includes a transition rule to effect the participation exemption regime added elsewhere by the bill. 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 9, 2017 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 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.

The transition rule includes a participation exemption, the net effect of which is to tax a U.S. shareholder's income inclusion at a 14.5% rate to the extent it is attributable to the shareholder's cash position and at a 7.5% rate otherwise.

KPMG observation

The Senate bill follows the approach of the House bill by including two measuring dates; a change from the original description of the Finance Committee's mark transition rule which used a single measuring date. The Senate bill's November 9 measuring date adds complexity to its transition rule because it would require each SFC to calculate its deferred income or E&P deficit on a date that is not likely to coincide with regular reporting cycles. Additionally, like the House bill, the addition of December 31, 2017 as a measuring date will require SFCs to compute their deferred income twice.

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

9, 2017. However, unlike the House Bill which provided Treasury with generic regulatory authority, the Senate bill specifically provides the Treasury with authority to issue regulations to prevent avoidance of the purpose of section 965 including through a reduction in earnings and profits by changes in accounting methods.

SFC and U.S. shareholder definitions

An SFC is a foreign corporation that is a controlled foreign corporation (CFC) or a section 902 corporation as defined by section 909(d)(5). The Senate bill 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 Senate bill’s transition rule.

The Senate bill removes section 958(b)(4). 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. This amendment would apply for purposes of the Senate bill’s transition rule because it is effective 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. Accordingly, the Senate bill’s transition rule uses the current definition of U.S. shareholder in section 951(b), taking into account downward attribution of stock owned by foreign persons.

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 or value. As a result, non-corporate U.S. shareholders are exposed to inclusions under the Senate bill’s transition rule if the SFC is a controlled foreign corporation or a section 902 corporation, even though the proposed participation exemption regime for dividends from foreign subsidiaries in the Senate bill will only apply to corporate U.S. shareholders.

The Senate bill’s definition of SFC follows the definition of SFC in the House bill. However, the Senate bill’s repeal of section 958(b)(4) appears to make the Senate bill’s transition rule much broader than the House bill’s transition rule in an important way. The House bill would only eliminate section 958(b)(4) for purposes of determining whether a foreign corporation is an SFC by reason of having a corporate U.S. shareholder (within the meaning of current section 951(b)) and for purposes of determining whether a U.S. person is a U.S. shareholder of a CFC after the House bill is effective. The Senate bill eliminates section 958(b)(4) for all purposes for the last tax year of foreign corporation’s beginning before January 1, 2018 and all subsequent years. Thus, downward attribution

from foreign persons to U.S. persons appears to apply for purposes of determining which U.S. persons are U.S. shareholders subject to the Senate bill's transition.

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 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.

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 9 or December 31, 2017) and that are not attributable to effectively connected income or amounts included in income under subpart F (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 distributions during the tax year that includes the measuring date. A U.S. shareholder can reduce, but not below zero, its pro rata share of an SFC's deferred income by its allocable share of its SFCs' post-1986 E&P deficits.

The Senate bill 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 later in this report.

KPMG observation

The Senate bill, similar to the House bill, computes post-1986 E&P without regard to current year distributions. This "add-back" may reduce the expected U.S. federal income tax benefits of commonly used E&P and FTC-planning techniques that were recently completed in anticipation of tax reform.

It is possible that the Senate bill's measuring date falls in the tax year that immediately precedes the year in which the SFC's deferred income is included in its subpart F income (e.g., an SFC with a November 30 tax year end). In this case, it appears that an SFC's current year distributions would not be attributed to current year previously taxed income (PTI) under section 959, because PTI only takes into account amounts that have been or are taxed—not amounts that will be taxed. If an SFC's distributions are added back to its post-1986 E&P for purposes of determining its deferred income but are not treated as

PTI, it appears that distributed E&P is double counted: once with respect to the SFC and once with respect to the recipient (either an upper-tier SFC or a U.S. shareholder).

The Senate bill'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. This is more favorable than the House bill's transition rule, which would treat as deferred income all of an SFC's post-1986 E&P whether or not the E&P was accumulated during period when the corporation was an SFC.

Although the Senate bill's definition of post-1986 E&P appears more favorable than the definition included in the House bill, the Senate bill, like the House bill, does not 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 Senate bill's E&P deficit provisions are similar to those in the House bill because they allow a U.S. shareholder to benefit from its share of its SFC post-1986 E&P deficits. However, unlike the House bill, the Senate bill does not include rules that allow a U.S. shareholder to reduce its aggregate deferred income for net E&P deficits of its affiliates. Also, unlike the JCT description of the House bill, the Senate bill does not state that hovering E&P deficits are taken into account for this purpose. Thus, the Senate bill's E&P deficit rules appear stricter than the House bill's E&P deficit rules.

Participation exemption

Under the Senate bill'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 cash position is taxed at 14.5% and the remaining portion is taxed at 7.5%. 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 cash position at 14.5% and all other deferred income at 7.5%.

A U.S. shareholder's cash position is the greater of the pro rata share of the cash position of all SFCs as of the last day of the tax year of the mandatory inclusion or the average of the cash position determined on the last day of each of the two tax years ending immediately before the measuring date (i.e., November 9 or December 31, 2017).

KPMG observation

The Senate bill's deduction is less favorable than the one in the House bill. The House bill deduction results in deferred income being taxed at a 14% rate to the extent

attributable to a U.S. shareholder's cash position and a 7% rate otherwise, while the Senate bill would result in a 14.5% and 7.5% tax of such respective amounts.

Like the House bill, the Senate bill 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.

The Senate bill uses different measuring dates for measuring a U.S. shareholder's cash position than the House bill, which uses a 3-year average of the U.S. shareholder's cash position on November 2 and the two prior tax years. The Senate bill provides a list similar to the House bill of assets that will be considered to be included in the U.S. shareholder's cash position. Unlike the House bill which looks to the fair market value of foreign currency, the Senate bill adds foreign currency to the definition of "cash." Unlike the House bill, the Senate bill does not state that "blocked" assets are excluded from a U.S. shareholder's cash position.

The Senate bill provides a rule to avoid double counting of certain cash assets. Cash positions attributable to net accounts receivable and obligations with a term of less than one year may be excluded from the cash position of an SFC if the U.S. shareholder can demonstrate to the satisfaction of the Secretary that those amounts are taken into account by the U.S. shareholder through another SFC. The Senate bill's double counting rule does not however allow cash to be offset by accounts payable. This could cause many SFCs in the retail business to be treated as having a higher cash position because the measuring dates are during the portion of the year in which they may have significant cash receipts financed by payables due later next year due to the holiday shopping season.

Foreign tax credits

The Senate bill 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 (58.6% of the foreign taxes paid attributable to the cash portion of the inclusion taxed at 14.5% and 78.6% of the foreign taxes paid attributable to the non-cash portion of the inclusion taxed at 7.5%). Foreign tax credits disallowed are not subject to section 78 and may not be taken as a deduction.

Like the House bill, the Senate bill does not address the use of foreign tax credit carryforwards to offset the mandatory inclusion, and does not address the carryforward of any foreign tax credits not used in the tax year of the U.S. shareholder in which the mandatory inclusion is taken into account. As a result, the foreign tax credit carryforward period would remain 10 years under the bill.

KPMG observation

The Senate bill 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. This is counter to the discussion in the JCT report on the Ways and Means bill and the JCT report on the Chairman's mark which provided that foreign tax credits would not be allowed to offset the tax on the mandatory inclusion.

The Senate bill "haircuts" the foreign tax credits associated with a U.S. shareholder's mandatory income inclusion by 58.6% for foreign income taxes associated with the portion of the inclusion attributable to the shareholder's cash position and 78.6% for foreign income taxes associated with the other portion of the inclusion. These percentages are equal to the amount of the U.S. shareholder's income inclusion that is offset by the participation deduction that is calculated using a corporate tax rate of 35%. These percentages imply that the Senate bill intends that the participation deduction will be calculated using the highest corporate rate similar to the House bill.

Overall foreign loss recapture

The Senate bill does not provide any discussion of the impact of the mandatory inclusion on a U.S. shareholder's overall foreign loss (OFL), or on separate limitation losses (SLLs), unlike the JCT report on the Ways and Means bill. The House bill provides that a U.S. shareholder's OFL recapture amount is unaffected by its income inclusion under section 965 and the JCT report on the Ways and Means bill states that SLLs would likewise be unaffected.

Net operating loss election

The Senate bill 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 Senate bill is similar to the House bill in 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 Senate bill differs from the House bill (which provides for 8 equal payments) and 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. For both the House bill and the Senate bill, only the U.S. federal income tax due on the mandatory inclusion is eligible to be paid in installments. The Senate bill 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 Senate bill does not provide for any exceptions to acceleration, unlike the House bill.

The Senate bill 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 later in this report.

S corporations

The Senate bill 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.

The triggering events listed in the Senate bill are generally the same as the House bill. A “triggering event” for purposes of the bill’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 Senate bill’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 Senate bill, like the House bill, 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 Senate bill 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 Senate bill’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 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 doesn’t 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 House bill’s transition rule does not include rules similar to the Senate bill’s inversion recapture rules. By incorporating the U.S. anti-inversion rules, the Senate bill’s transition rule is more complicated than the House bill’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 Senate bill’s inversion recapture rules may apply to U.S. shareholders other than the target entity. Also, given the punitive treatment of the amounts subject to the Senate bill’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 Senate bill) 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 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 Senate bill would impose a tax on a U.S. shareholder’s pro rata share of its CFCs’ 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 20% 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 would be potentially 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% for 2019-2025⁵ 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 even at an effective rate of 10% 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".

GILTI is similar to the "Foreign High Return Amount" ("FHRA") in Section 4301 of the House bill. The two bills share certain general similarities in methodology and terminology, but differ in significant ways, including in defining the "tested income" on which the GILTI or FHRA is based.

