Tax Reform Executive Edition: Highlights of the New Tax Law

March 5, 2018

kpmg.com

The president on December 22, 2017, signed into law H.R. 1, originally known as the Tax Cuts and Jobs Act. Public Law No. 115-97 represents the culmination of a lengthy process in pursuit of business tax reform over the course of more than 20 years.

This document provides a high-level overview of the new law. For more details, observations, and technical analysis (including discussions of industry issues and financial accounting considerations), please read KPMG's 218-page report: **Tax Reform – KPMG Report on New Tax Law** (the "KPMG Book").

This is one of a series of reports KPMG prepared as tax reform moved through various stages of the legislative process. To read these reports as well as coverage of subsequent developments related to the new tax law, see **TaxNewsFlash-Tax Reform** and **TaxNewsFlash-United States**.

Contents

Overview 3
Digest—Summary and considerations 10
- Key changes to taxation of individuals 11
- General considerations for business taxpayers 14
- Considerations related to accounting methods, deductible items, and other items ... 17
- Compensation-related considerations 20
- Considerations for passthrough entities 24
- Considerations for multinational businesses 29
- State and local tax considerations 33

Documents 35
KPMG contacts 36

Overview

The new tax law introduces substantial changes to many areas of the U.S. tax system, including the taxation of individuals, businesses in all industries, multinational enterprises, and other areas. Overall, it provides a net tax reduction of approximately $1.456 trillion over a 10-year "budget window" (according to estimates provided by the Joint Committee on Taxation (JCT) that do not take into account macroeconomic/dynamic effects).

Key features of the new law include:

- A permanent reduction in the statutory C corporation tax rate to 21%, repeal of the corporate alternative minimum tax (AMT), and a broad limitation of the deduction for interest expense

- Fundamental changes to the taxation of multinational entities, including a shift from a system of worldwide taxation with deferral to a hybrid territorial system that features a participation exemption regime with current taxation of certain foreign income, a minimum tax on low-taxed foreign earnings, and new measures to deter base erosion and promote U.S. production

- Changes to the taxation of executive compensation and employee benefits

- A temporary "expensing" provision that allows taxpayers to immediately write-off the cost of qualifying new property

- A temporary new deduction for certain kinds of domestic income from partnerships, S corporations, and sole proprietorships

- Significant changes relevant to the taxation of tax-exempt organizations, insurance businesses, financial institutions, regulated investment companies (RICs), and real estate investment trusts (REITs)

- Temporary reductions in the individual income tax rates, accompanied by new limits on itemized deductions (such as the deduction for state and local taxes), other temporary changes to the individual income tax rules, and a more restrictive permanent cost-of-living bracket adjustment

- Effective permanent repeal of the individual mandate in the Patient Protection and Affordable Care Act (ACA)

The discussion below summarizes key provisions of general applicability to businesses, and provides additional information about effective dates, possible clarifying or corrective legislation, and practical considerations. Following that discussion is a "digest" highlighting additional considerations regarding some provisions in the new law. See the **KPMG Book** [PDF 10.3 MB] for further in-depth details and analysis.

General business provisions

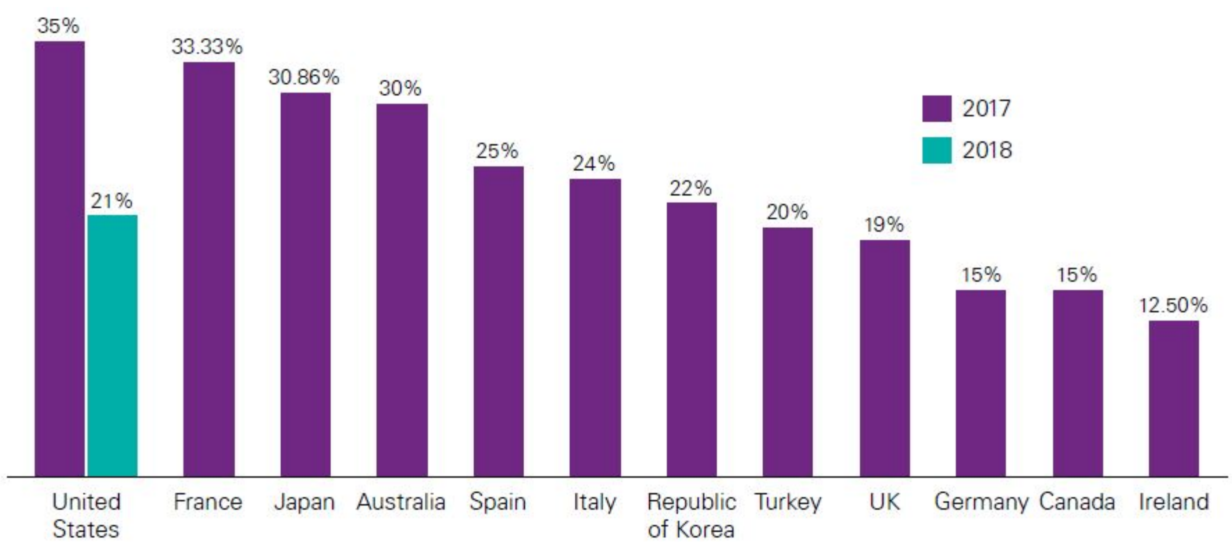
The full list of changes for businesses is extensive and includes a number of new tax benefits as well as new tax increases. These changes may affect a host of business decisions, such as location of people and assets; investments; acquisitions and other transactions; financing; supply chain management; compensation; distributions; and choice of business entity.

Corporate rate and corporate alternative minimum tax

The centerpiece of the new law is the permanent reduction in the corporate income tax rate from 35% to 21%. The rate reduction generally took effect on January 1, 2018. The Code provides special rules that affect how the rate change applies to fiscal year corporate filers. For information on these rules, see discussion in the **KPMG Book** [PDF 10.3 MB].

As indicated in the chart below, the rate reduction puts the U.S. statutory corporate rate closer to middle of the "pack" of statutory corporate rates levied by central governments of major OECD nations (not including local taxes and surtaxes)—achieving a policy priority of many Republicans.

U.S. and other OECD statutory corporate tax rates
Corporate income tax rates* in select OECD countries



*Basic, top corporate income tax rate levied by central government. Local level taxes and surtaxes are not included and can be substantial for some countries (e.g., the 2017 German rate could vary between 22.83-36.83% with local trade tax rates).
Source: KPMG International, Tax Rates Online, 2017 data

The new law also repeals the corporate AMT.

Expensing

The new law temporarily makes expensing the principal capital cost recovery regime, increasing first-year "bonus" depreciation deduction to 100% and allowing taxpayers to write off immediately the cost of acquisitions of plant and equipment. This expensing regime goes further than pre-enactment law bonus depreciation by applying to *both new and used* property. The 100% bonus depreciation rule applies through 2022 and then ratably phases down over the succeeding five years.

Temporary deduction against business income earned by passthrough entities

The new law permits certain noncorporate owners (i.e., owners who are individuals, trusts, or estates) of certain partnerships, S corporations, and sole proprietorships to claim a 20% deduction against domestic qualifying business income. There are numerous limitations on the income eligible for the deduction, with the apparent goal of treating compensation for services as ordinary income that is not eligible for the special deduction. Importantly, the deduction against qualifying income is scheduled to expire for tax years beginning after December 31, 2025. On the revenue raising side, the law also includes significant, but temporary, business loss limitation rules for taxpayers other than C corporations.

Revenue-raising provisions

To partially offset the costs of these tax benefits, the new law repeals or modifies a number of Code provisions. For example, the new law:

- Limits the deductibility of net business interest expense to 30% of adjusted taxable income. The new law starts with a broader definition of adjusted taxable income, but significantly narrows that definition beginning in 2022
- Limits the carryover of net operating losses (NOLs) to 80% of taxable income and eliminates the carryback of these losses (with special rules for certain insurance and farming businesses)
- Requires certain research or experimental (R&E) expenditures to be capitalized (beginning in 2022)
- Repeals the domestic manufacturing deduction that was in Code section 199
- Narrows the scope of the rules relating to non-taxable contributions to capital
- Modifies the deductibility of business entertainment expenses
- Provides significant changes for taxation of the insurance industry

Letting the numbers do the talking

The JCT's revenue estimates indicate that the following provisions are among the most significant tax cuts and tax increases for businesses in general:

Top business tax increases and tax cuts
(in $ billions / over 10 years)

Tax increases		Tax cuts	
Limit interest deduction	$253.4	21% corporate rate	-1,348.50
Limit use of NOLs	$201.1	20% partnership deduction	-414.5
Disallow passthrough losses in excess of $500,000	149.7	Expensing	-86.3
Amortization of R&E expenditures	$119.7	Repeal corporate AMT	-40.3
Repeal of manufacturing deduction	$98.0	Simplified accounting (small business)	-30.5
Modify credit for rare condition drugs	$32.5	Increase small business expensing	-25.9
Limit like-kind exchanges	$31	S Corp conversions to C Corps	-6.1

*Estimates based on JCT conventional scores, not taking into account estimated growth in GDP. See JCX-67-17.

