Tax Reform and the Potential Impacts to the Banking Industry

Supplement to KPMG Report on New Tax Law

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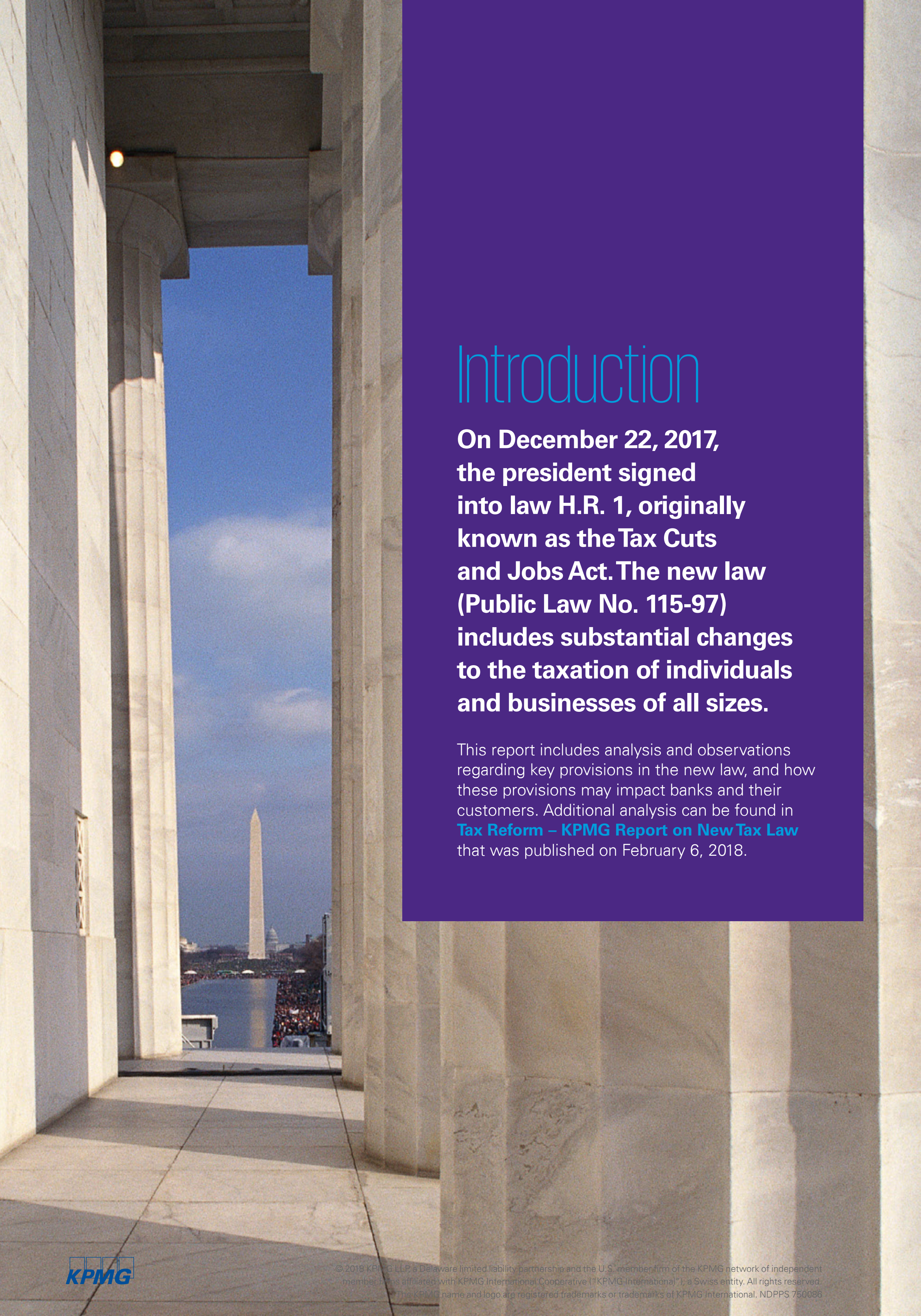


Introduction

On December 22, 2017, the president signed into law H.R. 1, originally known as the Tax Cuts and Jobs Act. The new law (Public Law No. 115-97) includes substantial changes to the taxation of individuals and businesses of all sizes.

This report includes analysis and observations regarding key provisions in the new law, and how these provisions may impact banks and their customers. Additional analysis can be found in **Tax Reform – KPMG Report on New Tax Law** that was published on February 6, 2018.

For the banking industry, the lower corporate tax rate is expected to be a significant windfall. Banks have historically had a higher effective tax rate than other industries, and as a result, have more to gain from the reduced rate.

As discussed below, the banking industry may also escape some of the provisions that are expected to be revenue raisers for the government, such as the rules limiting the deductibility of net interest expense. However, banks are not completely unfazed and will need to take into account a number of new adjustments that will negatively impact their tax liability, such as limitations placed on the deductibility of FDIC premiums and the new executive compensation rules under section 162(m). Like all multi-national companies, global banks will also need to consider the significant changes that were made to the international rules.

Finally, banks will not only need to take into account how the law impacts their corporate tax liability, but also how the changes impact the behavior of their customers. The law change is expected to impact all facets of the bank's operations, from limitations on the mortgage interest deduction impacting retail banking to the mandatory repatriation of foreign earnings and base erosion rules potentially changing the services offered by investment banks.