One significant difference between the GILTI and FHRA rules is that the full amount of GILTI would be included in a U.S. shareholder's income under the Senate bill, while only 50% of the FHRA would be included in income under the House bill. Nonetheless, the Senate bill provides a deduction for corporate shareholders equal to 50% of GILTI for 2018 through 2025, which would be decreased to 37.5% beginning in 2026. As a result, assuming that the new 20% corporate tax rate is in effect, the effective tax rate on GILTI when a shareholder is allowed the 50% deduction would be 10%⁶. The effective tax rate on FHRA would be 10% for all years under the House bill. The shift from an exclusion in the House Bill to a deduction in the Senate bill also results in the absorption of net operating losses against the full amount of GILTI rather than merely against the taxable portion. Non-corporate U.S. shareholders would be subject to full U.S. tax on GILTI inclusions, based on applicable rates.

Tested income. The Senate bill 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

⁵ The effective tax rate on GILTI would be commensurately higher (i) in 2018 prior to the reduction of the corporate tax rate to 20% in 2019; and (ii) starting in 2026 after the GILTI deduction is reduced to 37.5%.

⁶ This effective rate would increase to 12.5% when the deduction is reduced in 2026.

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

KPMG observation

Although GILTI and FHRA are each calculated based on a CFC's "tested income", the two proposals define "tested income" differently. Both the Senate bill and the House bill would reduce a CFC's gross income for ECI, subpart F income, amounts excluded from subpart F under the high-tax exception rule, and dividends from a related person. The FHRA proposal also would reduce gross income for related party amounts excluded from subpart F income under Code section 954(c)(6), active finance income described in Code section 954(h), insurance income described in Code section 954(i) or Code section 953, and dealer income described in Code section 954(c)(2)(C). The GILTI rules do not contain any similar exclusions for purposes of determining net income. Furthermore, the two proposals differ on the exclusion of commodity income. Although the GILTI rules don't have a commodities exception, they do exclude both foreign oil and gas extraction income. On the other hand, the FHRA rules exclude commodity income, which generally is defined based on income derived from the disposition of commodities that are produced or extracted by the CFC.

Net deemed tangible income return. The Senate bill describes the "net deemed tangible income return" as 10% of the CFCs' qualified business asset investment ("QBAI"). 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).

KPMG observation

The Senate bill would apply a 10% rate to calculate the net deemed tangible income return or "routine return" on QBAI, while the FHRA proposal would apply a rate of 7% plus the applicable Federal short-term rate on QBAI to determine the routine return. Based on the current rate, the GILTI rate of 10% is higher than the rate that would apply under the FHRA proposal. Both bills define QBAI in a similar manner, which generally limits relevant assets to depreciable property used in the CFC's trade or business. Both bills measure the amount of assets based on their adjusted bases, and the GILTI proposal specifically provides that Code section 168(g) rules would apply in determining basis. The House bill reduces the routine return by the amount of certain allocable interest expense. No similar reduction to the routine return in the GILTI rules is provided in the Senate bill.

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 includable in a U.S. corporate shareholder's income, the Senate bill provides for a limited deemed credit for 80% of the foreign taxes attributable to the tested income (as defined above) of the CFCs. The methodology to calculate the deemed-paid credit in the Senate bill is similar to the methodology to calculate the deemed-paid credit on FHRA in section 4301 of the House bill, although the House bill also allows foreign taxes attributable to the tested losses of the CFCs to be taken into account. The Senate bill 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 bill also would modify the Code section 78 gross-up rules to treat the deemed paid taxes as an increase in the GILTI. However, the proposal would compute the section 78 gross-up by reference to 100% of the related taxes, rather than by reference to the 80% that are allowable as a credit.

In addition, the bill 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 Senate bill 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 Senate bill, only taxes paid or accrued by a CFC that has tested income would be creditable, while the House bill would allow all taxes paid or accrued by a CFC to be creditable, regardless of whether the CFC

had tested income or tested loss (so long as it had any gross tested income). In general, as a result of the deemed paid foreign tax credit, a U.S. shareholder would be indifferent to the new tax imposed on GILTI when the effective tax rate on the underlying income is at least 12.5% (ignoring base and timing differences), while the new 20% corporate tax rate is in effect.

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 Senate bill would reduce the creditable amount whenever there is at least one loss CFC. A similar result would occur under the deemed FTC rule in the House bill. It is not clear whether this result is intended in either bill.

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, these rules would increase revenues by \$135.0 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 Senate bill would provide a 12.5% 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 15.625% starting in 2026. Specifically, for tax years 2018-2025, the bill 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 and GILTI cannot exceed a corporation’s taxable income, determined without regard to this provision.

The bill 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 20% tax rate on its fixed 10% return on its U.S. depreciable assets and a 12.5% (increased to 15.625% as of 2026) tax rate on any excess return that is attributable to exports of goods or services.

The bill 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 property which is sold 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, unless the services are not substantially similar to the services provided by the foreign related person to persons located in the United States.

In addition, new reporting rules would apply with respect to FDII, which would include a requirement to certify under penalties of perjury that the FDII does not relate to the sales of products into the United States. A monetary penalty of \$1,000 per day (capped at \$250,000) would be imposed for a failure to comply with the new FDII reporting obligations.

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

KPMG observation

This is a new proposal that was not included in the House bill. The preferential rate on deemed intangible income attributable to export activities, coupled with new section 966 (discussed below) regarding transfers of intangible property from CFCs to their U.S. shareholders, presumably is intended to encourage U.S. corporations to keep (or relocate) production activities in the United States. Interestingly, under the bill 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 versus a CFC.

Add special rules for transfers of intangible property from controlled foreign corporations to U.S. shareholders

New section 966 would allow a CFC to distribute appreciated intangible property that it currently holds to a corporate U.S. shareholder without triggering a current income inclusion to the shareholder. For this purpose, intangible property is property described in section 936(h)(3)(B) and computer software described in section 197(e)(3)(B). Under current law, a CFC generally would be required to recognize any gain realized on a distribution of intangible property to a U.S. shareholder and that gain generally would be subpart F income, thus subjecting the U.S. shareholder to a current income inclusion. The bill would change this result by providing that a CFC would not recognize gain on a distribution of appreciated intangible property to a U.S. shareholder.

Special basis rules are provided for distributions that are not taxable as dividends. Specifically, a U.S. shareholder that receives a distribution of intangible property would increase its basis in the CFC stock by the amount of the distribution that exceeds the CFC's E&P and the shareholder's basis in the stock (i.e., the portion of the distribution that would be treated as a sale or exchange under section 301(c)(3)). The U.S. shareholder would take a basis in the distributed property equal to the CFC's basis immediately before the distribution, reduced by the amount of any basis increase in the shareholder's CFC stock. These rules thus have the result of eliminating built-in gain with respect to the stock of the CFC attributable to the distributed intangible but at the cost of reducing the amortizable basis in the distributed intangible.

The provision would apply to distributions made by a CFC to a corporate U.S. shareholder before the last day of the third tax year of the CFC beginning after December 31, 2017.

KPMG observation

This provision is intended to encourage U.S. multinationals to repatriate valuable intangible property that currently is held offshore by CFCs. Although a distribution of intangible property to a corporate U.S. shareholder would not give rise to current U.S. taxation for the shareholder, any built-in gain in the intangible property would be preserved and potentially subject to future U.S. taxation. Calendar year CFCs would have three years to distribute existing intangible property without triggering tax. Importantly, the provision would apply only to intangible property held by a CFC on the date of enactment of the provision. The Senate Finance Committee Report explains that new section 966 is not intended to benefit intangible property that is developed or acquired by a CFC after the date of enactment because other provisions of the bill will provide incentives for business to locate and develop intangible property in the United States on a go-forward basis. The provision appears to be limited in its scope to distributions directly to a U.S. shareholder so that intangibles held in second- (or lower-) tier subsidiaries would not be able to qualify for this nonrecognition.

Other modifications of subpart F provisions

Eliminate inclusion of foreign base company oil related income

A provision (section 14211 of the Senate bill) 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. This provision is identical to section 4202 of the House bill.

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 Senate bill, 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.

Inflation adjustment of de minimis exception for foreign base company income

A provision (section 14212 of the Senate bill) would amend section 954 of the Code to require an inflation adjustment to the \$1 million *de minimis* threshold, with all increases rounded to the nearest multiple of \$50,000. This provision is substantially identical to section 4203 of the House bill.

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 reduce revenues by approximately \$400 million over 10 years.

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

A provision (section 14213 of the Senate bill) would repeal section 955 of the Code. As a result, there would no longer be current U.S. tax imposed on previously excluded foreign shipping income of a foreign subsidiary if there was a net decrease in qualified shipping investments. This provision is substantially identical to section 4201 of the House bill.

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 14214 of the Senate bill) would eliminate a constructive ownership rule in section 958(b)(4) of the Code that prevents downward attribution of stock owned by a foreign person to a U.S. person. As a result, for example, stock owned by a foreign corporation would be treated as constructively owned by its wholly-owned domestic subsidiary for purposes of determining the U.S. shareholder status of the subsidiary and the CFC status of the foreign corporation. This provision is identical to section 4205 of the House bill, other than an earlier effective date.

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 \$215.5 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 de-controlling 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 percent U.S. owner of the foreign parent corporation could be treated as the owner of the foreign subsidiary CFC. Although the Senate Budget Committee's explanation of the Senate Finance Committee's bill, which contains a provision identical to Section 14214 of the Senate bill, states that the repeal of the downward attribution rule is not intended to result in a foreign corporation being treated as a CFC with respect to a US shareholder when the foreign corporation is a CFC as the result of downward attribution from a foreign person to a US person not related (more than 50%) to the US shareholder, the Senate bill does not contain this limitation, or any other limitation. This provision would apply to the last tax year beginning before January 1, 2018, which is a year earlier than the similar rule in section 4205 of the House bill, which applies to tax years beginning after December 31, 2017.