Multinational entity taxation

The new law makes fundamental changes to the taxation of multinational entities. In general, the new law shifts the United States from a system of worldwide taxation with deferral to a participation exemption regime with current taxation of certain foreign income. To accomplish this, the new law includes several features, including:

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

Furthermore, the new law includes significant additional anti-base erosion measures. Notably, the law includes a base erosion anti-abuse tax (BEAT). The BEAT generally imposes a minimum tax on certain deductible payments made to a foreign affiliate, including payments such as royalties and management fees, but excluding cost of goods sold. The BEAT generally applies to certain payments paid or accrued in tax years beginning after December 31, 2017.

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

The JCT's revenue estimates indicate that the following provisions are among the most significant tax cuts and increases for multinational businesses:

Top international tax increases and tax cuts
(in $ billions / over 10 years)

Tax increases	Repatriation	338.8	Tax cuts	Participation exemption	-223.6
	BEAT	149.6		FDII	-63.8
	GILTI	112.4		Foreign oil-related income taxation	-4.0
	Reduced tax on CFC sales/transfers	11.8		Increase domestic loss recapture for pre-2018 losses	-2.3

*Estimates based on JCT conventional scores, not taking into account estimated growth in GDP. See JCX-67-17.

Individual provisions—subject to sunset after 2025

The new law makes a number of temporary changes to the individual rate structure, as well as to deductions and credits.

Most of these changes (including the 20% deduction for certain owners of passthrough businesses) are scheduled to end after December 31, 2025, and to revert to their pre-2018 form. Future legislation would be required to make the provisions effective beyond 2025. The 2025 sunset, however, does not apply to the new law's repeal of the ACA's individual shared responsibility payment (the individual mandate) or the substitution of a new, lower inflation index for individual rate brackets and other items.

Individual rate structure

The new law retains seven tax brackets but modifies the "breakpoints" for the brackets and reduces the rate for the top bracket to 37%. The standard deduction also is temporarily increased. At the same time, the deduction for personal exemptions is repealed, while the child tax credit is enhanced and the phase-out thresholds are substantially increased.

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

The tax rates for capital gains and dividends are left unchanged. Also left unchanged is the 3.8% tax on net investment income.

Affordable Care Act modifications — "individual mandate"

The new law effectively repeals the individual mandate in the ACA by reducing the "individual shared responsibility payment" to zero for individuals who do not purchase health insurance that qualifies as minimum essential coverage, starting in 2019.

Estate and gift

The new law doubles the basic exclusion amount from $5 million to $10 million per individual. This enhanced exclusion applies to estates of decedents dying, generation-skipping transfers made, and gifts made after 2017. The exclusion is indexed for inflation and is $11.18 million per person for 2018. The exclusion is scheduled to return to $5 million (as indexed for inflation) after 2025. Consideration should be given to making lifetime gifts that will utilize this enhanced exclusion while it is available.

Letting the numbers do the talking

The JCT's revenue estimates indicate that the following provisions are among the most significant tax cuts and tax increases for individuals in the new law:

Top individual tax increases and tax cuts
(in $ billions/over 10 years)

Tax increases	Repeal personal exemptions	1,211.5
	Repeal/limit itemized deductions	668.4
	Reduce individual mandate penalty to zero	314.1
	Alternative inflation measure	133.5
	Require valid SSN for child tax credit	29.8
Tax cuts	Restructure and lower rates and brackets	-1,214.2
	Increase standard deduction	-720.4
	Increase AMT exemption and phase-out	-637.1
	Increase child tax credit	-573.4
	Double Estate Tax Exemption	-83.0

*Estimates based on JCT conventional scores, not taking into account estimated growth in GDP. See JCX-67-17.

Other issues and industries

The new tax law also includes a host of other provisions, including provisions of relevance to compensation, financial products and instruments, S corporations, partnerships, real estate investment trusts (REITs), regulated investment companies (RICs), craft beverages, and compliance.

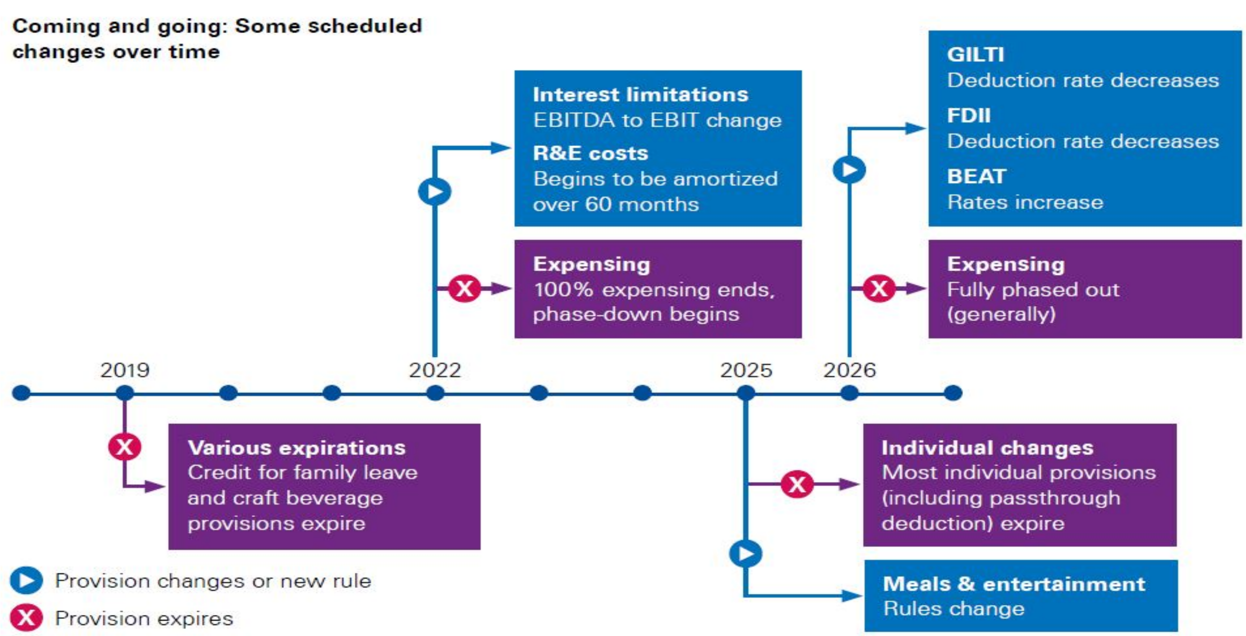
In addition, enactment of the new law raises state and local tax as well as financial accounting considerations.

Effective dates and temporary provisions

The effective date of many of the provisions in the new law is tax years beginning after December 31, 2017. However, effective dates of several provisions are tied to the date of enactment (December 22, 2017), while other provisions have still different effective dates.

Moreover, as illustrated in the chart below, some new rules are scheduled to change over time, and a limited number of the business provisions, as well as most of the individual provisions (other than the new indexing method and the effective repeal of the individual mandate), are scheduled to expire.

Read the **KPMG Book** [PDF 10.3 MB] for a more complete discussion of effective dates and scheduled changes to, or expirations of, new rules.



Possible need for subsequent clarifications

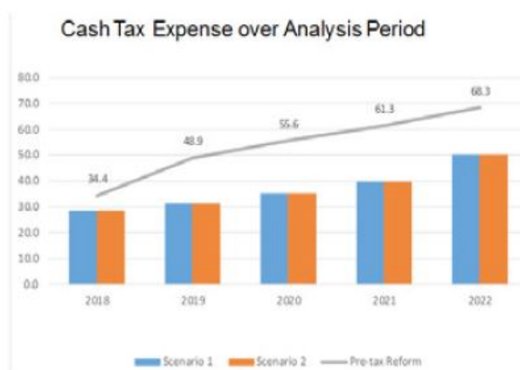
Given the sheer size of the new law and the rapid pace of developments from the start of the Ways and Means Committee's markup to enactment, clarifications and corrections can be expected to be needed for some provisions.

As discussed in the **KPMG Book** PDF 10.3 MB], enacting corrective legislation might not be easy, at least in the current Congress. Read **TaxNewsFlash-Legislative Updates** for information regarding possible developments with respect to corrective legislation.

Practical considerations

The significant changes made by the tax law raise a host of planning issues and opportunities, as well as compliance considerations. (Practical issues and considerations are highlighted in the KPMG Book.) Some businesses also may want to model the potential impact of some changes, based on their particular facts and circumstances.

