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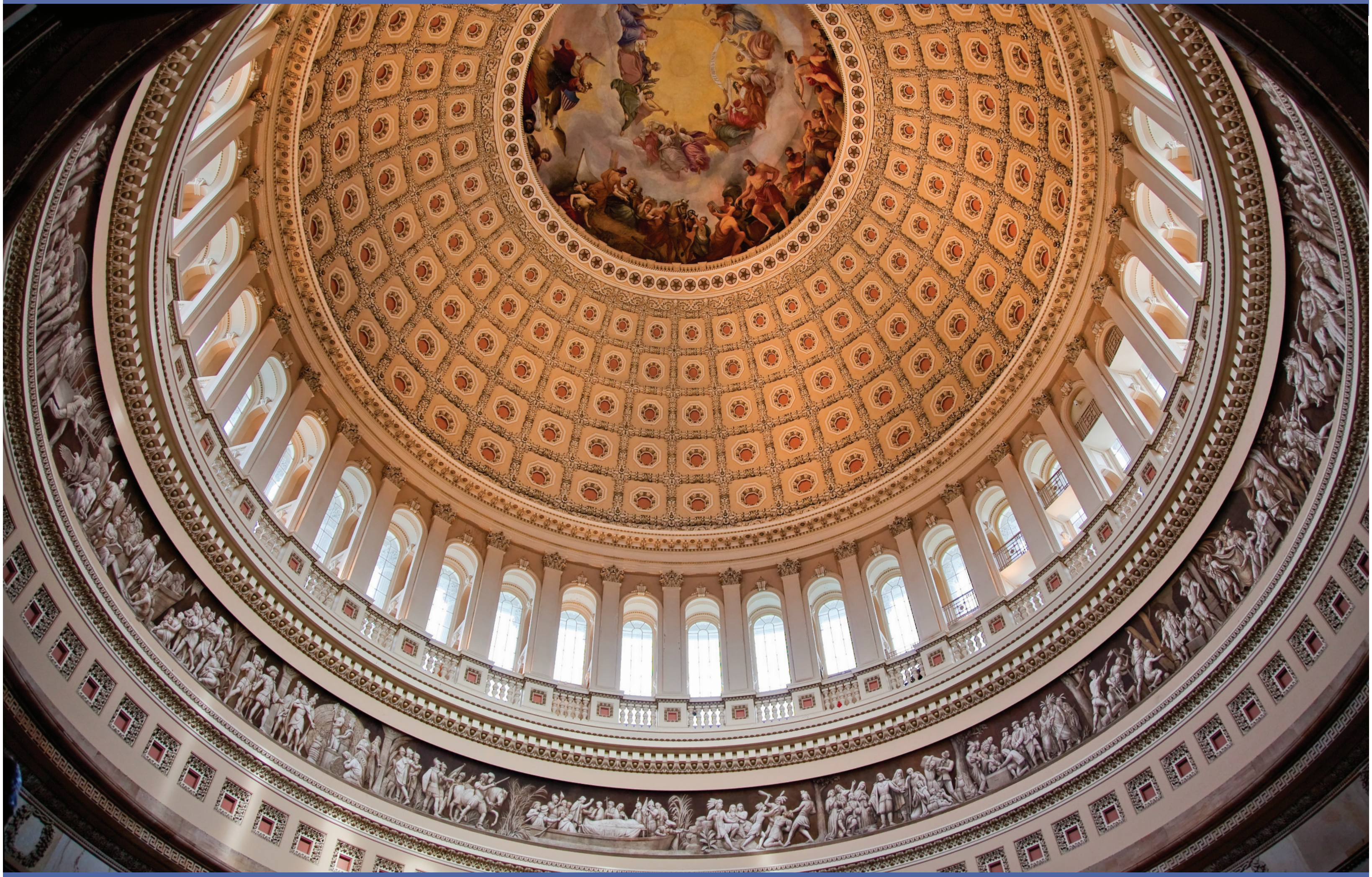

Summary Report:

TAX CUTS AND JOBS ACT

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INDEX

I. Individuals.

A. Income Tax Rates of Individuals, Estates, and Trusts.

1. **Prior Law:** Prior law generally provides for seven income tax brackets, with tax rates as follows: 10%, 15%, 25%, 28%, 33%, 35% and 39.6%.