Modification of definition of United States shareholder

A provision (section 14215 of the Senate bill) 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 House bill does not contain any similar provision.

The provision would be effective for the tax years of foreign corporations beginning after December 31, 2018, 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 \$1.4 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 14216 of the Senate bill) would eliminate the requirement in section 951(a) of the Code for a foreign corporation to constitute a CFC for an uninterrupted period of at least 30 days in order for a U.S. shareholder to have a current income inclusion. As a result, for example, a U.S. shareholder could have a current subpart F inclusion when a CFC generates subpart F income during a short tax year of less than 30 days. This provision is identical to section 4206 of the House bill.

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 \$400 million over 10 years.

Look-thru rule for related controlled foreign corporations made permanent

A provision (section 14217 of the Senate bill) would make permanent the exclusion from the definition of foreign personal holding company income the receipt of certain dividends, interest, rents, and royalties from related parties under section 954(c)(6) of the Code. This provision is identical to section 4204 of the House bill. As currently enacted, the temporary exclusion in section 954(c)(6) of the Code expires on December 31, 2019.

The provision would be effective for tax years of foreign corporations beginning after December 31, 2019, 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 \$11.8 billion over 10 years.

KPMG observation

While the amendment of section 954(c)(6) of the Code would exclude from the definition of foreign personal holding company income the receipt of certain dividends, interest, rents, and royalties from related parties, taxpayers need to carefully analyze existing transaction flows to determine whether these types of related-party payments generate CFC “tested income” subject to the new GILTI rules that impose tax on the excess of a CFC’s income over a normal return on tangible assets. In contrast to the similar minimum tax provision in section 4301 of the House bill, there is no general exclusion from “tested income” for amounts excluded from subpart F income under Code section 954(c)(6). As a result, these amounts generally would be included in a CFC’s “tested income” unless an exception described in the Senate bill applies, such as the exception for dividends received from a related person, within the meaning of section 954(d)(3) of the Code. Although a Code section 954(c)(6) payment may be included in a recipient’s GILTI, the payor CFC can reduce its “tested income” by the payment. This framework (a reduction in GILTI for the payor and an increase in GILTI for the recipient) may be easier to administer than the framework in the House bill, which would require a taxpayer to establish that a Code section 954(c)(6) payment did not reduce a payor’s “tested income” in order for the payment to be excluded from the recipient’s “tested income.”

Corporations eligible for deductions for dividends exempted from subpart F inclusions for increased investments in United States property

Consistent with the House bill, the Senate bill would amend Code section 956 to exclude U.S. corporate shareholders of CFCs from having a current income inclusion with respect to investments in U.S. property made by a CFC. The proposal would apply to corporations that are U.S. shareholders in CFCs either directly or indirectly through a partnership.

The provision would be effective for tax years of CFCs beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such years of the CFCs end.

KPMG observation

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

reason for U.S. corporate shareholders to be subject to taxation by reason of a CFC's investment in U.S. property.

Prevention of base erosion

Deny deduction for interest expense of United States shareholders which are members of worldwide affiliated groups with excess domestic interest

The Senate bill retains the proposal that would limit interest deductions that are attributable to disproportionate indebtedness of U.S. corporations that are members of a worldwide affiliated group. Excess domestic indebtedness generally is the amount by which the total indebtedness of the U.S. members of the worldwide affiliated group exceeds 110% of the total indebtedness those members would have if their debt to equity ratio was proportionate to the debt to equity ratio of the worldwide affiliated group. The proposal remains substantially unchanged from the version approved by the Senate Finance Committee, except for the noteworthy addition of a limited transition rule that provides for a phase-in of the limitation. Under the prior version of the bill, the 110% threshold was effective for tax years beginning after December 31, 2017. As amended, the current bill provides a more favorable threshold for tax years beginning in a calendar year before 2022. Specifically, during tax years beginning in 2018, excess domestic indebtedness is based on 130% instead of 110% of "excess domestic indebtedness." This percentage is reduced by 5% in each subsequent year (125% for 2019, 120% for 2020, 115% for 2021, and finally 110% for 2022 and thereafter).

KPMG observation

The gradual phase-in to the 110% excess domestic indebtedness threshold is important in light of the absence of any rules to grandfather existing debt and the potential application of the provision to unrelated party loans. Although not as generous as many would have hoped, the phase-in **should** give taxpayers some additional flexibility to use deductions as they work to restructure their debt so as to mitigate the impact of the interest expense limitation. It is important to note, however, that the interest expense limitation contained elsewhere (in section 13301 of the Senate bill) in proposed section 163(j) does not contain a similar phase-in to the 30% of adjusted taxable income threshold, and (as discussed below) taxpayers will be subject to the greater of the two limitations immediately.

Like section 4302 of the House bill, section 14221 of the Senate bill would 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. Also like section 4302 of the House bill, the Senate bill's limitation for disproportionate indebtedness would apply *in addition to* section 13301 of the Senate bill, which provides a new *general* disallowance of net interest expense by amending Code

section 163(j), and which corresponds to section 3301 of the House bill. As in the House bill, the provision (Code section 163(j) as amended or new section 163(n)) that denies the greater amount of interest deductions will apply.

Although section 4302 of the House bill also includes a proposal to disallow a measure of disproportionate interest, there are a number of very significant differences between the House and Senate bills as passed by each chamber. One significant difference is the scope of companies covered by each proposal. Unlike the House bill, which would apply to a U.S. corporation that is a member of any “international financial reporting group” (“IFRG”), the Senate provision would apply only to U.S. corporations that are members of an “affiliated group” of corporations. For this purpose, affiliated group is defined by reference to Code section 1504, but substituting a more than 50% ownership threshold (by vote and value) for the 80% threshold contained in Code section 1504(a)(2), and by disregarding Code section 1504(b)(3) so as to permit inclusion of foreign corporations in the “affiliated group.” By contrast, in the House bill, an IFRG is a group of entities that: (1) includes at least one foreign corporation engaged in a trade or business in the United States or at least one domestic corporation and one foreign corporation; (2) prepares consolidated financial statements for the reporting year; and (3) reports annual gross receipts in excess of \$100 million. Perhaps most significantly, the Senate bill does not contain an annual gross income requirement.

KPMG observation

The Senate bill clarifies that it would *not* apply to a 50-50 joint venture with an unrelated person, because it changes the ownership threshold in Code section 1504(a)(2) from “at least 80 percent” to “more than 50 percent” by vote and value. Nonetheless, the proposal could still apply to treat more-than-50%-owned companies with significant unrelated minority shareholders as a member of a worldwide group. Presumably both the Senate and the House proposals to limit the ability of U.S. members of a multinational group to claim disproportionate interest deductions are premised on the notion that money is fungible, and that, absent such limits, multinational groups can substitute debt for equity in controlled entities depending on whether the entity is in a low- or high-tax jurisdiction. For investments involving unrelated parties, however, the choice of financing through debt versus equity could have significant deal implications when the partners hold disproportionate interests in the debt.

Unlike proposed section 163(j), both the House and Senate versions of proposed section 163(n) would NOT exclude from its scope regulated utilities, real property businesses, and trades or businesses with “floor plan financing indebtedness.”

In sharp contrast to the House bill, which uses an earnings-related measure to determine a U.S. group’s proportionate share of interest expense, the Senate proposal takes a balance sheet approach. Specifically, the Senate bill would reduce the deduction for interest paid or accrued by an affected U.S. corporation by the product of the

U.S. corporation's net interest expense and the "debt-to-equity differential percentage" of the worldwide affiliated group.

Net interest expense is defined as the excess (if any) of: (1) interest paid or accrued by the U.S. corporation during the tax year, over (2) the amount of interest includable in the gross income of the U.S. corporation for the tax year.

The debt-to-equity differential percentage of the worldwide affiliated group is defined as the "excess domestic indebtedness" of the group divided by the total indebtedness of the domestic corporations that are members of the group. "Excess domestic indebtedness" generally is the amount by which the total indebtedness of the U.S. members exceeds 110% (after the phase-in period ends in 2022) of the total indebtedness those members would hold if their total indebtedness to total equity ratio were proportionate to the ratio of total indebtedness to total equity in the worldwide group, subject to the phase-in described above. Total equity means, with respect to one or more corporations, the excess (if any) of: (1) the money and adjusted basis (for purposes of computing gain) of all other assets of such corporations, over (2) the total indebtedness of such corporations. "Intragroup" debt and equity interests are disregarded for purposes of this computation. This means the debt and equity interests held by all U.S. members of a worldwide affiliated group are treated as if held by one corporation. However, for purposes of computing the U.S. group's debt to equity ratio, receivables owed by a foreign member of the worldwide group to a U.S. member generally would not be disregarded under this rule. Such receivables therefore would appear (subject to the observation noted below) to reduce the debt to equity ratio of the U.S. members and allow them to deduct additional interest expense. The bill also provides, however, that an "interest" held by a domestic corporation in a foreign corporation that is also a member of the worldwide affiliated group is excluded from the total equity amount.

KPMG observation

It appears that the debt-to-equity differential percentage must be computed using balance sheets based on U.S. tax principles. This is a significant departure from the House bill, which would calculate the interest limitation based on amounts reported in the group's financial statements. A requirement to compute a U.S. tax balance sheet could be quite burdensome for a foreign-parented company that has a majority of its operations outside of the United States. Presumably, a motivating factor for the House bill's reliance on the financial statements was to alleviate this burden.