Illustration of some types of output from KPMG modeling tool



Company Total Tax Summary

Pre-tax Reform

Tax Reform Scenario 1

Description	Pre-tax Reform 2018	2019	2020	2021	2022	Total	Tax Reform Scenario 1 2018	2019	2020	2021	2022	Total	Total Difference
Book Earnings before Tax	89.3	94.1	109.3	128.3	149.3	**570.3**	89.3	94.1	109.3	128.3	149.3	**570.3**	-
Taxable Income after NOL and special deductions	106.8	145.3	164.7	181.0	200.8	**798.6**	161.2	174.8	192.7	210.1	244.9	**983.6**	**185.0**
Total Tax (Line 31, Form 1120)	37.4	50.9	57.6	63.3	70.3	**279.5**	28.1	31.0	34.8	38.4	45.7	**178.0**	**(101.6)**
Payments and Refundable Credits	(3.0)	(2.0)	(2.0)	(2.0)	(2.0)	**(11.0)**	(3.0)	(3.0)	(3.0)	(2.0)	(2.0)	**(13.0)**	**(2.0)**
Total Tax on Repatriation of Foreign Earnings	-	-	-	-	-	-	3.4	3.4	3.4	3.4	6.4	**20.1**	**20.1**
Total Taxes Paid by Company	34.4	48.9	55.6	61.3	68.3	**268.5**	28.5	31.4	35.2	39.8	50.2	**185.1**	**(83.4)**
Present Value of Total Taxes Paid	**32.8**	**44.3**	**48.1**	**50.5**	**53.5**	**229.1**	**27.2**	**28.5**	**30.4**	**32.7**	**39.3**	**158.1**	**(71.0)**
Regular NOL Carryforwards	-	-	-	-	-		-	-	-	-	-		-
Interest Expense Carryforwards	-	-	-	-	-		-	-	-	-	-		-
Cash Tax Rate	**38.5%**	**51.9%**	**50.9%**	**47.8%**	**45.7%**	**47.1%**	**31.9%**	**33.4%**	**32.2%**	**31.0%**	**33.6%**	**32.5%**	**-14.6%**

Digest—Summary and considerations

Key changes to taxation of individuals

The changes made to individual taxation result in significant tax cuts for many—though not all—taxpayers. For legislative procedure and budgetary reasons, most changes applicable to individuals are temporary and apply only to tax years 2018 through 2025. Unless otherwise indicated, the changes to individual taxation discussed below expire beginning with the 2026 tax year.

Lower tax rates

The legislation maintained the key elements of the U.S. progressive tax rate system, with seven tax "brackets" ranging from 10% to 37%. However, most of the tax rates were lowered by several percentage points, with the highest rate being reduced from 39.6% to 37%. At the same time, the bracket thresholds were generally raised, with the most significant raises going to "married filing joint" filers. The combination of lower rates and higher bracket thresholds equates to lower income tax liability for most taxpayers. It is important to note, however, that tax rates are applied to taxable income and the legislation eliminated or curtailed many tax deductions that some taxpayers utilized to lower taxable income. Thus, many taxpayers may see their federal income tax liability increase as a result of a higher taxable income.

Notably, while the individual AMT was maintained, the legislation implemented higher exemption amounts and phase-out thresholds for the exemption, which should mean that far fewer taxpayers will be subject to this tax.

In January 2018 the IRS issued new wage withholding tables. Rates of withholding on supplemental wages have also been reduced: the new rates are 22% for supplemental wages up to $1 million per year and 37% for cumulative supplemental wages in excess of $1 million.

The "marriage penalty," which caused many married couples to pay more income tax than they would if they remained single, has been eliminated for all but those taxpayers in the highest income tax bracket. The 3.8% "net investment income tax" was retained, as was the 0.9% additional Medicare tax applicable to annual wages over a certain threshold based on the taxpayer's filing status.

The special tax rates that apply to long-term capital gains and qualified dividends were maintained at their previous levels. Therefore, most taxpayers will continue to be subject to a 15% rate on such income, but with a 0% rate for lower-income taxpayers, and a 20% rate applicable to those who would have been subject to the highest rate of tax under the pre-enactment tax brackets.

Higher standard deduction and child credit

Taxpayers are entitled either to claim specific itemized deductions, or to claim the flat amount of the "standard deduction." The legislation nearly doubles the standard deduction (to $12,000 for a taxpayer filing as single and $24,000 for married joint filers), while limiting or eliminating many itemized deductions. As a result, many fewer taxpayers are expected to claim itemized deductions than did in the past.

In addition, the legislation suspends the deduction for the "personal exemption" amount that was allowed for the taxpayer, spouse, and each dependent under prior law. For all filing statuses, the new standard deduction amount is greater than the combination of the standard deduction and personal exemptions under previous law, unless the taxpayer has dependents. Even in that case, however, larger tax credits allowed for dependents under the legislation may mitigate the impact of the loss of personal exemptions for most taxpayers. The credit for children under age 17 is doubled to $2,000, and a new credit of $500 is allowed for certain older children and other dependents. Also, the phase-out amount applicable to these credits is much higher, so many more taxpayers should be able to take advantage of them. However, a new requirement limits the $2,000 credit to dependents who have a social security number (under prior law, an individual taxpayer identification number was sufficient).

Curtailment of many deductions

For many taxpayers who claim itemized deductions rather than the standard deduction, their largest single deduction is for state and local taxes (SALT), comprising property taxes and either income tax or sales tax. Under prior law, these taxes generally had been deductible in full, but the new law limits the total SALT deduction to a maximum of $10,000 ($5,000 for married taxpayers filing separately). This change may be of particular interest to those who reside in states with higher tax burdens and a higher cost of living (generally, states on the West and Northeast coasts).

The deduction for home mortgage interest also is subject to new limitations, although of a less drastic nature. Deductible mortgage interest related to debt incurred in the acquisition, construction, or substantial improvement of one's home (or homes—interest related to the primary residence and one other residence qualifies for this treatment) was previously limited to debt of $1 million. For mortgages incurred after December 15, 2017, that amount is reduced to $750,000. Existing acquisition debt of up to $1 million is "grandfathered" and remains deductible, but the deduction for interest on up to $100,000 of home equity debt has been suspended.

The deduction for qualified moving expenses—which is not an itemized deduction but an "adjustment" allowed even to taxpayers who claim the standard deduction—has been suspended. Additionally, employer reimbursements for such expenses will now be included in taxable compensation.

Other changes to itemized deductions that may have more limited impact include:

- Deductions for charitable contributions are now limited to 60% of adjusted gross income (AGI), rather than 50%.

- The threshold for deducting medical expenses is lowered from 10% of AGI to 7.5%, but only for tax years 2017 and 2018.

- Casualty losses are deductible only if they are suffered in relation to a federally-declared disaster.

- The entire category of "miscellaneous itemized deductions" that are deductible to the extent they exceed 2% of AGI has been suspended. This category includes unreimbursed employee business expenses, tax preparation fees, and investment expenses.

- The phase-out of itemized deductions has been suspended, so while fewer taxpayers will likely be claiming itemized deductions, those who do so will be allowed the benefit of the deductions in full.

Other items

In some situations, individuals (as well as trusts and estates) that own businesses through partnerships, S corporations, and sole proprietorships may benefit from a new deduction. However, they also may be subject to new loss limitation rules. (See discussion of passthrough considerations below.)

Although gift and estate taxes were not repealed, the exemption amount was doubled to an inflation-adjusted $10 million, so far fewer transfers of property will be subject to this tax.

The "kiddie tax," which required that some children's investment income be taxed at their parents' marginal tax rate, has been simplified, so that such income is now taxed as if it were retained by an estate or trust.

The new law permanently changes the treatment of alimony paid, effective for divorce settlements finalized after 2018. Alimony paid with respect to those future divorces will not be deductible to the payor, and will not be taxable to the recipient. Tax treatment of alimony paid with respect to divorces finalized in years prior to 2019 remains unchanged, even if paid in 2019 or later.

One change was made to the ACA, which mandates that all individuals purchase medical insurance. Those who fail to purchase insurance are liable for an addition to their income tax, unless one of many exceptions applies. A permanent law change effectively repeals the mandate beginning in 2019 by reducing the "Shared Responsibility Payment" tax to zero.

For a more detailed discussion of the application of the new tax law to individuals, please see the **KPMG Book** [PDF 10.3 MB]

General considerations for business taxpayers

The following items are among the more significant changes in U.S. income taxation of businesses in general enacted as part of the new tax law:

Corporate rate reduction

For many taxpayers, the single most significant U.S. corporate income tax change effected by the new tax law is the 14 percentage point reduction in the corporate rate, to 21% (from the former top rate of 35%). This 40% reduction in the rate generally took effect on January 1, 2018, and is intended to make the U.S. "headline" rate more in line with the internal corporate tax rates imposed in other jurisdictions.

The rate reduction can be expected to have a number of significant effects on U.S. corporations. For example, the lower rate intersects financial accounting in material ways, most immediately through the balance sheet values associated with deferred tax assets and certain deferred tax liabilities. As an example, loss carryovers are worth less now if the income that will be shielded is taxable at a 21% rate rather than the former, higher rate. The rate reduction also will be felt through the income statement provision for income tax expense. For many U.S. headquartered multinationals, the initial income statement effect might include the effects of adjustments to the balance sheet deferred tax items, as well as the transition tax, also referred to as the mandatory repatriation provision, the one-time tax imposed with respect to previously unrepatriated earnings of foreign subsidiaries.

See the discussion of passthrough considerations for a discussion of a new deduction for individuals, trusts, and estates that own certain passthrough businesses. This deduction can have the effect of lowering the rate on certain kinds of passthrough business income.

Bonus depreciation (expensing)

In recent years, businesses have been able to claim enhanced 50% first-year "bonus" depreciation for certain newly-acquired tangible, depreciable property. The new law extends and significantly enhances the depreciation benefit by increasing the write-off to 100%, meaning that businesses can now immediately expense the full cost of qualifying property, for property placed in service before 2023. The percentage phases down in 20 percentage point increments, from 2023 through 2026. The law also expands the provision to include the acquisition of previously used property (provided the used property is purchased from an unrelated party and it is the taxpayer's first use of the property).