2. **New Law:** The Act replaces the existing tax brackets with a new set of tax brackets for taxable years beginning after December 31, 2017 and before January 1, 2026. The revised system will retain seven tax brackets, but will change the rates to consist of the following: 10%, 12%, 22%, 24%, 32%, 35% and 37%. The breakpoints for the different tax brackets will vary depending on the filing status of the taxpayer as follows:

Single Taxpayers

Taxable income over	But not over	Is taxed at
$0	$9,325	10%
$9,325	$37,950	15%
$37,950	$91,900	25%
$91,900	$191,650	28%
$191,650	$416,700	33%
$416,700	$418,400	35%
$418,400+		39.6%

Heads of Household

Taxable income over	But not over	Is taxed at
$0	$13,350	10%
$13,350	$50,800	15%
$50,800	$131,200	25%
$131,200	$212,500	28%
$212,500	$416,700	33%
$416,700	$444,500	35%
$444,500+		39.6%

Married Taxpayers Filing Joint Returns and Surviving Spouses

Taxable income over	But not over	Is taxed at
$0	$18,650	10%
$18,650	$75,900	15%
$75,900	$153,100	25%
$153,100	$233,350	28%
$233,350	$416,700	33%
$416,700	$470,700	35%
$470,700+		39.6%

Married Taxpayers Filing Separately

Taxable income over	But not over	Is taxed at
$0	$9,325	10%
$9,325	$37,950	15%
$37,950	$76,550	25%
$76,550	$116,675	28%
$116,675	$208,350	33%
$208,350	$235,350	35%
$235,350+		39.6%

Trusts and Estates

Taxable income over	But not over	Is taxed at
$0	$2,550	25%
$2,550	$6,000	28%
$6,000	$12,500	33%
$12,500+		39.6%

New Law: The new law keeps with the system of seven rate brackets but the rates are reduced to 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The brackets for 2018 are as follows:

Single Taxpayers

Taxable income over	But not over	Is taxed at
$0	$9,525	10%
$9,525	$38,700	12%
$38,700	$82,500	22%
$82,500	$157,500	24%
$157,500	$200,000	32%
$200,000	$500,000	35%
$500,000+		37%

Heads of Household

Taxable income over	But not over	Is taxed at
$0	$13,600	10%
$13,600	$51,800	12%
$51,800	$82,500	22%
$82,500	$157,500	24%
$157,500	$200,000	32%
$200,000	$500,000	35%
$500,000+		37%

Married Taxpayers Filing Joint Returns and Surviving Spouses

Taxable income over	But not over	Is taxed at
$0	$19,050	10%
$19,050	$77,400	12%
$77,400	$165,000	22%
$165,000	$315,000	24%
$315,000	$400,000	32%
$400,000	$600,000	35%
$600,000+		37%

Married Taxpayers Filing Separately

Taxable income over	But not over	Is taxed at
$0	$9,525	10%
$9,525	$38,700	12%
$38,700	$82,500	22%
$82,500	$157,500	24%
$157,500	$200,000	32%
$200,000	$300,000	35%
$300,000+		37%

Trusts and Estates

Taxable income over	But not over	Is taxed at
$0	$2,550	10%
$2,550	$9,150	24%
$9,150	$12,500	35%
$12,500+		37%

3. **Comment:** Higher tax brackets combined with lower rates should generally result in a lower overall effective tax rate in 2018. However, due to the changes to the standard deduction, the elimination of the personal and dependent exemptions, and the elimination or modification of certain other deductions, taxpayers will not necessarily see a lower tax bill in 2018.

B. **Standard Deduction.**

1. **Prior Law:** For 2017, the standard deduction is $6,350 for single taxpayers and taxpayers who are married but file separately, $9,550 for taxpayers who file as head of household, and $12,700 for taxpayers who are married and file jointly and for qualified surviving spouses. Taxpayers who are blind or age 65 or above receive an additional standard deduction of $1,250 which may be increased to $1,550 if the taxpayer is also unmarried and not a surviving spouse.

2. **New Law:** Beginning in 2018, the standard deduction is $12,000 for single taxpayers and taxpayers who are married but file separately, $18,000 for taxpayers who file as head of household, and $24,000 for taxpayers who are married and file jointly and for qualified surviving spouses. The additional standard deduction for the blind and the taxpayers 65 or over is unchanged and remains in effect.