The use of tax balance sheets could also result in unfavorable treatment for domestic corporations, the U.S. assets of which are likely to have a proportionately lower adjusted tax basis due to accelerated depreciation and expensing. Moreover, if a taxpayer fully expenses an asset, as provided in both the Senate and House bills, its adjusted basis would be zero. In contrast, tangible property used offshore generally is required to use the straight-line method of depreciation. Interestingly, the computation of qualified

business asset investment (QBAI) for purposes of determining GILTI and FDII under sections 14201 and 14202 of the Senate bill already requires the determination of adjusted basis using the alternative depreciation system under section 168(g), so taxpayers that wish to avail themselves of FDII are already subject to the burden of having to compute their U.S. tax basis under the alternative regime. This unfavorable treatment of domestic assets that are the subject of accelerated cost recovery and expensing may be premised on the notion that expensing and interest limitations go hand-in-hand in order to avoid the negative tax rates that otherwise would arise from debt-financed assets that are fully expensed. Accordingly, interest expense limitations have generally been linked to full expensing throughout the tax reform debate. In modeling the impact of these proposals, taxpayers should take into account these basis differences.

Finally, it should be noted that it is ambiguous whether the requirement for U.S. members to disregard “interests” held in CFCs is limited to equity interests or also extends to debt interests. The latter interpretation would not appear to be grounded in any policy, and would impair the ability of U.S. multinational corporations (MNCs) to self-help by leveraging up their CFCs with debt owed to the U.S. members of the group. The purpose of the rule to disregard interests in foreign corporations appears to be to exclude equity interests in CFCs from the U.S. asset base so that such assets do not give rise to increased interest limitation, presumably based on the idea that such assets are tax exempt or eligible for reduced taxation under GILTI. It is consistent with the policy of the rule to allow U.S.-parented multinationals, which typically would borrow from unrelated parties at the U.S. parent level, to on-lend to their CFCs in order to reduce the extent to which the U.S. is viewed under the rule as disproportionately leveraged compared to that of the worldwide group. Although the interest income from such loans would offset the increased interest deductions that would be allowed, such on-lending could, for example, create interest deductions at the CFC level that would reduce the inclusion for GILTI. If forthcoming amendments do not clarify the scope of this provision as being limited to equity interests, it would be important for administrative guidance to do so quickly.

Disallowered interest expense under the Senate bill can be carried forward indefinitely. In contrast, section 4302 of the House bill would only permit disallowed net interest expense to be carried forward for 5 years.

The Senate bill would provide the Secretary with broad regulatory authority to provide rules to: (1) prevent the avoidance of the proposal, (2) providing adjustments for corporations that are members of an affiliated group that are necessary to carry out the purposes of the provision; (3) coordinate the proposal with section 884, (4) address the treatment of partnership indebtedness and the allocation of partnership debt, interest, and distributive shares, and (5) coordinate the proposal with section 163(j). Note that the authority granted to the Secretary to provide rules with respect to affiliated groups is a new addition to the Senate bill.

KPMG observation

While the House bill specifically includes partnerships and foreign corporations within the purview of its proposal, the application of the Senate proposal to these entities is left to regulatory authority. Therefore, if the Senate version becomes law, there will likely be uncertainty as to how the provision will apply to partnership liabilities and the interest thereon, as well as liabilities and interest of a foreign corporation that are allocable under the principles of section 882 to a U.S. trade or business (at least until administrative guidance is provided).

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

The JCT estimates that this provision would increase revenues by approximately \$8.4 billion over 10 years. The phase-in added to the Senate bill reduces revenue raised under the original Senate proposal by \$0.4 billion over 10 years.

KPMG observation

Although both the House bill and the Senate bill include provisions aimed at disproportionate leverage in U.S. members of multinational groups, the Senate version raises substantially less revenue (\$8.4 billion) than the House version (\$34.2 billion) over the 10-year budgetary window. Of course, the bills use very different mechanics (debt-equity ratios in the Senate bill, while the House bill refers to EBIDTA ratios), which could have very different scaling effects. In addition to the newly added phase-in of the denial of interest deductions, the Senate bill is also more generous by allowing an indefinite carryforward of all disallowed net interest expense.

Another likely reason for the difference in the revenue estimates, however, is that the House and Senate proposals on disproportionate indebtedness may both be scored after taking into account the House and Senate's respective proposals to modify section 163(j). Although both the House and Senate bills would apply new section 163(j) based on 30% of "adjusted taxable income," the Senate bill would define adjusted taxable income without any addback for depreciation and amortization, making it a much tighter limit (as reflected in the revenue estimates for the House (\$171.7 billion) and Senate (\$308.1 billion) versions of new section 163(j)).

Adds limitations on income shifting through intangible property transfers

The Senate bill 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 bill 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 bill 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

Consistent with new section 966 discussed above, which is designed to make it easier to bring intangible property back into the United States, 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 Senate bill 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 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 Senate bill 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 foreign branches; (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; and (7) exceptions to the proposal's general rule.

The provision would be effective for tax years beginning after 2017 and does not appear to contain grandfathering rules.

KPMG observation

The Senate bill would attempt 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). The House bill does not contain a similar proposal. However, 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 Senate bill'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 caught if there is no corresponding inclusion to the related party. Additionally, payments by a U.S. LLC that has elected corporate status for U.S. tax purposes to its foreign parent could be caught 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.

It is not clear whether interest and royalty payments made to a related entity located in a “no-tax” jurisdiction (e.g., the Cayman Islands) would be treated as paid pursuant to a hybrid transaction under the Senate bill. Such payments are nontaxable because the recipient jurisdiction does not tax income, not because of hybridity as commonly understood. However, it is not clear whether such payments would be treated as payments under a hybrid transaction because the recipient jurisdiction does not tax them as interest or royalties. A payment to a “no-tax” jurisdiction would not have been caught under President Obama’s FY 2017 Budget Proposal or the Recommendations.

The Senate bill 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, and deductible dividends that are excluded pursuant to a participation exemption.

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. Neither the Senate bill nor the House bill alters the dual consolidated loss rules. The House bill and the Senate bill, however, include provisions that would create a special foreign branch loss recapture rule that in certain circumstances overlaps with the overall foreign loss recapture provision, the section 367 branch loss recapture provision, and the dual consolidated loss recapture provision. These provisions contain rules that coordinate section 91 recapture with overall foreign loss recapture and section 367 branch loss recapture, but the provisions do not address the coordination of section 91 recapture with the dual consolidated loss recapture provision.

Preserve special rules for domestic international sales corporations

The Senate bill does not contain the proposal that would terminate existing DISC elections and prohibit any new corporate elections to be treated as a DISC. Thus, corporations continue to have access to the exemption from corporate level taxation allowed under the DISC rules.

According to JCT, this provision would have increased revenues by approximately \$5.3 billion over 10 years; the modification removing the provision is projected to decrease revenues by that amount.

Surrogate foreign corporations not eligible for reduced rate on dividends

The Senate bill's anti-base erosion provisions include a rule that prevents a dividend from a surrogate foreign corporation, which is not treated as a domestic corporation under section 7874(b), to an individual from qualifying for the reduced tax rate applicable to qualified dividends. This rule would be effective for dividends paid in tax years beginning after December 31, 2017.

KPMG observation

The Senate bill's rule regarding dividends paid by surrogate foreign corporations would apply to *all existing and future* surrogate foreign corporations. Thus, the rule would apply to dividends from foreign corporations that are already surrogate foreign corporations, notwithstanding that the associated domestic entity acquisition was completed prior to the mark's introduction. The House bill does not include a similar provision.

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 Senate bill 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 Senate bill, 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 Senate bill 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 be based on similar rules in the House bill, under which these foreign taxes would be allowed as credits under section 960 in the year the PTI is distributed. The Senate bill 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 Senate bill would make conforming amendments to other Code provisions to reflect the repeal of Code section 902, including amending Code section 78 to treat the “gross-up” for deemed paid taxes as an additional section 951(a) inclusion rather than a dividend.

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

These revisions to the foreign tax rules are essentially identical to the proposals in the “2014 tax reform proposal” and the House bill. 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 Senate bill adopts the language from the Senate proposal that 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 Senate bill grants the Secretary the authority to establish rules 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.

Acceleration of election to allocate interest on a worldwide basis

The Senate bill adopts the language from the Senate proposal that would accelerate the effective date of Code section 864(f), which is currently scheduled to take effect for tax years beginning after December 31st, 2020. The Senate bill would have section 864(f) take effect for tax years beginning after December 31st, 2017. Once effective, section 864(f) would permit taxpayers to apportion the interest expense of U.S. members of a worldwide affiliated group on a worldwide basis. Worldwide affiliated group is defined for this purpose by reference to section 1504(a) of the Code, but without taking sections 1504(b)(2) and (4) into account, and includes CFCs that are 80% or more owned directly or indirectly, applying section 958(a) with modifications, by domestic members of such group.

Currently, section 864(e) of the Code governs the allocation and apportionment of interest expense by members of an affiliated group. Under section 864(e), the interest expense apportionment of non-U.S. members of the affiliated group is not taken into account when apportioning interest expense of group members between U.S. and foreign source income. As a result the section 864(e) allocation method may cause an over-allocation of interest expense to foreign-source income, thereby reducing foreign source taxable income and limiting the foreign tax credit. Under the proposal, the common U.S. parent of a worldwide affiliated group could elect to make a “worldwide group election.” Under the worldwide group election, the taxable income of domestic members of the worldwide affiliated group would be determined by allocating and apportioning the interest expense of each such member as if all members of such worldwide group were a single corporation. The worldwide apportionment formula would adjust the amount of interest expense apportioned to foreign sources by domestic members of such group to account for interest apportioned to foreign sources by CFCs included in the worldwide group. As a result, the amount of interest expense allocated to foreign source income may be lower than if section 864(e) were applied and, therefore, an increase in foreign source taxable income and the foreign tax credit limitation may result.

Section 864(f) also provides special rules and an election for certain financial institutions included in a worldwide group.

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

According to JCT, this provision would decrease revenues by approximately \$2.0 billion over 10 years.