Qualifying property generally includes most tangible property other than buildings. The cost of intangibles (such as goodwill) is not generally eligible for the deduction. However, in an expansion of prior law, the cost of qualified film and television productions is eligible for the benefit.

The availability of the deduction could have a number of impacts on business acquisitions. Since buyers can claim an immediate deduction for the cost of qualified property, they may prefer asset acquisitions over stock acquisitions. Further, the availability of the deduction for tangible property (but not for real property or most intangibles) will likely result in negotiations between the parties regarding the appropriate purchase price allocation. The expansion of bonus depreciation to used property also is expected to have a beneficial impact for buyers in the M&A space.

Repeal of the corporate alternative minimum tax

The new law repeals the corporate AMT, simplifying U.S. corporate taxation. For corporations that previously paid AMT and hold an inventory of minimum tax credit carryovers, the law allows for the enhanced use of minimum tax credits to offset regular tax, and provides that excess minimum tax credits can be refunded from 2018 through 2021.

Net operating losses

The new law generally precludes the carryback of NOLs. This eliminates the countercyclical benefit of being able to carry back losses to obtain refunds of taxes paid in prior, flush years, which had been of significant benefit to corporations experiencing financial difficulties or working through a downturn in the business cycle.

At the same time, the law provides for the unlimited carryover of NOLs arising in 2018 and later years (prior losses remain subject to the prior 20-year carryover period). This change may have an effect on financial accounting for income taxes and valuation allowances for loss carryovers, to the extent it reduces the likelihood that losses otherwise would have expired unused. Finally, importing a concept from the former corporate AMT, the law imposes a new limitation on the use of NOLs arising in 2018 and later years, providing that these losses cannot offset more than 80% of taxable income.

Limitation on the deduction of net business interest expense

The new law generally disallows a deduction for net business interest expense of any taxpayer exceeding 30% of a business's adjusted taxable income (generally EBITDA for years before 2022 and EBIT thereafter) and floor plan financing interest. In general, business interest expense and business interest income is interest allocable to a trade or business and does not include investment interest expense or income.

The limitation does not apply to certain small businesses with average gross receipts under $25 million, nor does it apply to certain regulated public utilities and electric cooperatives. Furthermore, certain taxpayers, such as certain real estate businesses, may elect out of the new limitation, although businesses electing out of the provision are required to use an alternative depreciation system to depreciate certain property.

Subject to the above exceptions, the provision applies to all businesses, regardless of form, and any disallowance is generally determined at the tax filer or entity level (e.g., at the partnership level instead of the partner level). For a group of affiliated corporations filing a consolidated return, the conference report indicates the provision applies at the consolidated tax return filing level, although the provision itself does not address this point. Regulatory guidance is needed to address how the new rules apply in the consolidated return context.

Subject to special rules for partnerships, any business interest disallowed would be carried forward indefinitely, but would be subject to the tax code's loss limitations in the event a corporation undergoes an ownership change. Special rules allow a partnership's or S corporation's unused interest capacity to be used by its partners and shareholders.

The law does not grandfather existing debt, meaning that the new limitation also applies to interest on debt incurred before enactment — a key issue for highly leveraged companies. The new interest limitation also can be expected to have a disproportionate impact on corporations that employ a higher degree of leverage, operate in an economic downturn, or experience financial difficulty.

Observation: Effects on M&A

The new law is expected to significantly affect M&A activity. The new bonus depreciation (immediate expensing) rule discussed above may increase the incentive to structure acquisitions as asset deals or as deemed asset acquisitions using a section 338 election. At the same time, the lower individual and corporate rates may increase the willingness of sellers to part with built-in gain businesses, especially if the proceeds can be invested in a manner that qualifies for immediate expensing. The new tax rules also may increase the potential U.S. tax exposure items associated with targets, including with respect to the future repatriation transition tax payments of targets that elected an eight-year installment payout (repatriation discussed in greater detail below). The new U.S. international tax rules and interest limitation are expected to be felt in M&A modeling, structuring, and financing, and may complicate post-deal integration planning.

Financial modeling

The corporate rate reduction leaves the combined federal-state corporate rate near or above the effective rates associated with some other jurisdictions. At the same time, the new rate environment must be balanced with the myriad other corporate tax changes made by the new law. As explained below, the new U.S. international tax regime introduces several new concepts and acronyms (such as GILTI, FDII, and BEAT) and is expected to significantly complicate tax planning for inbound and outbound multinational operations. The new limitation on interest deductions is expected to affect how corporations finance their operations and acquisitions. The new 80% NOL limitation will affect the ability to deduct prior losses, and may result in the imposition of cash taxes on a corporation as it emerges from financial difficulty. Many of the new provisions can be expected to interact with other provisions in ways perhaps not anticipated by the Congressional drafters. Financial, business, and cash tax models should be updated to reflect the new tax rate and rules, as well as the risk associated with the many new uncertainties associated with the law.

Uncertainties

Enactment of the sweeping new law creates some uncertainties in the U.S. corporate tax system. First, the extensive new tax rules and new U.S. international tax regimes mean taxpayers face a learning curve. In addition, the law presents many new interpretative questions, which entail risk and require careful navigation and create a pressing need for regulatory guidance (particularly if Congress is not able to enact technical corrections legislation in the near future). The new international rules may prompt reaction from trading partners. Will the new rules be subjected to a WTO challenge, and if a challenge is successful, how will a future Congress react? Will our trading partners modify their tax laws in ways that might affect—or even target—U.S. headquartered multinationals? Finally, the new law contains many temporary provisions, raising the question whether they will be extended in the future. For example, the new interest deduction limit shifts to 30% of EBIT in 2022, immediate expensing starts to phase out in 2024, and the new global minimum tax and deduction for certain foreign-derived income changes materially in 2026, meaning higher taxes on those items. In addition, many of the individual income tax provisions sunset at the end of 2025. How all of this will play out is not clear. As Yogi Berra is reported to have said, “It is tough to make predictions. Especially about the future.”

For a more detailed discussion of the general application of the new tax law to corporate taxpayers, please see the **KPMG Book** [PDF 10.3 MB].

Considerations related to accounting methods, deductible items, and other items

Certain special rules for tax year of inclusion

Under the “all events test,” an accrual method taxpayer generally recognizes revenue upon the earliest of when amounts are received, due, or earned. The new tax law adds an additional criteria to this standard by providing that the all-events test is satisfied no later than the year in which the revenue is recognized in a taxpayer’s applicable financial statements (with certain exceptions). The new limitation also applies to holders of certain debt instruments with original issue discount (OID). The new book conformity rule will cause an acceleration in the recognition of income for many taxpayers (for example, any unbilled receivables for partially performed services must generally 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).

Longstanding IRS guidance provides several exceptions to the accrual principle that revenue must be recognized in the year that an advance payment is received or due. Under the exception provided in an IRS procedure, a taxpayer that receives advance payments for goods or services (or certain other qualifying items) may elect to defer the advance payments to the tax year following the year received or due, to the extent the revenue has been deferred in its financial statements. The new law effectively codifies the IRS procedure as the exclusive method for deferral of advance payments for goods and services and authorizes the IRS and Treasury to issue administrative guidance that sets forth any additional conditions or scope of the new law.

The new tax law also requires that, in the case of a contract containing multiple "performance obligations," the contract's transaction price must be allocated among the performance obligations for tax purposes in the same manner as it is allocated for financial accounting purposes. The concept of allocating fair value to performance obligations is taken from the new financial accounting standards (ASC 606 and IFRS 15) for revenue recognition, which is effective for public companies in 2018. The new tax law provision applies to tax years beginning after December 31, 2017.

A change in treatment of an item in order to implement the new rules is considered a change in method of accounting.

Repeal of domestic manufacturing deduction

Since 2005, companies engaged in a wide range of production activities in the United States generally have been permitted to deduct a stated percentage (generally 9%) of their net income (subject to many qualifications and special rules). Designed as a targeted rate reduction for certain industries, the "section 199" deduction seemingly was perceived as redundant in light of the new law's overall reduction in corporate tax rate, and has been repealed for tax years beginning after December 31, 2017. The deduction temporarily remains available in two circumstances: (i) for fiscal year taxpayers' tax years beginning in 2017; and (ii) for any taxpayers otherwise eligible to claim the benefit in open tax years prior to 2018, through the filing of amended returns. As a "permanent item," the ability to file amended returns claiming the section 199 deduction against income taxed at the higher, pre-2018 corporate rates is an attractive benefit to consider.

Expanded non-deductibility of certain fines and penalties

The tax code has for many years disallowed deductions for fines and penalties if they are paid to a government agency or instrumentality. The new tax law expands that prohibition to include *any* amounts that are paid "to or at the direction of" governmental or specific non-governmental entities. As under prior law, payments for restitution, remediation of property, or bringing the company into compliance with the law (including taxes due) remain deductible, but only if the amounts are identified as such in the applicable court order or settlement agreement. Although the IRS can still challenge whether the payments are in fact intended for one of these permitted purposes, the new law places a premium on the manner in which the payments are described in the underlying court order or settlement agreement. The new restriction generally applies to amounts paid or incurred after December 22, 2017, unless a binding order or agreement was entered prior to that date.