3. **Comment:** The new law doubles the standard deduction, but the additional standard deduction does not come without a cost. As discussed below, the new law does away with all personal and dependent exemptions and also eliminates or decreases numerous itemized deductions. It is likely that under the new law, many taxpayers who previously claimed itemized deductions will no longer do so, effectively eliminating the tax benefit of some very popular itemized deductions including but not limited to the property tax deduction, the mortgage interest deduction, and the charitable contribution deduction.

C. **Personal and Dependent Exemptions.**

1. **Prior Law:** For 2017, taxpayers receive a personal exemption amount of $4,050 for each taxpayer and a dependent exemption of $4,050 for each dependent.

2. **New Law:** Beginning in 2018, taxpayers may no longer claim any personal or dependent exemptions.

3. **Comment:** While the new law does away with the personal and dependent exemptions, Congress has attempted to make up for it with the increased standard deduction discussed above. However, the increased standard deduction will not make up for the loss of the personal and dependent exemptions in all situations. For instance, under 2017 law, a married couple with three children who does not itemize deductions could claim the standard deduction of $12,700 plus five personal/dependent exemptions of $4,050 each for a total exemption of $20,250. The end result for the couple is a reduction in taxable income of $32,950. Under 2018, that same couple can only claim the standard deduction of $24,000 and cannot claim any personal or dependent exemptions. Under this scenario, the couple will have an increase in taxable income of $8,950 in 2018 compared to 2017, all else being equal.

D. **Filing Thresholders for Individuals.**

1. **Prior Law:** In general, for 2017, a taxpayer is required to file an individual income tax return if the taxpayer's gross income exceeds the amount of the standard deduction plus the personal exemption.

2. **New Law:** The new law does not change the filing requirements but it does eliminate the personal and dependent exemptions as discussed above. Accordingly, a taxpayer whose gross income exceeds the available standard deduction is required to file an individual income tax return.

3. **Comment:** While a taxpayer may not be required to file an individual income tax return, it nevertheless may be advantageous to do so for a variety of reasons

including but not limited to claiming a refund if taxes were withheld during the year and claiming certain refundable credits.

E. **<u>Individual Health Care Mandate</u>.**

1. **<u>Prior Law</u>:** Section 5000A, which was added by the Affordable Care Act, imposed an individual shared responsibility penalty on most individuals for any month that an individual was not enrolled in minimum essential health coverage. The monthly penalty was 1/12th of the greater of $695.00 per adult, $347.50 per child, or 2.5% of the taxpayer's household income.

2. **<u>New Law</u>:** Section 11081 of the Act eliminates the individual shared responsibility penalty by reducing the penalty to zero.

It is important to note that the new law change is narrowly focused on the individual shared responsibility penalty, and the remainder of the Affordable Care Act remains in effect. For individuals, this means eligible taxpayers can continue purchasing insurance through the individual market place and claiming the premium tax credit. For employers, this means that the employer shared responsibility penalties and information reporting obligations remain in effect.

F. **<u>Combat Zone Tax Benefits for Services in Sinai Peninsula of Egypt</u>.**

1. The new law extends certain tax benefits generally referred to as "combat zone tax benefits" to members who are performing services in the Sinai Peninsula of Egypt.

G. **<u>Change to Inflation Adjustment from CPI to Chained – CPI</u>.**

1. **<u>Prior Law</u>:** For 2017, inflation adjustments throughout the IRC are based on the Consumer Price Index, or CPI.

2. **<u>New Law</u>:** For 2018, inflation adjustments throughout the tax code will now be based Chained Consumer Price Index, or Chained CPI.

3. **<u>Comment</u>:** Chained CPI factors in a consumer's preference for a lower cost substitute good and will likely result in smaller inflation adjustments each year as compared to CPI.

II. <u>Personal Tax Credits</u>.

A. **<u>Child Tax Credit</u>.**

1. **<u>Prior Law</u>:** For each dependent child under the age of 17, the law allowed a $1,000 tax credit. The credit was subject to a phase-out beginning at $110,000 for married individuals filing jointly, and $75,000 for individuals filing as single or head of household. Special rules apply for families with three or more children, which take into account the benefits of the Earned Income Tax Credit.