KPMG observation

The provision permitting taxpayers to elect to allocate interest on a worldwide basis will likely result in the availability of a higher foreign tax credit limitation for certain taxpayers

and, therefore, the ability to credit more U.S. taxes with foreign taxes paid or accrued than would be permitted if section 864(e) applied.

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

The Senate bill adopts the language from the Senate proposal that 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 this 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 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, which is identical to the proposal in the 2014 tax reform proposal and the proposal in the House bill, eliminates the beneficial title passage rule and replaces it with a rule that is meant to reflect solely the economics of production. It could, though, have the unintended result of encouraging companies to expand foreign production.

Amend overall foreign loss (“ODL”) rules to allow increased ODL recapture

A late amendment to the Senate bill 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.

KPMG observation

It will be more challenging under the Senate bill 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 referenced above. The ODL election will allow taxpayers to accelerate the use of those credits in years subsequent to enactment of the Senate bill 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

In addition, the Senate bill adopts the language from the Senate proposal that 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

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.” Both the House bill and the Senate bill include a number of international tax incentives and anti-base erosion provisions aimed at achieving this goal. Significantly, each bill includes a novel levy focused on deductible payments by large U.S. groups to foreign affiliates. In the House bill, this was the Sec. 4303 Excise Tax on “Specified Amounts.” The Senate bill’s corollary proposal is a new base-erosion-focused minimum tax (the “BEAT”) that differs in several key respects from the House proposal.

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 4% or higher for the tax year. 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*, including amounts

paid in connection with the acquisition of *depreciable or amortizable* property from the related party. For taxpayers that 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.

The legislative process resulted in additional restrictions to the provision’s scope. First, an exception was added for an “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. Second, an exception was added 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 inclusion of cross-border product flows where the payments were recovered through COGS was a surprising feature of the Excise Tax. Under the BEAT, however, U.S. payments treated as COGS generally are not within scope (subject to regulatory authority for the Secretary to write anti-avoidance regulations), except for taxpayer groups that “invert” after November 9, 2017 (and which are given more restrictive treatment in a number of the Finance Committee bill provisions). The inclusion of cross-border payments for COGS in the Excise tax would expand significantly the classes of taxpayers potentially affected by the proposal. For example, payments for inventory by foreign-owned U.S. distributors of goods that are manufactured outside the United States would be subject to the Excise Tax but would not be subject to the BEAT.

The BEAT’s scope is broader in some respects than the Excise Tax, however, in that the BEAT does not exempt deductible payments of interest, and in fact includes an unfavorable stacking rule (discussed below).

There also is no specific exception for payments made by U.S. multinationals’ domestic groups to their CFCs. Thus, absent coordination, payments that are treated as full inclusion subpart F income or as GILTI could 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 services payments to their foreign subsidiaries.

The provision also would affect certain industries disproportionately. As just one example, the proposal would have an economic impact on related-party cross border reinsurance, and therefore would significantly affect insurance companies that include off-shore reinsurance to an affiliated entity as an integral part of their business model.

The exception for services that qualify for the services cost method is similar to the exception provided in the House's Excise Tax, although the scope of the exception in the Senate bill is ambiguous. The services cost method is entirely a product of regulations (Reg. section 1.482-9) and other administrative guidance. That guidance includes a number of requirements, including numerous categories of services that are ineligible as "excluded activities," in addition to the general exclusion (which the Senate bill explicitly turns off) for services that contribute significantly to the risks of success or failure. It is unclear whether the Senate intends for these additional regulatory exclusions to apply or whether Treasury might make changes to the requirements in light of the new purposes to which the method would be applied. It is also unclear whether, if a markup is charged for an otherwise eligible service, the portion of the charge that reflects the service provider's cost would be eligible for the exception. The resolution of this question will significantly impact the utility of the exception, as many foreign countries require a mark-up on intercompany services.

The exception for qualified derivative payments has been reported as a significant concession to the financial services industry, although the exception taken in conjunction with the higher tax rate for banks and securities dealers (see *infra*) is presented by the JCT score as a net revenue raiser.

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 4% 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, and the deduction allowed under new section 250 for foreign intangible income.

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 Senate bill 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 proposed section 163(j) or (n) as being 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, 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, 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, allowed in that year.

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 in the computation of their overall tax liability. The following example may help illustrate the formula's application.

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 \$3,000 constitute research credits. Thus, the "floor" that the BEAT must cross is $\$20,000 - (\$5,000 - \$3,000) = \$18,000$. For companies that are taxpayers, this formula thus effectively adds back the research credit [\$3,000] to the otherwise final tax liability [\$15,000].

The BEAT would be owed to the extent that ABC's MTI equaled more than \$180,000 (that is, $\$18,000 \times 10$, or $.1$). Stated differently, ABC would have to deduct more than \$80,000 of base erosion tax benefits for the year to be subject to the BEAT.

The foregoing illustrates that, with a 20% corporate tax rate, a 10% BEAT rate, and absent the research credit allowance, the BEAT is only due when the taxpayer more than halves its taxable income through base erosion deductions.

The November 14 Chairman's modifications made two changes that would broaden the base of the BEAT for tax years beginning after December 31, 2025: (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. These changes are estimated to yield an additional \$14.1 billion in revenue over the 10-year window.

Reporting and penalties

The provision would introduce new reporting requirements under the existing Code section 6038A regime (Form 5472) regime 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.

The provision, after the Chairman's modification, was estimated to increase revenues by approximately \$137.6 billion over 10 years. The original estimate was \$123.5 billion. The higher rate for financial institutions, along with the exception for qualified derivative payments, are estimated to raise an additional \$2.4 billion.

KPMG observation

The BEAT is a significant new proposal and revenue raiser in the Senate bill's international proposals. If enacted, it would operate in tandem with the new interest deduction limitations, and the disallowance for payments involving hybrid transactions and hybrid entities, to significantly curtail the scope of deductible payments that can be made by U.S. groups to their foreign affiliates.

By implementing the base erosion levy as a new minimum tax on the U.S. taxpayer, the proposal may avoid some of the tax treaty override and trade agreement concerns that were raised with respect to the Excise Tax. The Excise Tax's effectively connected income election arguably reflects an assertion of taxing jurisdiction over profits currently seen as attributable to non-U.S. members of a companies' global supply chain. By comparison, the BEAT is a less drastic change in U.S. tax policy. It does, however, raise 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 proposal effectively denies a portion of the deductions for payments made to foreign entities where payments made to similarly situated domestic entities remain fully deductible.

Although both the House and the Senate bills clearly set out to address erosion of the U.S. tax base via cross-border related party payments, they use very different mechanisms that likely would have widely varying effects across the universe of taxpayers. The two chambers will need to reconcile the scope and policy differences between these two base erosion provisions.

Other provisions

The Senate bill does not include a proposal from the Finance Committee bill that would have modified the taxation of income earned from the transportation of passengers aboard cruise ships on "covered voyages" (as defined in Code section 4472).

Modify insurance exception to the passive foreign investment company rules

The text of this provision of the Senate bill is materially the same as section 4501 of the House bill, and has the same effective date and revenue effect. The section number of this provision of the Senate bill was changed, however, and now it is section 14501, whereas it was section 14502 of the original Senate mark.

Current law contains an 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 PFIC. As under section 4501 of the House bill, section 14501 of the Senate bill would amend the 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.

Like section 4501 of the House bill, section 14501 of the Senate bill 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.

The provision 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 impacts on non-U.S. insurance companies that insure long-tail and catastrophic risks.

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

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

Like section 4501 of the House bill, section 14501 of the Senate bill also could require the Department of the Treasury to issue new regulations, and the IRS to amend Form 8621, for taxpayers to take advantage of the election it would provide to U.S. shareholders of certain affected foreign corporations that fail the 25% liabilities test.

Repeal fair market value method of interest expense apportionment

The Senate bill adopts the provision from the proposal that would require taxpayers to allocate and apportion interest expense of members of an affiliated group (or, presumably, a worldwide group if elected pursuant to section 864(f)) using the adjusted basis of assets and would prohibit the use of the fair market value method.

According to JCT, this provision would increase revenues by approximately \$200 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 source rules involving possessions

The Senate bill would modify two Code sections that have an impact on citizens and residents of the U.S. Virgin Islands as well as citizens and residents of the United States who have income from sources within the U.S. Virgin Islands.

The sourcing rules that apply to determine whether the income of U.S. citizens and residents is possession source generally follow the principles for determining whether income is U.S. source. Code section 937(b) has a rule specifying that, except as provided in regulations, any income treated as income from sources within the United States or as effectively connected with the conduct of a trade or business within the United States is not treated as income from sources within the possession or as effectively connected with the conduct of a trade or business within the possession. The Senate bill would modify Code section 937(b)(2) to scale back this limitation so that only U.S. source (or effectively connected) income attributable to a U.S. office or fixed place of business would be removed from possessions source income.

In addition, the provision would modify the Code section describing the source rules for personal property sales. Code section 865 would be modified to provide Treasury with

the authority to waive the 10% foreign tax requirement for source treatment of capital gains income earned by a U.S. Virgin Islands resident.

The proposal would be effective for tax years beginning after December 31, 2018.

Modify Code section 4985 excise tax

The Senate bill would increase the Code section 4985 excise tax rate from 15% to 20%. This excise tax applies when a domestic corporation becomes an expatriated entity under section 7874 in a transaction that is taxable to the domestic corporation's shareholders, and is imposed on certain stock-based compensation directly or indirectly held by or for the benefit of certain "insiders" of the domestic corporation or a member of its expanded affiliated group and the family members of these insiders.

The JCT has estimated that this proposed rate structure would increase revenues by approximately \$100 million over a 10-year period.

CRAFT beverages/excise taxes on beer, wine, and distilled spirits

The Senate bill would make numerous temporary changes to the taxes imposed on beer, wine, and distilled spirits. The JCT has estimated that these proposals would decrease revenues by approximately \$4.2 billion over 10 years. These provisions would sunset after 2019.