Repeal of deduction for local lobbying activities

The new tax law precludes businesses from deducting lobbying expenses with respect to legislation before local governments (including Indian tribal governments). The new rule conforms the treatment of local lobbying expenses to those at other levels of government. Importantly, many categories of “governmental affairs” expenditures at all levels of government remain deductible, including costs for monitoring legislation, attempts to influence rules and regulations, relationship building, and reputational lobbying. Many companies overlook this distinction, resulting in an annual understatement of the deductions to which they are otherwise entitled. The expansion of the disallowance for local lobbying expenditures is effective for amounts paid or incurred on or after December 22, 2017.

Limits on like-kind exchange rules (section 1031)

The new law limits the like-kind exchange rules under section 1031 to exchanges of real property (other than real property held primarily for sale) and applies to exchanges completed after December 31, 2017. A transition rule provides that the new law does not apply to any exchange in which the taxpayer disposed of relinquished property, or received replacement property, on or before December 31, 2017.

The new law’s limitation on like-kind exchanges eliminates deferral for exchanges of tangible personal property and intangible property, which may adversely affect existing like-kind exchange programs. However, for tangible personal property, the new law’s allowance for full expensing may offset the negative impact of eliminating gain deferral under section 1031.

Research and development

The law leaves intact the research credit, which remains a permanent tax benefit for taxpayers.

The law allows taxpayers to fully deduct research expenses through 2021; however, starting in 2022, taxpayers must recover research expenses over a 5-year period (or 15 years if the expenses are related to research conducted outside of the United States).

Under the new law, taxpayers who conduct R&D for orphan drugs may continue to receive federal income tax credit at a credit rate of 25% of qualified clinical testing expenses (reduced from a 50% credit under prior law).

For a more detailed discussion of the application of the new tax law to accounting methods and related issues, please see the **KPMG Book** [PDF 10.3 MB].

Compensation-related considerations

$1 million deduction limit on executive compensation

The new law includes several significant changes to the limitation on the deduction for compensation paid to named executives of publicly-traded companies. Specifically, the limitation was amended to:

- Expand the definition of companies subject to Code section 162(m) to include certain companies with publicly-traded debt as well certain companies with American depository receipts.

- Expand the definition of "covered employee." In addition to the CEO and three highest-compensated named executives, the CFO is now subject to section 162(m). Due to a prior misalignment between the SEC disclosure rules and the tax rules, the CFO pay had not been subject to the section 162(m) limitation for the last 10 years. Now anyone serving as CEO or CFO during a given year is also subject to section 162(m). Previously, the rules looked only at who held this position at the end of the year. Also, once a covered employee for a company, always a covered employee for that company. While the determination of who is a covered employee is done on an annual basis, covered employees now include anyone who was a covered employee for any tax year after 2016.

- Make performance-based compensation awards (including annual performance bonuses, performance stock units, and stocks options) no longer exempt from the section 162(m) deduction limitations. This often utilized exception to section 162(m) has been eliminated.

- Provide a transition rule for compensation paid pursuant to a written, binding contract (such as a stock option or performance-based award agreement) in effect as of November 2, 2017, if not materially modified after that date. Merely having a plan in place on November 2, 2017, does not provide grandfathering. The award or arrangement must constitute a "written, binding contract." The compensation committee's right to reduce awards at the time of payment (sometimes called negative discretion), which is common in such arrangements, may affect the determination whether there is a binding contract.

Deduction limitations for fringe benefits

The new law makes several changes to common benefit deductions. In particular, the law reduces and/or eliminates deductions related to meals, entertainment, recreation activities, and qualified transportation benefits. These new rules apply for any expenses incurred on or after January 1, 2018, and thus are already in effect even for non-calendar tax years.

Meals

Prior law historically limited deductions for expenses related to meals and entertainment provided to employees. For example, meals related to business travel were already subject to a 50% deduction limitation. However, deductions for certain other meals were fully deductible. These categories of meals included:

- Meals excluded from employee income as de minimis fringe benefits
- Meals provided at qualified employer-operated dining facility on or near the employer's business premises that satisfy direct cost payment requirements, or were provided for the convenience of the employer

Under the new law, these meals that were previously fully deductible are now subject to a 50% limitation. In addition, after 2025, meals provided through an employer-operated dining facility or pursuant to the convenience of the employer rules will not be deductible. Expenses related to the operation of an employer-operated eating facility will also no longer be deductible after 2025.

These meals, however, remain excludable from employee income. To the extent employees pay for meals, and the amounts paid by employees equal or exceed the employer's direct cost, additional guidance is necessary to understand how deductions may be affected.

Entertainment, amusement, or recreation activities

Historically, deductions were not allowed for expenses related to the provision of entertainment, amusement, or recreation activities, unless there was a valid business event that occurred before, during or after the activity. If the activity was related to a business event, the expenses were likely 50% deductible. There were also strict definitions for what qualified as business-related entertainment, amusement, or recreation activities. This deduction limitation was also subject to exceptions, such as for non-discriminatory recreation, and for entertainment sold to customers.

The new law eliminates any deduction for expenses related to an employer's provision of entertainment, amusement, or recreation activities, even if the activities (such as theater and sporting events, golf outings, etc.) are related to business. The law also eliminates the "charitable sporting tournament" exception (though some portion of the payment might still be deductible as a charitable donation).

One exception remains intact. Events such as nondiscriminatory employee holiday parties or employee group recreation activities are potentially still deductible.

Qualified transportation fringe benefits

Under prior law, expenses to provide qualified transportation fringe benefits were generally deductible as ordinary and necessary business expenses. Qualified transportation benefits include:

- Transit passes — subway and bus passes
- Commuter highway vehicles — van pools and buses
- Qualified parking — parking on or near the employer's premises, on or near a location from which the employee commutes to work by subway, bus, vanpool, or carpool

These benefits remain excludable from employee income.

The new law, however, disallows deductions for the expense of any qualified transportation fringe benefit. The amount disallowed as a deduction appears to depend on how the benefit is provided to the employee.

The law also generally disallows a deduction for any expense incurred for providing transportation, payment, or reimbursement to an employee relating to travel between an employee's residence and place of employment (commuting expenses), except as "necessary for ensuring the safety of the employee." This rule appears to be broader than the qualified transportation benefit rule above, though focused only on commuting costs between home and office. Additional guidance is needed to determine what costs might be excluded, but it is possible that the administrative costs for transportation programs may be subject to a loss of deduction.

Because bicycle commuting reimbursements must now be reported as taxable compensation by employees from 2017 through 2025, employers are generally able to deduct expenses, payments or reimbursements to employees for such benefits. These benefits are includable in employee income, and are therefore not qualified transportation benefits during this period.

Qualified stock compensation

The new law addresses problems with stock compensation and the illiquid nature of stock in private companies. Private companies have been particularly challenged by the illiquid nature of their equity, when recruiting and retaining talent. One problem is that the illiquid nature of private company equity generates "dry income" — a situation where the individual in receipt of company equity is taxed on the fair market value, but does not have a viable resale market in order to cover taxes. The other problem is that, because of the dry income potential, individuals will often wait until a transaction or other corporate event (such as an initial public offering) to exercise or vest in equity, and consequently an individual who could have been subject to capital gains rates on a transaction had they acquired the equity earlier is instead subject to ordinary income tax rates.

The law, while subject to many qualifications and caveats, attempts to address these issues. It provides that certain employees who received qualified stock upon either the exercise of an option or the settlement of a restricted stock unit can elect to defer tax on their compensation. Not every employee of a privately-held corporation will be eligible to make the election. Excluded employees include anyone who is or was:

1. A 1% owner of the corporation during the current year or at any time during the 10 preceding calendar years,

2. The chief executive officer or chief financial officer of the corporation or an individual acting in either capacity,

3. A family member of an individual described in (1) or (2), or

4. One of the four highest compensated officers of the corporation during the current year or for any of the 10 preceding tax years.

In general, deferral stock is subject to tax at the earliest of:

- The first date the deferral stock becomes transferable (including to the employer),

- The date the qualified employee first becomes an excluded employee,

- The first date the corporation's stock becomes readily tradable on an established securities market,

- Five years after the first date the employee's qualified equity grant vests or becomes transferable, or

- The date the employee revokes his or her election with respect to his or her deferral stock.

In order for stock to be eligible for this election, the stock compensation awards must be provided to at least 80% of employees who provide services in the U.S. The stock granted must provide the employees with the same rights and privileges. Because of these restrictions, and the fact that employees may end up with the same dry income problem in the fifth year after transfer of the qualified stock, use of the new provision may be limited.

For a more detailed discussion of the new law and provisions related to the taxation of compensation and benefits, please see the **KPMG Book** [PDF 10.3 MB].

Considerations for passthrough entities

General changes to treatment of individual taxpayers

The new law's changes to the taxation of individuals have important implications in the partnership and S corporation taxation context as they could affect the tax position of the owners and entity choice considerations. See discussion of the individual changes on pages 11 -14.