Effective dates and temporary provisions

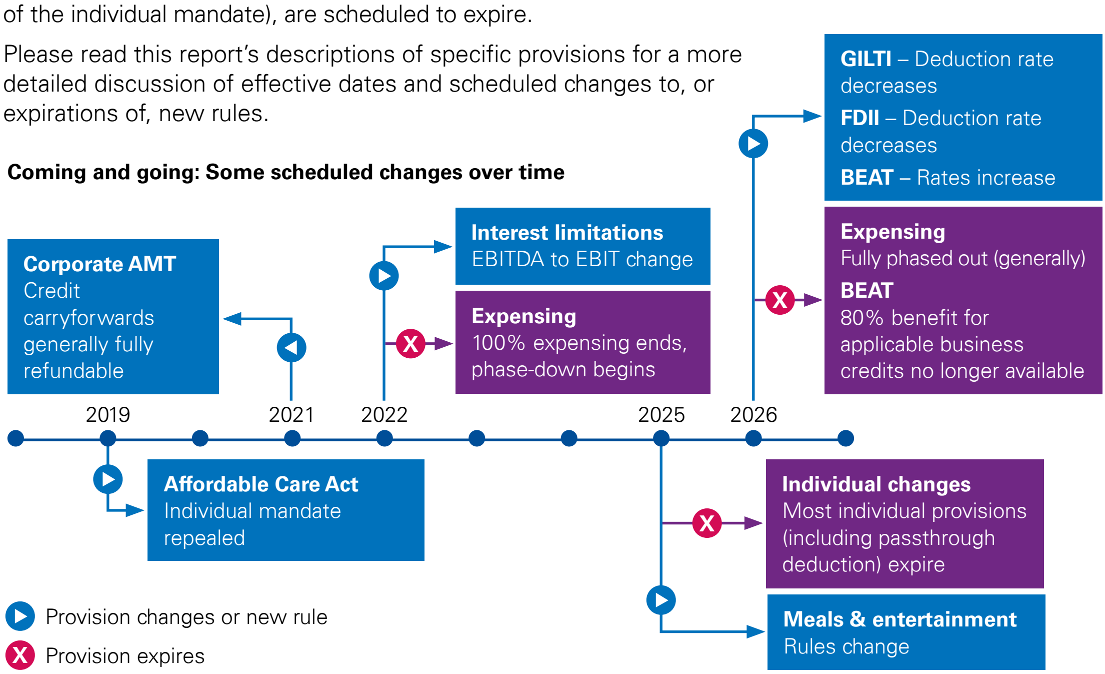
In general

Many of the effective dates in the new law are based on tax years beginning after December 31, 2017, while the effective dates of some provisions are keyed off the date of enactment (December 22, 2017). Still other provisions have different effective dates. For example, the temporary 100% expensing provision generally applies retroactively to property acquired and placed in service after September 27, 2017 and before 2023. Proper application of effective dates is critical in complying with the new law, and special attention should be paid to the dates set forth in the sections below.

Moreover, as illustrated in the chart below, some of the new rules are scheduled to change over time, while 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.

Please read this report's descriptions of specific provisions for a more detailed discussion of effective dates and scheduled changes to, or expirations of, new rules.

Coming and going: Some scheduled changes over time



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The full list of changes for businesses is extensive, including tax benefits as well as tax increases. The significant changes made by the tax law raise a host of planning issues and opportunities, as well as compliance considerations. Such planning issues and considerations are highlighted throughout this document.

Overall, banks may be expected to benefit more than other industries from a lower tax rate, since banks have typically had higher than average effective tax rates in the past. However, the new law is not without its negative impacts, as many banks have reported significant financial statement write-downs from the decrease in value of their deferred tax assets. Furthermore, significant changes can be expected to banking operations as customers respond to new net interest expense limitations, capital expensing rules, and other changes that impact how banks and their customers decide whether to borrow or lend, lease or purchase.

Reduction in corporate tax rate and dividends received deduction

The new law eliminates the progressive corporate tax rate structure, with a maximum corporate tax rate of 35%, and replaces it with a flat tax rate of 21%. In addition, the new law lowers the dividends received deduction for corporations. These changes are generally effective January 1, 2018. Non-calendar-year taxpayers will need to compute tentative taxes by applying both the 21% tax rate and their tax rate under the prior law to taxable income on a prorated basis.

Tax and accounting considerations

— Generally accepted accounting principles (GAAP) requires taxpayers to record adjustments to deferred taxes resulting from a change in tax laws or rates through income from continuing operations. This treatment creates a stranded tax effect for deferred taxes established through other comprehensive income (OCI). On February 14, 2018, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2018-02, providing companies the option to reclassify from OCI to retained earnings the income tax effects arising from the change in the U.S. federal corporate tax rate. Common deferred taxes seen at a bank that may result in a residual tax effect include book-tax differences from available for sale (AFS) securities, certain pension adjustments, fair value adjustments from cash flow and net investment hedges, and certain foreign currency adjustments.

— For fiscal year banks, scheduling will be necessary to appropriately measure deferred tax balances. More specifically, for the year that includes December 31, 2017, banks will be required to apply a "blended" tax rate. The application of the blended tax rate for one year will require the bank to determine the deferred taxes expected to be recognized at the blended tax rate, and the deferred taxes expected to be recognized at the 21% tax rate.

— Banks may need to assess valuation allowance potential for tax attribute carryforwards in light of the reduced tax rate.

Regulatory capital considerations

— A reduction in the corporate tax rate will require banks to revalue their deferred taxes, reducing the value of deferred tax assets and negatively impacting earnings in 2017. The hit to earnings will initially hurt banks' regulatory capital, however, the reduced corporate tax rate should help earnings in future years.