KPMG observation

The House bill does not include similar provisions. The Senate provisions are in line with the Craft Beverage Modernization and Tax Reform Act of 2017, first introduced on January 30, 2017.

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 Senate bill 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 expenses (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 tax years beginning after December 31, 2019.

Reduced rate of excise tax on beer

The Senate bill would amend section 5051 to reduce the amount of federal excise tax imposed on brewers and importers of beer. The Senate bill 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 bill 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 Senate bill 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

The Senate bill 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 Senate bill 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

The Senate bill would modify the section 5041(c) credit for small domestic producers of wine. The Senate bill would allow the credit to be claimed by foreign and domestic producers of wine, regardless of the gallons of wine produced. The Senate bill would also allow the credit for sparkling wine producers.

Under the Senate bill, 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 Senate bill also provides special credit rates for hard cider.

The Senate bill also provides 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 expires for tax years beginning after December 31, 2019.

KPMG observation

The Senate bill 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

The Senate bill 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 Senate bill 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 Senate bill 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

The Senate bill 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 Senate bill, 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 Senate bill 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 section 5001, all distilled spirits are taxed at a rate of \$13.50 per proof gallon. The Senate bill would institute a tiered rate for distilled spirits. The Senate bill 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, it 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 bill 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 Senate bill would provide a two-year significant rate reduction for distilled spirit producers and importers.

Allow transfer of bonded spirits in bottles

The Senate bill 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 Senate bill would allow transfers of distilled spirits in bottles to be made tax-free under bond for two years.

Procedural provisions

Several procedural provisions that were in the Finance Committee bill were removed as a result of the manager's amendment approved during Senate floor consideration. The provisions below remain in the Senate bill.

Uniform tax treatment of attorney fees and court costs in connection with whistleblower awards

The Senate bill would provide an above-the-line deduction for attorney fees and courts costs paid by, or on behalf of, a taxpayer in connection with any action involving a claim under State False Claims Acts, the SEC whistleblower program, and the Commodity Futures Trading Commission whistleblower program. The proposal would sunset after 2025.

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

KPMG observation

The Senate bill does not sunset the proposal for tax years beginning after December 31, 2025, as was provided in the Finance Committee bill.

Whistleblower claims are brought under a variety of federal and state statutes. The statute under which the claim is made can materially affect its Federal income tax treatment. Not all claims qualify to have legal fees deductible "above the line," thus, allowing the whistleblower to not pay any tax on the legal fees. Otherwise, the whistleblower has to claim a miscellaneous itemized deduction, which is subject to a number of limits. This problem was made clear in *Commissioner v. Banks*, 543 U.S. 426 (2005), where the Supreme Court held the plaintiff's entire recovery of economic damages for a claim under

Title VII of the Civil Rights Act of 1964 was taxable income, including the portion paid to the plaintiff's attorney under a contingent fee agreement.

The American Jobs Creation Act of 2004, (P.L. 108-357) section 703, enacted current Code section 62(a)(20) to allow an above-the-line deduction for attorney fees and court costs paid by an individual "in connection with any action involving a claim of unlawful discrimination," within the meaning of section 62(e). The Tax Relief and Health Care Act of 2006 (P.L. 109-432), section 406, enacted current Code section 62(a)(21) to allow an above-the-line deduction for attorney fees and court costs paid by an individual in connection with a whistleblower award under section 7623(b). This provision is limited in application, and generally does not apply to other fees related to whistleblower awards outside of section 7623(b).

However, no provision under current Code section 62(a) explicitly includes an above-the-line deduction for attorney fees and court costs paid by an individual for a whistleblower claim under the federal False Claims Act, the SEC whistleblower program, and the Commodity Futures Trading Commission whistleblower program.

The Committee explanation to this proposal indicates their belief that an above-the-line deduction for attorney fees related to whistleblower awards may encourage more people to report unlawful acts.

Improvement of the IRS whistleblower program

The Senate bill would amend current Code section 7623(b) to define collected proceeds eligible for awards to whistleblowers to include: (1) penalties, interest, additions to tax, and additional amounts, and (2) any proceeds under enforcement programs that the Treasury has delegated to the IRS the authority to administer, enforce, or investigate, including criminal fines and civil forfeitures, and violations of reporting requirements. This definition would also be used to determine eligibility for the enhanced reward program under which proceeds and additional amounts in dispute exceed \$2,000,000.

This provision would be effective for information provided before, on, or after the date of enactment with respect to which a final determination has not been made before such date.

KPMG observation

The explanation posted on the Budget Committee website for this proposal indicates that clarification in the law is required because there have been conflicting interpretations of law as to whether the FBAR penalties are within the meaning of collected proceeds and that the proposed clarification will encourage more people to report unlawful acts. For example, in *Smith v. Commissioner*, 148 T.C. No. 21 (2017), in which the Tax Court held

that the “amounts in dispute” referenced in the section 7623(b)(5)(B) threshold (\$2 million) are the total amount of the liability that the IRS proposed with respect to a taxpayer’s examination that was commenced using the information provided by a whistleblower, and are not limited as the IRS argued to the part of the collected proceeds attributable only to the specific information provided or allegations made, by the whistleblower. The explanation also indicates that clarification in the law is required to encourage more people to report unlawful acts.

Modification to user fee requirements for installment agreements

The Senate bill would limit the ability of the IRS to increase from current levels user fees charged when a taxpayer enters into an installment agreement to pay tax liabilities. It would also assist low-income taxpayers (incomes below 250% of Federal poverty guidelines) to either avoid the user fee by making automated installment agreement payments via a debit account, or recoup the user fee if unable to make automated payments but successfully complete the required installment agreement.

The JCT has estimated that this provision would result in a gain in revenue of less than \$50 million over a 10-year period.

The proposal would be effective for agreements entered into on or after the date that is 60 days after the date of enactment.

KPMG observation

This provision is not in the House bill.

Under current law, installments agreements are available if the total tax, penalties, and interest is below \$50,000 in the case of individuals and \$25,000 in the case of businesses.

Extension of period for contesting IRS levy

The Senate bill would extend the period of time from nine month to two years for returning the monetary proceeds from the sale of property that has been wrongful levied upon by the IRS. The Senate bill 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 is not in the House bill.

REITs

KPMG observation

The Senate bill would provide a deduction to individual taxpayers of 23% 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 Senate bill of ordinary REIT dividends and “qualified business income” (setting aside the 50% wage-based limitation, which would not apply to limit the deduction applicable to ordinary REIT dividends). The Senate bill would also provide for a maximum marginal tax rate on ordinary income (other than certain “qualified domestic business income”) of 38.5%. For individual taxpayers, this would reduce the maximum marginal tax rate on ordinary REIT dividends to approximately 33.45% (including the 3.8% Medicare tax, which is seemingly applied before application of the 23% deduction). The House bill, by contrast, proposes a maximum rate of 28.8% on REIT dividends and certain active business income earned through passthrough entities.

As with the House bill, the Senate bill would reduce the effective tax rate on dividends paid by a domestic C corporation to noncorporate domestic taxpayers to approximately 39% (including 20% at the corporate level) once the reduction in the maximum corporate tax rate becomes effective (see below). The effective tax rate under the Senate bill on ordinary dividends paid by REITs to individual taxpayers would appear to decrease from 43.4% to approximately 33.45%. This is a smaller disparity than would exist either under the House bill or under current law. Under both the Senate bill and the House bill, the disparity in tax rate for these taxpayers for distributions attributable to capital gain generally would be slightly more than 15% (approximately 39% for C corporations, and 23.8% for REITs).

Importantly, the Senate bill’s reduction in corporate tax rate would apply to tax years beginning after 2018, and would be permanent. The 23% deduction described above (and the changes in individual income tax brackets), however, generally would apply to tax years beginning after 2017. In addition, both this deduction and the proposed rate structure for individuals (which, among other things, would reduce the maximum individual income tax rate from 39.6% to 38.5% (not taking into account the 3.8% Medicare tax)) would sunset for tax years beginning after 2025. Under the Senate bill,

therefore, for tax years beginning after 2025, 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 individual taxpayers from REITs would increase to 43.4%; the effective rates for capital gain income generally would not change as a result of a sunset.

Foreign income

As described elsewhere, the changes proposed by the Senate bill 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). A similar proposal is included in the House bill. Under current law, however, seemingly left unaffected both by the Senate bill and by the House bill, REITs would appear to be ineligible for this deduction (as REITs generally are ineligible for the dividends-received 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 proposal they also would be taken into account in calculating a REIT's taxable income and, therefore, its distribution requirement.

As a transition to territorial system which incorporates the dividends-received deduction for foreign-corporate dividends described above, the Senate bill, like the House bill, 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 attributable to cash assets). Both the Senate bill and the House bill treat 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 Subpart F income. The Senate bill explicitly disregards the repatriation inclusions for REIT gross income test purposes. The House bill, by contrast, does not characterize these inclusions for REIT gross income test purposes. The Senate bill's clarity is helpful. 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 Senate bill allows REITs to avoid this uncertainty.

Moreover, under the Senate bill, REITs would be entitled 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. 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). This is important, because REITs (which are calendar year taxpayers) would otherwise have only limited time to determine, and make a distribution of, the repatriated amount; this would have put pressure on the REIT's ability to satisfy its distribution requirement for 2017, and potentially caused it to incur excise tax and/or entity-level income tax on undistributed income. The House bill, by contrast, does not appear to permit REITs to stagger these inclusions for purposes of determining their annual distribution requirement.

Furthermore, the Senate bill permits a taxpayer to receive a deduction in respect of the Subpart F inclusion of either 78.6% or 58.6% (depending on the assets in which the accumulated deferred foreign income deemed repatriated is held). The House bill also provides for a deduction, generally in an effort to tax the analogous inclusion at a specific rate. Under both bills REITs would appear to be entitled to the relevant deduction.