State tax deduction. One of the most significant changes in the taxation of individuals is the general suspension (through 2025) of the deduction for payments of state and local taxes. The potential loss of this deduction by individuals has received much attention, as has the substantial uncertainty as to how states may tax partnerships in the future. The disparate treatment may factor into the analysis of whether to conduct business in a partnership or corporation.

Itemized deductions. Importantly, the elimination of most itemized deductions will result in the inability of fund investors to deduct management fees and may result in a restructuring of such fees.

20% deduction for certain passthrough income

A much-discussed provision of the new law generally allows individual taxpayers (and trusts and estates) to deduct 20% of certain qualified business income derived from a partnership, S corporation, or sole proprietorship. The deduction is only available for tax years beginning after December 31, 2017 and before December 31, 2025.

The provision is one of the more complex in the new law and it contains a number of important limitations (which had been described as "guardrails" during the legislative process). For example:

- The amount of the deduction is limited under a multi-part formula that is based, in part, on the W-2 wages paid with respect to a qualified trade or business and on the "unadjusted basis" of qualified property used in the business. This multi-part formula applies separately with respect to *each* qualified trade or business.

- Certain classes of income are ineligible for the deduction, including investment income and capital gain, payments received by a partner in exchange for services, and compensation received by an owner of an S corporation.

- Income derived from a "specified service" is generally not eligible for the deduction. Specified services include businesses such as those in health, law, accounting, performing arts, consulting, athletic services, financial services, brokerage services and any trade or business where the principal asset of the business is the reputation or skill of one or more of its employees or owners of the business. However, this carve-out does not apply to taxpayers with taxable income below a certain threshold.

The deduction applies at the partner, shareholder, or proprietor level. Partnerships required to make tax distributions might consider reviewing and, if necessary, revising their partnership agreements to take this new deduction and the new 21% corporate rate into account. Any reduction in the amount of required tax distributions could enhance the partnership's cash flow.

From a planning perspective, taxpayers should consider the potential effects of the new deduction on how they organize their operations and on future reporting. However, these effects may be uncertain, because key elements of this provision require guidance, which might not be immediately forthcoming. For example, how will a trade or business be defined, and who will do the defining? What is the scope of the specified services trades or businesses, and will rules be written to address potential carve-outs? Will anti-avoidance regulations be issued and if so, what will they say? How will the rules apply in the context of tiered entities?

Lastly, the new deduction expires after 2025. In contrast, the corporate tax reduction in the law is permanent. The temporary nature of this provision complicates planning, and should be considered by taxpayers in evaluating whether to continue to operate in passthrough form or convert to corporate form to take advantage of the new, lower corporate tax rates. Taxpayers will likely need to model the anticipated effect of the new deduction and other changes in the new law to help assess the implications of tax reform on future planning.

Interest expense limitations

As explained on pages 15 - 16, the law imposes a new limitation on the deductibility of interest, and does not grandfather existing debt. In general, the amount a taxpayer can deduct for any tax year for net business interest expense is limited to 30% of "adjusted taxable income." Importantly, this limitation does not apply to an electing real property trade or business. This new rule has complex implications in the passthrough entity context.

For interest incurred by a partnership, the limitation applies at the filer level. Similar rules apply to S corporations and their shareholders. However, carryovers of excess business interest expense apply at the partner level. In particular, a partnership's excess business interest expense is allocated to the partners, and is generally treated as paid or accrued by the partner in the next tax year in which the partner is allocated excess taxable income from the same partnership. This allocation reduces the partner's basis in the partnership. However, a partner that disposes of its partnership interest generally can add back to its basis in the partnership the amount of disallowed business expense allocated to the partner and not previously deducted, for purposes of determining the partner's gain or loss on the disposition. For S corporations, however, the carryover occurs at the S corporation (rather than at the shareholder) level.

Even where there is no interest limitation at the partnership level, there are still complex considerations and uncertainties to be addressed in determining interest deductibility at the partner level. Hopefully, future guidance will quickly resolve some of the uncertainties of the new law.

Taxpayers should review their debt structures to determine how the new law applies and whether any interest expense will be limited and, if limitations are anticipated, evaluate whether there may be ways to mitigate the impact of the new rules. Taxpayers should also consider modeling the anticipated effect of the new interest limitation when deciding how to finance future acquisitions and operational cash needs.

Loss limitation rules

The new law temporarily limits an individual's active net business loss (as opposed to passive losses which are limited to passive income) to $500,000 for married individuals filing jointly or $250,000 for other individuals. Any business loss in excess of such amount is treated as part of the taxpayer's NOLs and carried forward to subsequent tax years. NOLs carried forward to later years are limited to 80% of taxable income.

Carried interest provision

The new law addresses the taxation of "carried interests" ("applicable partnership interests," or "APIs"). Generally, a taxpayer that recognizes long-term capital gain from the sale of an API may have some portion of that gain treated as (higher-taxed) short-term capital gain. At a high level, the provision requires the taxpayer to have a three-year asset-holding period to avoid short-term gain treatment. The new law applies to tax years beginning after December 31, 2017, without any grandfather rules or transition relief.

To be an API, the partnership interest must be transferred to, or held by, the taxpayer in connection with the taxpayer's (or a related person's) performance of substantial services in any "applicable trade or business." The law provides a detailed definition of "applicable trade or business," which generally involves raising or returning capital along with investing, disposing, or developing certain specified assets. It appears that the new law applies both to the sale of a partnership interest, as well as to a partner's share of gain recognized by the partnership upon a sale of its assets.

Excluded from the definition of an API are those interests (i) held by a corporation or (ii) where the partner has a capital interest. In addition, an interest is not an API if held by a person who is employed by solely by an entity other than the entity conducting the applicable trade or business.

Also, the new law requires a three-year hold for certain assets. As a result, some assets (such as property used in a trade or business) may fall outside the scope of the new law.

As a practical matter, taxpayers should review their partnership interests to identify any applicable trades or businesses in which they hold an API, and evaluate whether an exception may be available. Taxpayers that hold APIs subject to the three-year rule should consider avoiding new holding periods. For instance, how follow-on investments are financed may impact whether a new holding period is created in an API. Also, prior to any sale, analysis should be done to determine how the sale might be structured to minimize the potential of gain that would not meet the three-year rule.

Repeal of partnership technical termination rules

Under prior law, a transfer of 50% or more of the interests in a partnership triggered a "technical termination." The new law repeals this rule.

The repeal of the technical termination provisions can have implications that may be viewed favorably or unfavorably by taxpayers, depending on the particular facts and circumstances.

Although repealed for federal tax purposes, technical terminations may still be relevant for state tax purposes, particularly in states which impose transfer taxes as a result of the technical termination. Thus, prior to any transfer of a partnership interest, consideration should be given as to whether a technical termination may result for state tax purposes. In some instances, the partnership agreement may restrict the ability of partners to transfer their partnership interests if the transfer would result in a technical termination if it could have adverse tax consequences.

Tax gain on the sale of foreign partner's partnership interest on look-through basis

The new law codifies the longstanding IRS position that a foreign partner's gain from a sale of an interest in a partnership that is engaged in a U.S. trade or business will be subject to tax as effectively connected income (ECI) to the extent that a sale of assets by the partnership would have resulted in ECI for the foreign partner. This provision overrules a 2017 Tax Court case that had rejected the IRS position.

In addition, the new law imposes a new 10% withholding obligation on buyers of such partnership interests, unless the seller certifies that it is not a foreign person. This withholding obligation is backstopped with a requirement that if the buyer does not withhold the correct amount, the partnership must withhold from distributions to the buyer the amount the buyer failed to withhold, plus interest. Treasury has issued a notice suspending the application of the withholding provisions to publicly traded partnerships until guidance is issued.

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

This provision is significant because (1) it confirms the treatment of dispositions of interests in such partnerships by foreign partners; (2) it adds a withholding requirement, meaning there is a new need for diligence and contractual protection in connection with transfers of partnership interests, and creates the potential for duplicative withholding in certain cases (e.g., when the seller is itself a foreign partnership); and (3) the new partnership backstop withholding obligation requires increased partnership involvement in transfers of partnership interests amongst partners. There is also considerable uncertainty regarding how the provision could apply to nonrecognition exchanges. The provision may be particularly important for investment funds that invest directly or indirectly in U.S. trade or business partnerships, and for transfers of interests in such investment funds.

Taxpayers should consider revising their partnership agreements to address the new law, the potential for partnership level withholding, and the creation of indemnification rights for withholding liability exposure.

Additional considerations for S corporations

The new law includes four provisions specifically applicable to S corporations and their shareholders. Moreover, the law allows particularly favorable treatment to the shareholders of S corporations that own stock in foreign corporations subject to mandatory repatriation.

Two generally favorable provisions apply to “eligible terminated S corporations,” which are S corporations that revoke their S election within two years of the date of enactment and meet other requirements. Corporations meeting the requirements may spread income from accounting method changes occurring as a result of the C corporation to S corporation conversion in income over a six-year (rather than the general four-year) period. Further, corporations meeting the requirements are subject to a special distribution rule that allows an extended period of time for the corporation to distribute to its shareholders without dividend treatment all of the income of the corporation that was taxed to its shareholders while the corporation was an S corporation. These two changes affect the equation for S corporations considering a conversion to C corporation status as a result of changes made by the new law, and may allow converting corporations to avoid the resulting strain on liquidity caused by an accelerated distribution of earnings previously taxed to the corporation’s shareholders.