— While deferred taxes are revalued, credits are not. If banks were unable to use the credits under the previous (i.e., higher) rate, the reduced tax rate could result in more credits being disallowed.

For additional information, see **Tax Reform – KPMG Report on New Tax Law**

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For additional information, see Tax Reform – KPMG Report on New Tax Law page 40

Operational considerations

- Banks will need to update their underwriting and pricing models to reflect the reduced corporate tax rate.
- The after-tax cost of borrowing may increase as interest expense deductions become less valuable to customers in light of a reduced corporate tax rate.
- Certain tax-sensitive investments (e.g., low-income housing tax credits (LIHTC), municipal bonds) will see a reduction in after-tax yield.
- Demand for tax credit investments may decrease to the extent taxpayers do not have the capacity to utilize the credits. However, financial institutions will likely still find that certain tax credit investments provide an appealing source for earning Community Reinvestment Act (CRA) credit.
- Tax credit investment pricing will need to "re-balance" to take into account the impact of lower corporate tax rates. For LIHTC there should be a decline in the cost resulting from a reduction in the after-tax yield (i.e., the tax benefit from partnership losses passed through to investors has declined). However, for new markets tax credits, there will likely be an increase to the after-tax yield as a result of the gain when "unwinding" the investment being taxed at the lower rate.

Corporate AMT

The new law repeals the corporate alternative minimum tax (AMT) effective for tax years beginning after December 31, 2017. Any AMT credits carried forward to tax years after that date may be utilized to the extent of the taxpayer's regular tax liability (as reduced by certain other credits). In addition, AMT credit carryforwards in excess of regular tax liability are partially refundable in years 2018, 2019 and 2020 and fully refundable by 2021.

Tax and accounting considerations

- Valuation allowances for AMT credit carryforwards may no longer be applicable. However, taxpayers subject to the BEAT (see discussion below) may find that they are unable to utilize the benefit of their AMT credit carryforwards, and consequently could still require a valuation allowance.
- Although the corporate AMT was repealed and a portion of AMT credits were made refundable in future years, the mechanism for obtaining the refund (via section 6401) was not amended to address instances where AMT credits might not reduce the tax liability to zero (e.g., where credits are limited following an ownership change under section 383). The literal wording of the statute, therefore, may limit the refundability of AMT credits in certain circumstances. It is unclear whether technical corrections to the statute will be made.
- The repeal of the AMT rules may increase the benefit from private activity bonds (private activity bonds were previously taxed under the AMT rules).
- In prior years, sequestration under the Balanced Budget and Emergency Deficit Control Act of 1985 has reduced refunds of certain corporate AMT credits. The sequestration rate can vary, but may be 6.6% for 2018. In the past, the IRS has stated that the sequestration rate would be applied unless and until a law is enacted that cancels or otherwise affects the sequester. Thus, AMT credit refunds claimed under the new law might be subject to reduction due to sequestration requirements.

Regulatory capital considerations

- All or a portion of existing deferred tax assets related to AMT credit carryforwards may be reversed and reflected as an income tax receivable. The recognition as an income tax receivable, rather than as a deferred tax asset (DTAs), will favorably impact a bank's regulatory capital because receivables are treated as "good assets" and are not included in the DTA disallowance calculation.

Modified Net Operating Loss Deduction

The new law limits the net operating loss (NOL) deduction to 80% of taxable income with respect to losses arising in tax years beginning after December 31, 2017. The new law also generally disallows carrybacks and provides for an indefinite carryforward with respect to losses arising in tax years ending after December 31, 2017.

Tax and accounting considerations

- The indefinite NOL carryforward may favorably impact bank earnings by changing the valuation allowance analysis.
- Banks should track NOLs arising in tax years beginning before December 31, 2017, separately from those arising in taxable years beginning after December 31, 2017, as only the latter NOLs will be limited to 80% of taxable income. Furthermore, losses arising in tax years ending after December 31, 2017 cannot be carried back, but will be eligible for indefinite carryforward.

Regulatory capital considerations

- The inability to carry back NOLs will negatively impact banks that forecast losses in their stress testing calculations, as non-carryforward DTAs will not be reduced through the NOL carryback in the hypothetical calculation, resulting in fewer DTLs being allocated against carryforward DTAs.
- Risk weighted assets will also be increased for advanced approaches banks, since DTAs that cannot be carried back are subject to 250% risk weighting instead of 100%.
- Limiting the NOL deduction to 80% of taxable income will result in fewer carryforwards being allowed in stress testing, and a potentially higher NOL disallowance.

For additional information, see **Tax Reform – KPMG Report on New Tax Law**

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For additional information, see Tax Reform – KPMG Report on New Tax Law

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Cost Recovery

Temporary 100% expensing for certain business assets

Generally, the new law provides for 100% expensing of qualified property acquired after September 27, 2017 and before January 1, 2023.

Under the new law, the definition of qualified property is expanded to include used property so long as the acquiring taxpayer had not previously used the acquired property and so long as the property was not acquired from a related party.

Product and customer considerations

— Banks, as lessors, will receive the benefit of immediate expensing for assets held in lease portfolios (assuming the bank is treated as the owner of the property for tax purposes).

— Banks should consider reassessing criteria used to determine whether a contract qualifies as a "true lease" for federal income tax purposes (as compared to a secured financing).

Regulatory capital considerations

— Immediate expensing will generate a deferred tax liability (DTL), which could provide additional DTLs to allocate against carryforward deferred tax assets (DTAs). This netting could result in a lower capital reduction and could improve regulatory capital.