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. The House bill simply exempts those businesses. 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 both the Senate bill and the House bill, 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 of the Finance Committee bill indicated that the definition of a "real property trade or business" should 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.

As with the House bill, under the Senate bill, 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. Under the Senate bill, disallowed interest expense could be carried to future tax years indefinitely (in contrast to five years under the House bill).

It is interesting to note that, in computing the taxpayer's "adjusted taxable income," the House bill excludes deductions for depreciation and amortization. In comparison, the Senate bill's definition of "adjusted taxable income" is determined after the deduction for those amounts. Assuming that the proposal described in the Senate bill is ultimately enacted, for a REIT engaged in a "real property trade or business," the amount of its cost recovery deductions (taking into account the potential benefit associated with the optional reduction in recovery periods for depreciation of real property described below) 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).

Both the Senate bill and the House bill include other provisions intended to combat "base erosion." While both the Senate bill and the House bill generally allow for the exemption of many real estate businesses from these new interest limitation rules described above, the Senate bill proposes a separate limitation on deductions for net interest expense of domestic, and certain foreign, corporations that are members of "worldwide affiliated groups" (WAGs). For these purposes, WAGs are defined by reference to the rules for affiliated groups, except that foreign corporations are included and the relevant ownership percentage is reduced from 80% (i.e., the current ownership threshold for affiliation) to 50%. Under the rules defining which corporations are includable in an affiliated group, REITs are explicitly excluded. The Senate bill does not appear to modify that exclusion. It therefore appears that a REIT would not be subject to this particular interest limitation even if it would otherwise (i.e., absent REITs not being includable members) be a member of an affiliated group.

The Senate bill also proposes a tax generally equal to the amount by which 10% (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 is determined by excluding tax benefits associated with certain payments made to foreign affiliates. The Senate bill 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 clear 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.

The House bill also includes provisions combatting base erosion by including a somewhat similar concept, imposing a 20% excise tax applicable to certain deductible and capitalizable payments (or a portion thereof to not exempt from U.S. withholding tax) made by domestic corporations (and certain foreign corporations) that are members of “international financial reporting groups” (IFRGs) that are made to certain of their foreign affiliates. The House bill did not exempt REITs, which technically could be members of IFRGs, and also appeared to apply its tax to REIT dividends (which are generally deductible).

The interest limitation provisions under either set of proposals might have the effect of reducing the efficiency of “leveraged blocker” structures used by some foreign investors to make investments in U.S. real estate and in real-estate lending businesses, including investments through REITs, directly or indirectly. Moreover, it is possible that these provisions might affect those investors in an entity which are not members of the entity’s WAG (or, under the House bill, their IFRG), given that the proposed taxes apply at the entity level. Minority investors might, then, be advised to protect themselves against being disadvantaged by these rules as a result of other investors’ ownership.

- Second, under the Senate bill, the recovery period for real property (nonresidential and residential) is reduced to 25 years. These provisions would apply to property placed in service after 2017. Those taxpayers electing out of the interest limitations under new section 163(j) would be required to use ADS to recover any nonresidential and residential real property and any qualified improvement property. The Senate bill, however, reduces the ADS recovery period for residential real property from 40 years to 30 years.

The Senate bill also 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 and qualified improvement property. REITs do not appear to be generally ineligible for these benefits. Under the House bill, by contrast, many REITs (and the partnerships in which they invest) are excluded from immediate expensing benefits by virtue of being “real property trades or businesses.”

- Third, the Senate bill, like the House bill, limits the utilization of net operating loss (NOL) carryovers. The Senate bill limits the utilization of NOL carryovers to 90% for tax years beginning after 2017, and 80% for tax years beginning after 2022, in either

case for losses arising in tax years beginning after 2017. The House bill, by contrast, limits NOL carryover utilization to 90% of taxable income, and applies for tax years beginning after 2017. Both the Senate and House bills specify that, 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 modification would be necessary to avoid causing a REIT to fail the minimum distribution requirement, incurring a corporate-level tax, or forgoing the NOL carryovers. Furthermore, if enacted, such a proposal (assuming that the 90% (or 80%) limitation is calculated on a pre-DPD basis) seemingly would mean that a REIT could use an NOL carryover to offset all of its REIT taxable income after paying distributions to its shareholders, provided that the REIT distributed at least 10% (or 20%) of pre-DPD REIT taxable income.

Unlike the House bill and the Finance Committee bill, however, the Senate bill does not appear to repeal the corporate AMT; the Senate bill also appears not to modify the current law treating 10% of the amount offset by the utilization of an NOL carryover as an AMT preference item.

- Fourth, as with House bill, the Senate bill 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, similar to the House bill, the Senate bill 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

Provisions in the Senate bill may have significant consequences for RICs, from potentially limiting RIC expenses to accelerating RIC income from investments. In addition, global asset managers of RICs may be significantly impacted by the international tax reform provisions of the proposal.

Potential acceleration of RIC income and gain

The bill 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 business development companies (BDCs) due to the substantial debt holdings of many BDCs, much of which is originated by such BDCs and involve payments of upfront fees. The accelerated inclusion of OID would apply to tax years beginning after December 31, 2018.

As noted above, an exemption for RICs is provided from the bill's change to the cost basis determination rules for specified securities to prohibit the use of the specific identification method for sales of specified securities beginning in 2018. The RIC exemption would reduce the revenue estimated to be raised from the repeal of the specific identification method to approximately \$2.4 billion. This is an important issue to monitor as the tax reform process moves ahead, given that any elimination of the RIC exemption could have a profound impact on RICs and their shareholders and also could be a potential revenue raiser for other proposals.

Neither of these proposed changes is in the House bill.

Other impacts

A number of other provisions in the Senate bill may affect RICs:

- RICs that invest in advance refunding bonds should be aware that the bill would repeal the exclusion from gross income for interest on such bonds issued after December 31, 2017. This proposed change is also included as part of the House bill.

For tax years beginning after December 31, 2018, the bill 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. While this proposed change is included as part of the House bill, it would apply one year earlier (for tax years beginning after December 31, 2017).

- It is arguable that RICs should be exempt from the proposed limitation on the deductibility of net business interest expense. Net business interest expense is

defined as any 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), and business interest income does not include investment income within the meaning of section 163(d). Section 163(d) applies to taxpayers other than corporations. The question is whether the investment activities of RICs should be treated as giving rise to “business interest expense” which is properly allocable to a trade or business. 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.

- The bill’s deduction of 23% for certain passthrough income treated as qualified business income, effective for tax years beginning in 2018 but expiring after December 31, 2025, specifically treats dividends from a REIT (other than any portion that is a capital gain dividend) as qualified business income. However, the bill does not extend similar treatment to ordinary dividends paid by RICs. The House bill, by contrast, proposes a maximum rate of 25% on business income earned through passthrough entities including REIT dividends, but it similarly does not provide for any reduction in the maximum tax rate for ordinary dividends paid by RICs. For RICs investing in REITs, the industry could seek comparable treatment for RIC dividends to the extent such dividends are attributable to REIT distributions treated as qualified business income.
- The bill includes specific provisions for REITs subject to mandatory repatriation of foreign earnings. The industry could seek comparable treatment for RICs subject to mandatory repatriation inclusions, including with respect to the determination of a RIC’s gross income and distribution requirements.
- The bill specifically excludes RICs from the so-called “BEAT” or “base erosion anti-abuse tax.”
- For a RIC transferring an interest in a partnership, the RIC should consider the implications of the requirement in the bill that the transferee of a partnership interest withhold 10% of the amount realized on the sale or exchange of the interest unless the transferee 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 bill’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.

State and local tax implications

KPMG observation

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.

As noted, states do tend to pick and choose the items to which they will conform, often choosing not to conform to items that have major revenue loss consequences. For example, many states have decoupled 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 Senate bill are reviewed below. Many of these provisions, particularly the individual provisions and the business tax provisions, are similar to those in the House bill. Also, select international provisions differ significantly from the House bill.

Individual provisions

- **Tax rates:** The Senate bill would retain seven individual income tax rate brackets with a maximum rate of 38.5%. These rates and all the individual income tax provisions in the bill would expire after December 31, 2025, and revert to the law as in effect before January 1, 2018. The House bill, which contains only four rate brackets, would make the rate changes and individual tax changes permanent. The revision of tax rates and brackets proposed in the bill would not directly affect state taxes as states establish their own individual tax rate structures.
- **Passthrough deduction:** Rather than reducing the tax rate applied to the income of owners and shareholders of passthrough entities as proposed in the House bill, the Senate bill would allow an individual taxpayer to deduct 23% of domestic qualified business income from a partnership, S corporation, or sole proprietorship. This deduction would sunset after 2025. The deduction generally would be limited to 50% of the sole proprietorship's W-2 wages or 50% of the taxpayer's allocable or pro rata share of W-2 wages of the partnership or S corporation. The 50% of wages limitation does not apply in the case of a taxpayer with income of \$500,000 or less for married individuals filing jointly (\$250,000 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). 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, etc.). There is an exception allowing the 23% deduction in the case of certain taxpayers with income from a specified service business whose taxable income does not exceed \$500,000 for married individuals filing jointly or \$250,000 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, which means that it would likely be a deduction that is taken into account in computing AGI for individual income tax purposes. As such, the deduction would affect the tax base in most states that impose personal income taxes. In rolling conformity states, this provision would likely have an immediate effect unless the state legislature acts to decouple. By contrast, the House bill would reduce the tax rate applied to certain passthrough income, and thus would have no direct effect on the state tax treatment or tax rate applied to passthrough income. The JCT's revenue tables suggest that the 23% passthrough deduction would reduce federal revenues by about \$476 billion over the eight years it is in effect. If the state revenue impact is proportionate to the federal impact, it could be significant for states.