The new law also contains two changes to the rules affecting an electing small business trust (ESBT), which is one of the limited types of trusts permitted to hold S corporation stock. First, the law broadens the ability of a trust to qualify as an ESBT by allowing a nonresident alien individual to be a potential current beneficiary of an ESBT. Second, the rules regarding charitable deductions by ESBTs are revised to provide that the individual limitations on those deductions (rather than the rule applicable to trusts) apply.

Finally, the new law contains special rules applicable to the shareholders of S corporations that own stock in foreign corporations subject to the law’s mandatory repatriation. Generally speaking, a U.S. shareholder of certain foreign corporations must treat previously untaxed income of the foreign corporation as distributed to the U.S. shareholder; the tax associated with the deemed distribution may then be paid over an eight-year period. If the mandatory repatriation rules apply to an S corporation, the S corporation itself is the U.S. shareholder and the mandatory repatriation amount, as well as the associated participation exemption deduction, are included by the S corporation in the required year. However, special rules permit an S corporation shareholder to elect to defer payment of its tax obligation attributable to mandatory repatriation until there is a “triggering event,” which may not occur for many years. This may allow a shareholder significant deferral of its tax obligation associated with mandatory deferral.

For a more detailed discussion of the application of the new tax law to passthrough businesses, please see the **KPMG Book** [PDF 10.3 MB].

Considerations for multinational businesses

The new law makes fundamental changes to the taxation of U.S. multinational corporations and their foreign subsidiaries. U.S. multinational corporations under the prior law were subject to immediate and full U.S. income taxation on all income from sources within and without the U.S. The earnings of foreign subsidiaries under the old law, however, were not subject to U.S. income tax until the earnings were repatriated through dividend distributions. Under prior law, an anti-deferral regime (subpart F) which dated back to 1962, applied to certain categories of foreign subsidiary earnings and taxed those earnings in the hands of the U.S. corporate owners as if such amounts had been repatriated via dividend distribution.

The earnings of foreign subsidiaries under the new law, in contrast, are either subject to immediate taxation under expanded anti-deferral provisions, or are permanently exempt from U.S. taxation. The new law generally retains the existing subpart F regime that applies to passive income and related-party sales and services income, and it creates a new, broad class of income (“global intangible low-taxed income” or “GILTI”) that is also deemed repatriated in the year earned and, thus, is also subject to immediate taxation. GILTI income is effectively taxed at a reduced rate, however, while subpart F income is taxed at the full U.S. rate.

To accomplish this shift to the new regime, the new law includes several key features, including:

- A 100% deduction for dividends received from the foreign source income of 10%-owned foreign corporations;
- A tax on GILTI, and
- A one-time transition tax or deemed repatriation tax on the accumulated earnings of certain foreign corporations.

Some of the stated goals in enacting the new tax law were simplification and a shift from a worldwide system of taxation to a territorial tax system (i.e., a tax system that taxes profits where they are earned). Whether the new law achieves these goals is debatable. The new tax law contains complex new provisions that will require significant reasoned analysis and judgment, as well as additional administrative guidance to properly implement. While it might be nominally accurate to state that the new tax system moves towards a territorial system—because certain profits earned by foreign subsidiaries are not subject to immediate taxation and will not be taxed when repatriated—the non-taxable profits are (in most situations) a small portion of the profit pool. Moreover, by expanding the anti-deferral regime to include GILTI (albeit at a reduced effective rate), the new tax law expands the base of cross-border income that is subject to immediate U.S. income taxation.

Other key provisions of the new law are a reduced tax rate for a new class of income earned directly by U.S. corporations ("foreign-derived intangibles income" or "FDII") and a new tax on deductible payments made by U.S. corporations to related foreign persons. The new law also includes a number of smaller changes to the international tax rules that are not discussed in this summary.

Taxation of foreign subsidiaries

Immediate taxation of GILTI

Most foreign subsidiary earnings that had been eligible for deferral under the prior law are now subject to immediate U.S. income taxation under the new GILTI provision. A U.S. shareholder of a controlled foreign corporation (CFC) generally is taxed immediately on its share of the CFC's income that is GILTI. Corporate shareholders are allowed a deduction equal to 50% of GILTI for 2018 through 2025, which will be decreased to 37.5% beginning in 2026. As a result, the effective tax rate on GILTI for a U.S. corporate shareholder is 10.5% prior to 2026, and 13.125% after 2026. A U.S. corporation's GILTI deduction, however, may be limited when its GILTI and foreign-derived intangible income amounts (discussed below) exceed the corporation's taxable income.

In general, GILTI is the excess of all of the U.S. corporation's net income over a deemed return on the CFC's tangible assets (10% of depreciated tax basis). In many situations most of a CFC's gross income that is not subject to current taxation under the existing subpart F regime will be subject to immediate taxation as GILTI. The generally small sliver of income represented by the permitted return on tangible assets is not subject to U.S. taxation when earned by the foreign subsidiary and, as discussed in the next section, is eligible for a 100% dividends received deduction (DRD). A credit is allowed for 80% of foreign taxes paid.

Although lowering the U.S. statutory rate from 35% to 21% presumably reduces incentives to shift profits outside the United States, the GILTI provision reflects a concern that a shift to a territorial tax system could exacerbate those incentives because any profits shifted offshore would be permanently exempt from U.S. tax. The inclusion of GILTI in a U.S. shareholder's income is intended to reduce those incentives by ensuring at least a minimal rate of tax, at least on those earnings of CFCs that exceed the permitted return on tangible assets.

Participation exemption for foreign subsidiary dividends

Under the new law, a domestic corporation that is a 10% shareholder (by vote or value) of a foreign corporation generally is entitled to a 100% DRD for dividends received from the foreign corporation that are attributable to the corporation's foreign earnings. The 100% DRD is available only to domestic C corporations that are neither REITs nor RICs. Thus, foreign earnings that were not taxed under the subpart F or GILTI regimes are fully exempt from U.S. taxation when those earnings are distributed to a 10% corporate shareholder A corporate shareholder may not claim a foreign tax credit or deduction for foreign taxes paid or accrued with respect to a dividend that is allowed a 100% DRD.

Transition rule: Mandatory repatriation

In connection with the change from the old system of deferral to the new system of current taxation or exemption, the new law imposes a one-time transition tax on the accumulated earnings of certain foreign corporations. Generally, a 10% U.S. shareholder (based on voting power) of a specified foreign corporation (SFC) must include in income its share of the SFC's undistributed earnings that were accumulated after 1986 and have not yet been subject to U.S. taxation. An SFC is a foreign corporation that is a CFC or that has a 10% U.S. corporate shareholder. The amount of an SFC's earnings subject to the transition tax is determined based on the greater of its untaxed earnings as of November 2 or December 31, 2017. A U.S. shareholder's mandatory inclusion may be reduced by its share of the deficit in post-1986 earnings of one or more other SFCs.

A U.S. shareholder's mandatory inclusion is taxed at a reduced rate that varies, depending on whether the SFC's earnings are attributable to liquid assets or hard assets. Earnings attributable to liquid assets are subject to an effective tax rate of 15.5%, while all other earnings are taxed at an 8% effective rate. Complex rules apply for determining whether earnings are subject to the 15.5% rate or the 8% rate. The new law also includes a claw-back provision that reverses the benefit of the lower repatriation rates for U.S. shareholders that engage in "inversion" transactions during the next 10 years.

A 10% U.S. shareholder of a calendar-year SFC will have an income inclusion for its 2017 tax year, and a 10% U.S. shareholder of a fiscal year SFC will have an income inclusion for its 2018 tax year. Although the income inclusion is front-loaded, taxpayers may elect to pay the mandatory repatriation tax in installments over an eight year timeframe, with no interest due.

Other cross-border provisions

Deduction for "foreign-derived intangible income"

As a complement to the new minimum tax regime on excess returns earned by a CFC, the new law provides a 13.125% effective tax rate (increasing to 16.406% in 2026) on "foreign-derived intangible income" (FDII) earned directly by a U.S. corporation from foreign sales, leases, licenses, and services. As in the GILTI regime, the reduced effective tax rates are achieved through a special deduction by the U.S. corporation. At a high level, a U.S. corporation's FDII is its net income from export activities reduced by a fixed 10% return on its depreciable assets used to generate the export income. Presumably, the goal of this provision is to provide an incentive for U.S. companies to locate productive assets in the United States, rather than offshore.

A U.S. corporation's FDII deduction may be limited when its GILTI and FDII amounts exceed the corporation's taxable income. In addition, the special FDII deduction is not available for S corporations, RICs, or REITs.

Base erosion and anti-abuse tax

Another new provision that applies to both U.S. and foreign-based multinationals is the "base erosion anti-abuse tax," commonly referred to as the BEAT. The BEAT is an additional tax that applies to large corporations that reduce their U.S. tax liabilities below a certain threshold by making deductible payments (e.g., interest and royalties) to related foreign entities. If applicable, a U.S. corporation will have a BEAT liability in addition to its regular income tax liability.