Operational considerations

— Banks will need to consider updating their fixed asset software (including leasing software) to account for new cost recovery rules.

M&A considerations

— The change in definition of qualified property could have an important effect on M&A transactions by increasing the incentive for buyers to structure a taxable acquisition as an actual or deemed asset purchase rather than a stock acquisition.

Business-related deductions exclusions, etc.

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 adjusted taxable income (generally EBITDA for years before 2022 and EBIT thereafter) and floor plan financing interest. In general, net interest expense consists of interest expense and income allocable to a trade or business and does not include investment interest expense or income. Several exceptions apply (e.g., certain small businesses with average gross receipts under $25 million, regulated public utilities and electric cooperatives), and certain taxpayers, such as certain real estate businesses (e.g., LIHTC partnerships) and certain farming businesses, may elect out of the new limitation. Businesses electing out of the provision are generally required to use the alternative depreciation system (ADS) 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's explanatory statement indicates the provision applies at the consolidated tax return filing level, although the provision itself does not address this point. Treasury personnel have indicated that Treasury and the IRS plan to issue guidance on a number of issues involving the new net interest expense limitation, including its application to consolidated groups. Subject to special rules for partnerships and applicable tax attribute carryforward limitations, any net business interest expense disallowed would be carried forward indefinitely.

For additional information, see **Tax Reform – KPMG Report on New Tax Law** page 48

Product and customer considerations

- Customers subject to the interest expense limitation will need to consider:
  - Whether to restructure current debt
  - The cost-benefit of borrowing to fund capital purchases, lease capital assets, or explore other financing structures (e.g., preferred equity, partnership structures, derivatives, prepaid contracts)
  - Borrowing through offshore foreign entities where the interest deductions could be more valuable via a deduction in the foreign jurisdiction
- Banks may also see potential changes in competitors if nonfinancials seek to generate business interest income to offset business interest expense.
- Leasing businesses of a bank (which generally have interest income capacity) may see an increase in demand for their leasing products if stand-alone leasing companies that historically finance their operations through debt are unable to reduce outstanding debt or otherwise qualify for an exception to the interest expense disallowance rule.

Tax and accounting considerations

- A bank's tax liability should be less directly impacted by the interest expense disallowance rules since they are likely to have net interest income.
- REITs are not included in a bank's consolidated group. Therefore, loans held in a captive REIT will generate interest income for the REIT and dividend income for the bank. Banks with sizeable loan portfolios held at the REIT (relative to the overall portfolio) may need to consider the potential impact of this rule.
- Because only taxable interest income will be included in the computation of net business interest expense, investments in tax-free municipal bonds will not increase a bank's interest expense capacity.

Operational considerations

- Banks should consider changing their underwriting models for commercial borrowers to account for potential nondeductibility of interest expense.

For additional information, see Tax Reform – KPMG Report on New Tax Law

Repeal deduction for income attributable to domestic production activities

Under the new law, the deduction for domestic production activities provided under section 199 is repealed for tax years beginning after December 31, 2017.

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Tax and accounting considerations

— Banks may still be able to claim the deduction for qualifying activities (e.g., development of computer software offered to customers) on their 2017 federal income tax returns.

Limits on like-kind exchange rules

The new law limits the deferral of gain under the like-kind exchange rules to exchanges of real property.

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Product and customer considerations

— These changes could limit or eliminate the market for like-kind exchange qualified intermediary (QI) services.

Tax and accounting considerations

— The repeal of the like-kind exchange rules for tangible personal property could negatively impact certain banks' leasing portfolios, particularly those participating in a like-kind exchange program. However, the provision allowing for full expensing may offset the negative impact of eliminating the gain deferral.

Deduction limits for FDIC premiums

The new law limits the amount certain banks may deduct for premiums paid pursuant to an assessment by the Federal Deposit Insurance Corporation (FDIC). Generally, the new limitation phases out the deduction for FDIC premiums for banks with total consolidated assets between $10 billion and $50 billion. For banks with total consolidated assets over $50 billion, no deduction is permitted.

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Tax and accounting considerations

— The limitation or disallowance will result in a new permanent adjustment in a bank's tax calculations.

M&A considerations

— Banks preparing to cross the $10 billion or $50 billion asset threshold should consider the impact of losing this tax benefit.

Expands nondeductibility of certain fines and penalties

The new law expands the non-deductibility of fines and penalties to disallow a deduction for payments paid or incurred at the direction of a government or specified nongovernmental entity.

For additional information, see Tax Reform – KPMG Report on New Tax Law

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Tax and accounting considerations

- The IRS has informally indicated that the Financial Industry Regulatory Authority (FINRA) meets the definition of a "corporation serving as an agency or instrumentality of the government" for purposes of generally disallowing a deduction for fines assessed by FINRA. While this is the IRS's position, there are currently differing viewpoints on this issue. This law change appears directed at removing some of this uncertainty.

Accounting methods

Special rules for tax year of inclusion

The new law requires taxpayers to recognize taxable income no later than the year the income is included in an applicable financial statement. The rule is not intended to apply to an item of gross income that uses a special method of accounting, 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).

The provisions related to OID are effective in 2019, and for items other than OID, the provisions are effective in 2018.

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Tax and accounting considerations

- Taxpayers continue to question the scope of the rule, including whether it limits the ability to defer the recognition of market discount (if the financial accounting rules recognize market discount prior to payment).
- These rules apply prior to applying the OID rules, and the provision will largely eliminate taxpayers' ability to defer certain fees and interchange received on credit card portfolios. However, banks with credit card portfolios that historically did not defer fees and interchange should assess whether they can file a method of accounting change for 2017 and receive the tax benefit from the favorable method on their 2017 tax return (i.e., at the higher tax rate). Taxpayers may still be able to utilize the automatic method change procedures, although the method change would apply on a cut off basis beginning in the year of change.
- The new law does not apply to any item of gross income in connection with a mortgage servicing contract.