- **Standard deduction, personal exemption allowance, and child credit:** The provisions in the Senate bill, if enacted, would effectively double the standard deduction for all tax filers, repeal the personal exemption allowances, and enhance the child tax credit, similar to the House bill. As noted above, the Senate 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.
- **Itemized deductions:** The Senate bill proposes to repeal and revise many federal itemized deductions, including deductions for state and local income and sales taxes, personal casualty losses (unless the loss occurred in a declared disaster area), and a variety of miscellaneous deductions (but not as many as would be repealed in the House bill). An amendment adopted on the Senate floor would retain the itemized deduction for real property taxes up to \$10,000 per return, similar to the House bill. The Senate bill also would provide an itemized deduction for unreimbursed medical expenses in excess of 7.5% of AGI for tax years 2017 and 2018. The House bill contains no similar provision. The Senate bill would also repeal the current limitation on itemized deductions and eliminate the current deduction allowed for certain home equity indebtedness; it does not make changes in the treatment of home mortgage interest, while the House bill reduces the cap on the amount of mortgage indebtedness on which interest may be deducted and disallows the deduction for new mortgages on second homes.

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.

Under the Senate bill, state, local and foreign property taxes and state and local sales taxes that are imposed on individuals and incurred in the conduct of a trade or business would remain deductible as an ordinary and necessary business expense. The suspension of the sales tax deduction and limitations on the deductibility of property taxes for individuals apply only to taxes other than those incurred in carrying on a trade or business or for the production of income. 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 appear to be deductible. Also, property taxes and sales and use taxes paid by the passthrough would remain deductible as under current law.

- **Repeal of the so-called “individual mandate”:** Under the Senate bill, the amount of the individual shared responsibility payment enacted as part of the Affordable Care Act would be reduced to zero. There is no similar provision in the House bill. Repeal of the individual mandate would not directly affect an individual's state tax liability.
- **Alternative minimum tax:** The Senate bill 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, if the individual AMT is retained, it should have little to no effect for state purposes.

Business provisions

- **Tax rates:** The proposed corporate tax rate reduction to 20% in 2019 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 Senate bill would increase the current 50% bonus depreciation regime under Code section 168(k) to 100% expensing for qualified assets placed in service by 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. The House bill also allows for 100% expensing of certain assets placed in service by December 31, 2022, but does not contain the phase-out. In other differences, the Senate bill does not apply to certain property of regulated utilities, but does allow real property businesses to qualify for full expensing. Unlike the House bill, the Senate bill does not extend the 100% expensing to used assets, but the Senate bill continues to apply to most assets that are currently covered by bonus depreciation, while the House bill is more restrictive on this point. 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 bill, if enacted, would disallow the deduction of net interest expense to the extent it exceeds 30% of a taxpayer's adjusted taxable income (ATI), with an exception for taxpayers with less than \$15 million in gross receipts (\$25 million in the House bill), certain real property businesses, farming businesses, regulated public utilities, and electric cooperatives. Unused amounts could be carried forward indefinitely. ATI is defined in the Senate bill as income arising from a trade or business without regard to business interest, business interest income, the 23% deduction for certain passthrough entities, and NOLs. 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. An additional item of note is that the Senate bill's definition of ATI is narrower than in the House bill (where it was essentially earnings before interest,

taxes, depreciation and amortization), meaning the amount of interest expense disallowed in the Senate bill is considerably greater than in the House bill.

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 level. 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 recompute 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 certain interest paid to related parties. Coordinating the state and federal rules in these states could also present complications.

- **Net operating loss limitations:** The Senate bill, much like the House bill, proposes to 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 90% of the taxpayer’s taxable income determined without regard to the deduction. For tax years beginning after December 31, 2022, the 90% limit would decrease to 80% of taxable income. This change would not appear to widely affect the states, as 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 adopt the federal NOL provisions. 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 Senate bill 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), albeit not quite as expansively as the House bill. 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 to which about one-half of the states currently conform. The bill proposes to repeal certain corporation tax credits, but again the list of proposed repeals is not as extensive as in

the House bill. The modification of the certain credits would not have a significant impact on state taxes.

Importantly, from a state and local government perspective, the Senate bill does not propose to revise the treatment of contributions to capital by non-shareholders, a provision in the House bill that would affect certain grants by states and localities for economic development purposes. Neither does the Senate bill place certain restrictions on the issuance of state and local debt to aid with economic development to the extent that the House bill does.

- **Alternative minimum tax:** The Senate bill retains the corporate AMT in its current form. The AMT would be repealed in the House bill. 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

As with the House bill, the Senate bill aims to accomplish 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 to a territorial system; (b) hasten the transition to a 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) put in place 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.”

Establish a territorial tax system

- **Deduction for foreign-source dividends received.** The territorial system encompassed in the Senate bill 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. The essential principle to which states must adhere was provided by the U.S. Supreme Court in *Kraft General Foods v. Iowa Department of Revenue*, 505 U.S. 71 (1992) where the Court held 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. As a result, many states apply their DRDs in the same manner to both foreign and domestic dividends. 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 Senate bill becomes law, taxpayers will need to evaluate how states conform to the federal DRD and the state's treatment of subpart F income, thus determining whether the dividends qualify for deduction or exclusion under state law. Assuming the hybrid dividend is treated as subpart F income for federal income tax purposes, the hybrid dividend may also qualify for exclusion or a DRD for state tax purposes.

Transitioning to the territorial system

- **Repatriation of deferred earnings.** To transition to the territorial system, the Senate bill 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 treating the post-1986 E&P as 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 Senate bill are 14.5% for cash and cash equivalents and 7.5% for other amounts, compared to rates of 14% and 7%, respectively, in the House bill. The bill would require this income inclusion in "the last tax year beginning before January 1, 2018." The Senate bill 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. As noted above, most states currently provide a reduction in state taxable income for subpart F income, but 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. The foreign commerce clause could be implicated if the undistributed earnings of 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 Senate bill and a state's DRD (or the subpart F exclusion that would otherwise apply).

Most states decouple, at least in part, from the federal NOL carryforward and carryback rules. In states that include subpart F income in the tax base, the amount of the related income to be included will likely be based on the amount that is recognized for federal tax purposes. Therefore, if a taxpayer elects not to offset the repatriated E&P deemed dividend with NOLs, the effect of that election may affect the ability to use NOLs in some states. However, it is not certain how state NOL

provisions, which frequently decouple from the federal provisions, may affect the overall state computation for states that conform in some manner to the proposed repatriation provisions.

Both the Senate bill and the House bill 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.

Preventing base erosion

The Senate bill includes several sections that, if enacted, would address potential base erosion on both outbound and inbound transactions. While the details of the provisions differ substantially from corollary provisions in the House bill, they address similar policy goals – avoiding excessive interest and other payments to foreign affiliates. A number of state issues would flow from these new rules. Of critical importance is the foreign commerce clause prohibition of discrimination 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 Senate bill 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 Senate bill, 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. 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.

While this provision would require GILTI to be treated as subpart F income for a number of purposes, it appears it would not be included in the definition of "subpart F income" under Code section 952. Because some states' exclusion from income (or

qualification for a DRD) is specific to the definition of subpart F income provided in current 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 could 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.

- **Limitation on interest deductions.** The Senate bill would limit interest that may be deducted by U.S. members of a multinational group. The stated purpose of this provision is to curtail disproportionate interest expense deductions. To this end, the Senate bill includes a formula for determining the amount of interest expense that would be considered proportionate for the U.S. members, based on the overall debt-to-equity ratio of the entire multinational group. Any excess interest would be disallowed, but could be carried over indefinitely. The provision would work in conjunction with the more generally applicable interest limitation discussed above under the general business reform provisions, with the amount of interest disallowed being the greater of the two. In addition, the Senate bill would disallow deduction for certain interest and royalty payments made to members of some multinational groups.

Many states currently disallow certain interest and/or royalty payments made to related parties. However, if the federal law results in disallowance of amounts that are not otherwise disallowed by the state expense disallowance provisions for payments to domestic affiliates, conformity to the federal law could run afoul of the foreign commerce clause. Further, some states have an exception to their addback provisions that applies to amounts paid to a related party in a jurisdiction that has a tax treaty with the United States or amounts that are subject to tax in a foreign jurisdiction. In those states, certain interest deductions may be limited under the federal proposal, even though the payment otherwise qualifies for an exception to the state addback statute. Also, because the state filing group may differ from the federal consolidated group, the computation of the interest limitation may be challenging and could further implicate foreign commerce clause concerns.

- **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 greater than \$500 million in annual gross receipts in the preceding three years. 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 the federal change would flow through to the state 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 prospects for substantial federal tax changes that would affect states appear to have improved substantially in recent weeks. The passage of substantial bills by each house of Congress, even with some key differences between them, make it possible for states and taxpayers to further delve into the state implications of these far-reaching potential changes. The interrelationships between state and federal income taxes are such that any federal changes will necessarily have implications for state taxes.

In evaluating the implications, state taxpayers would be well-advised to keep a few fundamentals in mind. First, the reaction to federal tax reform by individual states are 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.

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 the repeal of 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 federal tax reform is signed into law in the next few weeks effective for the 2018 tax year, states will have an extremely limited time to assess the fiscal and tax effect of the federal changes by the time state legislatures convene in early 2018. Some states may—out of necessity—simply delay addressing the changes until the impacts can be analyzed fully. This could be accomplished by freezing conformity to a pre-tax reform year, a step that would likely lead to a significant disconnect between federal and state tax laws—at least in the short-term.

Finally, there is no “one size fits all” state or state taxpayer response to federal tax reform. The proposed 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

Remeasurement of current and deferred taxes

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

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

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

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

after the sunset date. Therefore, companies may need the systems and processes to understand what years the tax basis of its existing assets and liabilities will reverse and what years the related financial reporting carrying amounts are expected to reverse.

Potential changes in significant judgments

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

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

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

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

Intraperiod tax allocation

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

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

Summary

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

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