The BEAT generally applies to corporations that are not S corporations, RICs, or REITs; are part of a group with at least $500 million of annual domestic gross receipts (over a three-year averaging period); and that have a "base erosion percentage" of 3% or higher (2% for certain banks and securities dealers). The base erosion percentage generally is determined by dividing deductions attributable to payments to related foreign persons by the total amount of the corporation's deductions for the year.

Corporations that meet the $500 million gross receipts test and the base erosion percentage are required to run a separate set of calculations to determine whether they are subject to a BEAT liability. The BEAT regime generally requires a taxpayer to recompute its taxable income as if it had not made any base erosion payments and then multiplies that "modified taxable income" amount by the applicable BEAT rate. The taxpayer generally will have a BEAT liability to the extent that amount exceeds the taxpayer's post-credit regular tax liability (the BEAT rules provide preferential treatment for four types of tax credits).

The BEAT rate generally is 5% for 2018, 10% for 2019-2025, and 12.5% after 2025. The BEAT rate is 1% higher for banks and registered securities dealers.

For a more detailed discussion of the application of the new tax law to multinational businesses, please see the **KPMG Book** [PDF 10.3 MB].

State and local tax considerations

Three general questions arise in analyzing how a particular federal tax change affects state corporate income tax liability.

The first is simple – does the state conform to the federal change?

Second, if the state does conform to the federal change, are there features of state law or ancillary issues and unknowns that must be addressed to determine how the federal change affects state tax liability?

Third – and this is the question that largely remains unanswerable at this juncture – what has the state done or will the state do in response to the federal change?

Conformity to the Internal Revenue Code

Nearly every state corporate and personal income tax conforms in some manner to the Internal Revenue Code. 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. States generally follow two patterns in conforming to the federal income tax. Rolling or current conformity states are tied 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 affirmatively act to incorporate subsequent federal changes into the state tax code. Both rolling and fixed-date conformity states, however, tend to pick and choose to which federal provisions they wish to conform, often based often on revenue and other policy considerations. Thus, taxpayers will need to evaluate whether the key states in which they do business are rolling or static conformity jurisdictions.

Taxpayers then further should consider whether the state fully or partially conforms to the federal law on key provisions, such as bonus depreciation.

In 2018, it seems unlikely that states will simply update the date of the Code reference or accept all the federal changes and move on. The number of federal changes, as well as their potential revenue and policy impact, will likely mean that states—both rolling and static conformity states—will scrutinize whether and in what manner to conform to individual changes contained in the federal reform. Some states may also use the occasion of the federal changes to consider broader changes in the state tax code. The actions of state legislatures will bear careful watching this year. It seems fair to say, however, that going forward compliance with state corporate income taxes will be more complex and require additional resources from corporate tax departments, regardless of the exact legislation that states enact.

State corporate income tax issues associated with certain federal changes

The discussion below highlights only a few of the federal changes—ones that we believe clearly create unique complexities for state corporate income tax purposes. There are, of course, myriad other changes that will affect state tax liability if the change is adopted by the state or will create additional disconnects if the state declines to adopt the change.

- **Limits on interest deductibility:** The new federal law will not mesh easily in all states, many of which have pre-existing state-level interest limitations. Furthermore, there is an additional question of which entity would be subject to the limitation in a given state because of different federal and state filing methodologies.

- **Net operating loss limitations:** The new federal limitation on use of NOLs may also conflict with pre-existing state tax limitations on NOL usage. It is not yet clear how states will reconcile their pre-existing rules with the new federal rule.

- **Mandatory repatriation**: Whether or not income from the repatriation provision is includible in a given state's tax base is likely going to be a state-by-state analysis. This raises complex sourcing and even constitutional issues that could well lead to tax controversy between taxpayers and the states.

- **GILTI:** Going forward, a U.S. parent of a foreign subsidiary includes in gross income the global intangible low-taxed income (GILTI) of the foreign subsidiary. There are numerous uncertainties as to how and whether states will include the GILTI income in their tax bases. Like many of the other issues, this will likely be a state-by-state analysis and may take time for state tax authorities to develop a position.

Conclusion

In recent weeks, states have begun to issue preliminary guidance on the state issues and fiscal considerations associated with the federal changes. Not surprisingly, much of the initial response has focused on the effect on individuals, rather than businesses. Going forward, state corporate taxpayers should vigilantly track state legislation affecting conformity and carefully review any guidance issued by state taxing authorities. Taxpayers should also be mindful that there is likely to be much uncertainty in the next few years and state compliance will likely be more complicated.

For a more detailed discussion of the new tax law's implications for state taxes, please see the **KPMG Book** [PDF 10.3 MB]

Documents

- Read the detailed KPMG Book: **Tax Reform – KPMG Report on New Tax Law**
- Read text of the tax bill, **H.R. 1** [PDF 491 KB] (185 pages)
- The **conference agreement** [PDF 4.25 MB] (1097 pages), which includes a lengthy explanatory statement
- The JCT provided estimates of the budget effects of the conference agreement on H.R. 1. Read **JCX-67-17**
- Read **JCX-69-17** (Macroeconomic Analysis of the Conference Agreement for H.R. 1)
- Read **JCX-68-17** (Distributional Effects of the Conference Agreement for H.R. 1)

KPMG contacts

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

Tax technical area	Name	Email	Phone
Passthroughs	Deborah Fields	dafields@kpmg.com	+1 (202) 533-4580
Global mobility services	Martha Klasing Joan Smyth	mklasing@kpmg.com jsmyth@kpmg.com	+1 (202) 533-4206 +1 (202) 533-4404
Corporate	Mark Hoffenberg Rob Liquerman	mhoffenberg@kpmg.com rliquerman@kpmg.com	+1 (202) 533-4058 +1 (202) 533-3054
Compensation and benefits	Robert Delgado Terri Stecher	rdelgado@kpmg.com tstecher@kpmg.com	+1 (858) 750-7133 +1 (202) 533-4830
Estates, gifts, and trusts	Tracy Stone Scott Hamm	ttstone@kpmg.com scotthamm@kpmg.com	+1 (202) 533-4186 +1 (202) 533-3095
Insurance	Frederick Campbell-Mohn Sheryl Flum	fcampbellmohn@kpmg.com sflum@kpmg.com	+1 (212) 954-8316 +1 (202) 533-3394
Regulated investment companies	Deanna Flores	djflores@kpmg.com	+1 (858) 342-7661
Banking	Elizabeth L'Hommedieu Matthew Mosby	elhommedieu@kpmg.com mmosby@kpmg.com	+1 (614) 249-1849 +1 (704) 371-5265
Other financial products & debt	Kevin Keyes Jon Zelnik	kkeyes@kpmg.com jzelnik@kpmg.com	+1 (202) 533-3577 +1 (202) 533-4193
Exempt organizations	Greg Goller Alexandra Mitchell	greggoller@kpmg.com aomitchell@kpmg.com	+1 (703) 286-8391 +1 (202) 533-6078

International	Manal Corwin Seth Green Danielle Rolfes Devon Bodoh Ron Dabrowski	mcorwin@kpmg.com sethgreen@kpmg.com drolfes@kpmg.com dbodoh@kpmg.com rdabrowski@kpmg.com	+1 (202) 533-3127 +1 (202) 533-3022 +1 (202) 533-3378 +1 (202) 533-5681 +1 (202) 533-4274
Mergers & acquisitions	Thomas Wessel	twessel@kpmg.com	+1 (202) 533-5700
International M&A	Devon Bodoh	dbodoh@kpmg.com	+1 (202) 533-5681
Income tax accounting	Eric Lucas	ejlucas@kpmg.com	+1 (202) 533-3023
Economic & valuation services	Stephen Blough	sblough@kpmg.com	+1 (202) 533-3108
Energy	Rich Blumenreich Robert Swiech	rblumenreich@kpmg.com rswiech@kpmg.com	+1 (202) 533-3032 +1 (713) 319-3257
Financial institutions and products	Mark Price	mhprice@kpmg.com	+1 (202) 533-4364
Accounting for income taxes	Ashby Corum Jenna Summer	acorum@kpmg.com jsummer@kpmg.com	+1 (313) 230-3361 +1 (202) 533-3614
State and local tax	Harley Duncan Ann Holley	hduncan@kpmg.com aholley@kpmg.com	+1 (202) 533-3254 +1 (202) 533-3248
Excise and credits	Deborah Gordon Taylor Cortright	dkgordon@kpmg.com tcortright@kpmg.com	+1 (202) 533-5965 +1 (202) 533-6188
REITs	David Lee Stephen Giordano	dwlee@kpmg.com stephengiordano@kpmg.com	+1 (202) 533-4071 +1 (202) 533-3535

Contact us

For questions on legislative matters, contact a professional in the Federal Legislative and Regulatory Services group of the Washington National Tax office:

John Gimigliano
T +1 (202) 533-4022
E jgimigliano@kpmg.com

Carol Kulish
T +1 (202) 533-5829
E ckulish@kpmg.com

Tom Stout
T +1 (202) 533-4148
E tstoutjr@kpmg.com

Jennifer Bonar Gray
T +1 (202) 533-3489
E jennifergray@kpmg.com

kpmg.com/socialmedia