For additional information, see Tax Reform – KPMG Report on New Tax Law

Business credits

Retention of business credits and modification of rehabilitation credit

The new law generally retains the research and development (R&D) credit, low income housing tax credit (LIHTC), new markets tax credit (NMTC), energy production tax credit (PTC), and the energy investment tax credit (ITC).

Further, the new law modifies the historic rehabilitation tax credit (HTC) by repealing the 10% credit for pre-1936 buildings and modifying the 20% credit for certified historic structures for amounts paid or incurred after 2017. Generally, the credit for certified historic structures will remain at 20%, but it must be claimed ratably over five years. A transition rule applies to properties owned or leased at all times on or after January 1, 2018. Under the transition rule, the 24-month period (or 60-months for phased rehabilitations) selected by the taxpayer to incur qualified expenditures must begin no later than the end of the 180-day period beginning on December 22, 2018.

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Product and customer considerations

— Tax credit investment pricing will need to "re-balance" to take into account the impact of the lower corporate tax rate. For LIHTCs, there should be a decline in the cost resulting from a reduction in the after-tax yield (i.e., the tax benefit from partnership losses passed through to investors has declined). However, for NMTCs, there will likely be an increase to the after-tax yield as a result of the gain when "unwinding" the investment being taxed at the lower corporate tax rate.

— The lower corporate tax rate may result in certain market participants reducing their tax credit portfolio as a result of less "tax capacity" (i.e., investors may be unable to utilize credits as a result of a lower corporate tax liability). Further, multinational banks subject to the new base erosion anti-avoidance tax (BEAT) will generally be limited to a maximum of 80% of the benefit of applicable business credits and will not receive any benefit from the HTC or NMTC when determining the BEAT liability. Additionally, for tax years beginning after December 31, 2025, the BEAT formula appears to remove the previously retained 80% benefit of the applicable business credits. The potential decline in investors could present a market expansion opportunity for certain banks to invest in these credits.

Tax and accounting considerations

— Certain real estate businesses, such as LIHTC partnerships, may elect out of the net interest expense limitation.

— LIHTC partnerships that elect out of the net interest expense disallowance rules will be required to apply the new ADS recovery period of 30 years for residential rental property placed in service after December 31, 2017 (property placed in service before this date continue to use a 40 year recovery period). These changes could further complicate the pricing of LIHTC investments.

Compensation

Modification of limitation on excessive employee remuneration

The new law repeals the exceptions for commissions and performance-based payments under section 162(m) and expands the definition of a covered employee to now include CFOs. The definition of a "publicly held corporation" is also expanded to include all domestic publicly traded corporations and all foreign companies publicly traded through American depositary receipts (ADRs). The new law also specifies that once an employee is a covered employee, the individual remains a covered employee for all future years, including with respect to payments made after retirement and death. Under a transition rule, the new provisions do 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.

Tax and accounting considerations

— The requirement that a covered employee remains covered for all future years (including payments made after retirement or death) means that companies could have a theoretically limitless number of employees considered covered employees.

Operational considerations

— The repeal of the performance-based exception may allow banks greater flexibility in structuring executive compensation plans because they may no longer feel obligated to comply with the "performance-based" requirements.

— As a result of the "once a covered employee, always a covered employee" rule, certain employers are considering restructuring deferred compensation and retirement plans to keep annual payments to covered employees below the $1 million threshold (e.g., rather than make a lump sum payment, payments are made over a number of years).

— The application of the rule to services provided by a former employee in another capacity, such as a nonemployee director, is currently unclear and will need to be addressed in subsequent guidance.

M&A considerations

— The application of the rule following a corporate transaction (e.g., acquisition, merger) is currently unclear and will need to be addressed in subsequent guidance.

For additional information, see **Tax Reform – KPMG Report on New Tax Law**

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For additional information, see Tax Reform – KPMG Report on New Tax Law

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Bonds

Repeal of tax credit bonds and advance refunding bonds

The new law repeals the tax exempt status of tax credit bonds and advance refunding bonds (i.e., bonds used to pay principal, interest, or redemption price on a prior bond that are issued more than 90 days before the redemption of the refunded bonds). Outside of these two changes, the tax treatment of municipal bonds is retained.

Product and customer considerations

- The repeal of advance refunding bonds could remove some flexibility for municipalities to reduce their cost of borrowing by preventing the municipalities from taking advantage of lower interest rates before outstanding bonds may be otherwise called.
- The reduced after-tax yield on tax exempt loans is expected to negatively impact pricing.
- The repeal of the corporate AMT may increase the value of private activity bonds (private activity bonds were previously subject to AMT).

Operational considerations

- Banks should consider changes to pricing models to account for the reduced corporate tax rate and the repeal of the corporate AMT.

Bank-owned life insurance (BOLI)

Scope of transfer for value rules

The new law imposes reporting requirements on issuers and acquirers with regard to direct or indirect acquisitions of an existing life insurance contract, in which the acquirer has no substantial family, business, or financial relationship with the insured other than the life insurance contract itself (a reportable policy sale).

The provision also modifies the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale. Historically, if a life insurance policy is transferred for valuable consideration, the amount of death benefits excluded by the buyer from taxable income is limited to the consideration paid for the contract. Under an important exception, the transfer for value rules have not previously applied to policies acquired in a carry-over basis transaction (e.g., a tax-free merger). The buyer can no longer use this exception for reportable policy sales after December 31, 2017 (i.e., death benefits in excess of the consideration paid for the policy will be taxable).

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M&A considerations

- If a bank acquires a BOLI policy in a merger or acquisition, the death benefits received from the policy may be taxable if the acquiring bank does not have a substantial family, business, or financial relationship with the insured. While it does not appear to be the intent of Congress to create a reportable policy sale in connection with the acquisition of a business, the current rules do not include a specific carve-out.

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

Deduction of 20% for certain pass-through income (subject to sunset)

For tax years beginning after December 31, 2017 (subject to a sunset at the end of 2025), a non-corporate taxpayer can deduct 20% of domestic qualified business income from a partnership, S corporation, or sole proprietorship. A taxpayer's eligibility for the deduction is subject to certain exclusions, and the amount of the deduction is generally subject to a limit based either on wages paid or wages paid plus a capital element. In determining a taxpayer's qualified business income, 20% of any dividends from a REIT (other than a capital gain dividend or qualified dividend income) and 20% of includible dividends from certain cooperatives and qualified publicly traded partnership income are deemed qualified items of income.

The deduction is not available for a "specified service trade or business," subject to an exception for taxpayers whose income does not exceed a specified threshold. A specified service trade or business includes any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business (other than engineering or architecture) where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. Furthermore, a specified service trade or business includes any trade or business which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

Qualified business income does not include amounts paid by an S corporation for reasonable compensation to a shareholder or amounts allocated to a partner who is acting other than in his or her capacity as a partner for services. Furthermore, certain investment items are excluded from qualified business income.

Tax and accounting considerations

- The scope of the term "specified service trade or business" is not entirely clear, and this provision should be monitored for future interpretative guidance on what banking and financial activities are prohibited.
- It is currently unclear how a business should be treated to the extent it engages in some "good" and some "bad" activities (e.g., analyzed on an entity-level basis or activity-by-activity basis).

For additional information, see **Tax Reform – KPMG Report on New Tax Law**

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Other business provisions of interest

Additional business provisions that may be of interest to banks are provided below, along with the page reference to Tax Reform – KPMG Report on New Tax Law where additional analysis can be found.

Provision	Description	KPMG report page reference
Limitation of deduction by employers of expenses for entertainment and certain fringe benefits	— Repeals deductions for entertainment, amusement, and recreation — Generally retains 50% deduction limitation for food and beverage expenses associated with a trade or business — Expands 50% limitation to certain meals provided by an employer that previously were 100% deductible — Beginning in 2026, certain meals will also be disallowed — Repeals deduction for any qualified transportation fringe benefits (including buses, van pools, subway or transit cards, and qualified parking fees) unless "necessary for ensuring the safety of an employee"	**54**
Short-term capital gain with respect to applicable partnership interests	— Requires a "three year asset holding period" for carried interest in order to receive long-term capital gain treatment; under an important exception, this rule does not apply to corporate partners	**80**

International provisions

In the context of international tax, the new law largely eliminates deferred taxation of foreign income within a U.S.-parented multinational group. Under the new law, income is generally taxed as earned or permanently exempt from U.S. taxation. As a transition to the new rules, existing untaxed earnings of "specified foreign corporations" are deemed repatriated and taxed at a reduced rate.

The subpart F rules are generally retained to provide immediate taxation of the classes of income captured by pre-enactment law. Further, a new, very broad class of income (global intangible low-taxed income) is subject to immediate taxation at a reduced rate.

The new law also contains provisions intended to curtail base erosion. In addition to the general business net interest expense limitation discussed above, deductions are disallowed for transactions involving certain hybrid instruments or transactions entered into with related parties. The new law also adopts a new alternative minimum tax focused on deductible payments made by U.S. persons to related foreign persons (i.e., the base erosion anti-abuse tax (BEAT)).

The sum total of these changes represents a significant expansion of the base of cross-border income to which current U.S. taxation applies.

For additional information, see Tax Reform – KPMG Report on New Tax Law

Establishment of participation exemption system for taxation of foreign income

U.S. participation exemption

The new law creates a 100% dividends received deduction (DRD) for the foreign-source portion of dividends received by U.S. corporate shareholders from 10% or more owned foreign corporations. The U.S. corporate shareholder must satisfy a one-year holding period requirement. Hybrid dividends are not eligible for the deduction and indirect hybrid dividends in tiered ownership structures are treated as subpart F income and included in the U.S. shareholder's income. The new law also disallows a foreign tax credit or deduction for foreign taxes with respect to any 100% DRD.

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Tax and accounting considerations

- Foreign-source dividend income from 10% or more owned foreign corporations can generally no longer be relied upon as a source of foreign-source income to utilize foreign tax credits. Taxpayers may need to consider whether foreign tax credit carryforwards remaining after the mandatory repatriation require a valuation allowance.
- The shift to a participation exemption system could put additional pressure on transfer pricing, although the GILTI provisions (discussed briefly below) may mitigate some of the incentives to shift income out of the U.S.

Mandatory repatriation

The new law provides for the mandatory deemed repatriation of post-1986 accumulated earnings and profits (E&P) of certain foreign corporations. E&P is determined based on the greater of the aggregate E&P on November 2, 2017, or December 31, 2017. A transition rule generally allows taxpayers to recognize a deduction to arrive at tax rates of 15.5% for repatriated income attributable to cash and cash equivalents and 8% for repatriated income derived from all other sources. The provision applies to all CFCs and all other foreign corporations (other than PFICs) in which a U.S. corporation directly, indirectly, or constructively owns a 10% voting interest.

Taxpayers are permitted to use foreign tax credits associated with the taxable portion of the mandatory inclusion.

Taxpayers may elect to pay any tax liability resulting from the deemed repatriation over an eight-year period based on a back-loaded payment schedule.

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Tax and accounting considerations

- Financial services companies will typically hold a larger proportion of their assets in cash and cash equivalents compared to other industries, and as a result may incur a higher tax on their repatriated earnings and profits. Further, the scope of whether certain items are included in an entity's cash position is uncertain, and the statute provides the Secretary regulatory authority to include additional categories.

Operational considerations

- It is important for banks to analyze E&P positions for both financial statement reporting and evaluating tax planning opportunities. Banks will need to calculate E&P twice—as of November 2, 2017, and December 31, 2017—which may present some operational challenges.

Rules related to passive and mobile income

Current-year inclusion of global intangible low-taxed income by U.S. shareholders

The new law requires 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. Generally, GILTI is the excess of a U.S. shareholder's "net CFC tested income" over its "net deemed tangible income return," which generally provides for a 10% return on a CFC's specified tangible property.

Corporate U.S. shareholders may also recognize a deduction associated with such income, effectively resulting in the income being taxed at a rate of 10.5% through 2025. Beginning in 2026, the deduction will be reduced to result in an effective rate of 13.125%. Foreign tax credits are generally limited to 80% of the amount paid.

For additional information, see Tax Reform – KPMG Report on New Tax Law

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Tax and accounting considerations

— It appears that active financing income is not included in the exceptions to "tested income". As a result, significant portions of financial institutions' overseas income could potentially be subject to current inclusion under the GILTI provision.

— Banks will likely have limited foreign tangible assets. Therefore, banks may receive marginal benefit from the net deemed intangible income return.

Add deduction for foreign-derived intangible income

In conjunction with the new minimum tax regime on excess returns earned by a CFC, the new law provides a 13.125% (increasing to 16.406% in 2026) effective tax rate on excess returns earned directly by a U.S. corporation from foreign sales (including licenses and leases) or services. This effective tax rate is accomplished by providing U.S. corporations a deduction for a portion of its "foreign-derived intangible income" (FDII). Financial services income (as defined in section 904(d)(2)(D)) is excluded from the definition of eligible income for FDII purposes.

Inbound provisions

Add base erosion and anti-abuse tax (BEAT)

The new law imposes a minimum tax on taxpayers with "base erosion payments"—generally, amounts paid or incurred by the taxpayer to foreign related parties for which a deduction is allowable, and includes amounts paid in connection with the acquisition of depreciable or amortizable property from foreign related parties.

The BEAT applies to domestic corporations that are not taxed on a flow-through basis (i.e., not S corporations, RICs, or REITs) and that meet certain gross receipts and "base erosion percentage" thresholds (2% for banks and registered securities dealers). A taxpayer's base erosion percentage, is determined by dividing the aggregate amount of the taxpayer's base erosion tax benefits for the tax year by the aggregate amount of the taxpayer's allowable deductions for the year (with certain exclusions).

Subject to certain exceptions, base erosion tax benefits are generally deductions attributable to: (i) deductible payments made to foreign related parties, (ii) amounts paid in connection with the acquisition of depreciable or amortizable property from a foreign related party, and (iii) certain reinsurance premiums paid to foreign related parties. Two important exceptions to the definition of base erosion tax benefits are for (i) "qualified derivatives payments and (ii) "amounts" paid or incurred for services that qualify "for use of the services cost method under section 482" (with certain other requirements).

For additional information, see **Tax Reform – KPMG Report on New Tax Law**

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The minimum tax is determined through a multi-step formula used to derive the base erosion minimum tax amount. The base erosion minimum tax amount is generally equal to the excess of the tax liability based on modified taxable income (using adjusted rates discussed below) over the regular tax liability reduced by credits. However, credits for these purposes will not include (i) the research credit or (ii) the portion of the applicable section 38 credits not in excess of 80% of the lesser of the amount of such credits or the base erosion minimum tax amount. Applicable section 38 credits include the low-income housing tax credit (LIHTC), renewable electricity production tax credit (PTC), and renewable energy investment tax credit (ITC).

The general BEAT rate on modified taxable income is 5% for 2018, 10% from 2019 through 2025, and 12.5% thereafter. For banks and regulated securities dealers the rate is increased by 1% (i.e. 6% for 2018, 11% for 2019 through 2025, and 13.5% thereafter).

Tax and accounting considerations

— The BEAT could negatively impact the deductibility of interest expense on total loss absorbing capital (TLAC) instruments required to be issued to a foreign parent for regulatory purposes. IRS guidance had previously indicated that TLAC instruments will be respected as debt (and allowed an interest expense deduction) despite having certain equity characteristics. This guidance was intended to ensure that certain regulatory requirements did not result in adverse tax implications for financial institutions. The BEAT may have the unfortunate consequence of limiting interest deductions on these instruments despite previous efforts to ensure such interest would be deductible.

— The BEAT does not generally allow companies to net payments going to and from foreign related parties. Instead, the gross amount of deductible payments is used to calculate the minimum tax. This could significantly impact cross border banking businesses where companies frequently lend to and from foreign affiliates to redeploy cash across their global operations.

— The exception for qualified derivative payments was reported as a significant concession to the financial services industry. Banks and securities dealers are otherwise treated less favorably in that they are subject to higher BEAT tax rates and a lower base erosion percentage threshold.

— As noted, the BEAT formula would allow banks to retain, at least initially, the benefit of the research credit and some benefit of "applicable section 38 credits" (defined as the LIHTC, PTC, and ITC). However, banks will not receive the benefit of other credits, including the HTC and NMTC, for the purposes of the BEAT. Furthermore, for tax years beginning after December 31, 2025, the BEAT formula appears to remove the previously retained benefit of the research credit and applicable section 38 credits.

— While the BEAT applies to a bank's interest expense deduction insofar as the interest is treated as paid or accrued to a foreign related party, it is unclear how deemed or allocated interest for a bank's U.S. operations will be treated. For example, guidance will be necessary to determine whether interest allocated to a foreign bank's U.S. branch under section 1.882-5 should be considered a base erosion payment of that U.S. branch.

Regulatory capital considerations

— The BEAT may be considered an additional tax that would be included in the bank's effective tax rate, which will reduce regulatory capital through a reduction in earnings.

Individual provisions

The new law makes a number of temporary changes to the tax rates and brackets, deductions, and credits for individual taxpayers. The new law retains seven tax brackets but modifies the "breakpoints" for the brackets and reduces the rate for the top bracket to 37% (from 39.6%). The new rate structure is effective for tax years beginning in 2018, but ceases to apply after December 31, 2025, as with many of the individual provisions in the new law.

Under pre-enactment law, individual taxpayers were able to claim itemized deductions to decrease taxable income, but the new law includes a number of provisions suspending or modifying these deductions, in favor of an increased standard deduction.

For additional information, see **Tax Reform – KPMG Report on New Tax Law**

Deduction for taxes (including state and local taxes) not paid or accrued in a trade or business

Under the new law, an individual's itemized deductions for state and local income, property, and sales taxes are limited to $10,000 in the aggregate (not indexed for inflation). The limitation does not apply to personal or real property taxes incurred in carrying on a trade or business or otherwise incurred for the production of income. The limitation applies to taxes incurred in tax years beginning after December 31, 2017 and before January 1, 2026.

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Product and customer considerations

— While a prepayment of 2018 state and local income tax may not be claimed as an itemized deduction for tax year 2017, the law is silent with regard to prepaid state and local property taxes. However, on December 27, 2017, the IRS advised that the prepayment of real property taxes that were not assessed prior to 2018 are not deductible in 2017. State or local law determines whether and when a property tax is assessed.

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

The new law modifies the deduction for home mortgage interest for tax years 2018 through 2025. First, the available deduction is limited by reducing the amount of debt that can be treated as acquisition indebtedness from $1 million to $750,000. The deduction for home equity indebtedness is also suspended. However, interest on certain home equity indebtedness may be deductible if the debt also qualifies as acquisition indebtedness (i.e., indebtedness used for acquiring, constructing, or substantially improving a taxpayer's residence).

A grandfathering rule applies to debt incurred before December 15, 2017.

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Product and customer considerations

— While retaining the deduction for home mortgage interest may be significant, the increase to the standard deduction, elimination of many of the other itemized deductions, and the cap on the deduction for state and local income and property taxes of $10,000 will result in fewer taxpayers choosing to itemize. Therefore, the number of people benefiting from the home mortgage interest deduction may be significantly reduced.

— The increase in the after-tax cost of mortgages, for homeowners unable to benefit from the home mortgage interest deduction, may impact demand for, or individual size of, new mortgages.

Operational considerations

— Banks should consider changes to current underwriting models in order to account for the new mortgage interest deduction limits and changes to the tax treatment of home equity indebtedness.

Other individual provisions of interest

Additional individual provisions that may be of interest to banks are provided below, along with the page reference in Tax Reform – KPMG Report on New Tax Law where additional analysis can be found.

Provision	Description	KPMG report page reference
Increased percentage limitation for certain charitable contributions	— Increases the AGI limitation for charitable contributions of cash made by individuals to public charities and certain private foundations to 60% — Applies to contributions made in tax years beginning after December 31, 2017 and before January 1, 2026	**27**
Suspension of exclusion for qualified moving expense reimbursements	— Suspends the exclusion from gross income and wages for qualified moving expense reimbursements for years 2018–2025 — Preserved for U.S. Armed Forces members (and family members)	**28**
Modification to individual AMT	— Retains the individual AMT — Temporarily increases the exemption amounts and the phase-out thresholds for individuals through 2025	**30**
Estate, gift, and generation-skipping transfer tax	— Doubles the basic exclusion amount from $5 million to $10 million per individual (indexed for inflation) — The enhanced exclusion applies to estates of decedents dying, generation-skipping transfers made, and gifts made after 2017, but is scheduled to sunset after December 31, 2025	**30**
Student lending	— Excludes any income resulting from the discharge of student debt due to death or disability for discharges of loans after December 31, 2017 and before January 1, 2026	**32**
Modification of education savings rules (529 plans)	— Expands definition of qualified higher education expenses to include public, private, and religious elementary and secondary schools — Limits the tax-free distribution amount to an aggregate of $10,000 per student per year for expenses with respect to elementary and secondary schools (limitation does not apply to distributions for postsecondary school expenses) — Effective for distributions made after December 31, 2017 and is not subject to a sunset clause	**32**
Reduce Affordable Care Act individual shared responsibility payment to zero	— The individual shared responsibility payment (also known as the "individual mandate") is reduced to zero, starting in 2019 — This provision is not subject to the December 31, 2025 expiration date applicable to many of the other provisions affecting the taxation of individuals	**37**

Notes

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