2. **New Law:** Effective for the tax year beginning January 1, 2018 the Act expands the child tax credit in four key ways. First, the credit is increased to $2,000, of which $1,400 is refundable. Second, the reform package adds a $500 non-refundable credit for other dependents. Third, phase-outs now begin at $400,000 for those who are married filing jointly and $200,000 for all other taxpayers. Finally, the new law requires that taxpayers provide a valid social security number for each child dependent (a child without a valid SSN is still eligible for the $500 credit). The credit is scheduled to sunset on December 31, 2025.

3. **Comment:** The key point for most taxpayers is to ensure that returns are filed with the proper SSNs for the dependent children; the failure to do so is subject to adjustment by the IRS under section 6213 as a mathematical or clerical error.

III. Education and Disability Benefits.

A. 529 Accounts.

1. **Prior Law:** Distributions from a 529 account were limited to higher education expenses, such as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution.

2. **New Law:** Effective upon enactment to the Act expands the permissible distributions to allow for cumulative distributions (on a per donee basis) of up to $10,000 per year for elementary and secondary schools. The allowance sunsets on December 31, 2025.

3. **Comment:** This may offer a planning opportunity for some. However, the shorter time frame between the contribution and the elementary school expenses will significantly limit the overall benefit. Also, note that the conference report allowed the use of 529 accounts for homeschooling expenses—this was removed as it violated the Byrd Rule.

B. Discharge of Student Loan Debt.

1. **Prior Law:** Under section 108, student loan forgiveness generally constituted taxable income.

2. **New Law** (effective for debts discharged after December 31, 2017)**:** Under an amended section 108(f), student loan forgiveness does not constitute taxable income in the event of the death or major disability of the student. The exclusion sunsets on December 31, 2025.

3. **Comment:** This exemption includes any amounts a guarantor of a loan would otherwise have to recognize as income in the event of the student's death.

C. **Contributions and Rollovers to ABLE accounts.**

1. **Prior Law:** Contributions were limited to the section 2503(b) annual gift tax exclusion limitations on a per donee basis.

2. **New Law** (effective for rollovers after December 31, 2017)**:** There are two parts to the new law: (i) permitting a rollover from a 529 account into an ABLE account, and (ii) temporarily increasing the contribution limitation by the lesser of (a) the Federal poverty line for a one-person household, or (b) the individual's compensation for the taxable year—provided that the contribution is by the beneficiary. The exclusion sunsets on December 31, 2025.

IV. **Personal and Nonbusiness Deductions.**

A. **Overall Limitation ("Pease Limitation") on Itemized Deductions Suspended.**

1. **Prior Law:** Higher income taxpayers who itemized their deductions were subject to a limitation on these deductions (commonly known as the "Pease limitation"). For taxpayers who exceed the threshold, the otherwise allowable amount of itemized deductions were reduced by 3% of the amount of the taxpayers' adjusted gross income exceeding the threshold. The total reduction could not be greater than 80% of all itemized deductions, and certain itemized deductions were exempt from the Pease limitation.

2. **New Law:** For tax years beginning after December 31, 2017 and before January 1, 2026, the Pease limitation on itemized deductions is repealed.

B. **Modification of Deduction for Home Mortgage Interest.**

1. **Prior Law:** Taxpayers could deduct qualified residence interest, which included interest paid on a mortgage secured by a principal residence or a second residence. The maximum amount treated as acquisition indebtedness was $1 million or $500,000 in the case of a married individual filing a separate return, plus home equity indebtedness of up to $100,000.

2. **New Law:** For tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for mortgage interest is limited to underlying indebtedness of up to $750,000 or $375,000 for married taxpayers filing separately. For tax years after December 31, 2025, the prior $1 million/$500,000 limitations are restored. The new lower limit does not apply to any acquisition indebtedness incurred before December 15, 2017. A taxpayer who has entered into a binding written contract before December 15, 2017 to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, shall be considered to incur acquisition indebtedness prior to December 15, 2017. The $1 million/$500,000 limitations continue to apply to taxpayers who refinance existing qualified residence indebtedness that was incurred before December 15, 2017, so long as the indebtedness resulting from the refinancing doesn't exceed the amount of the refinanced indebtedness.

The deduction for interest on home equity indebtedness is eliminated for the tax years beginning after December 31, 2017 and before January 1, 2026.

C. **State and Local Tax Deduction.**

1. **Prior Law:** One of the key areas of contention among legislators has been the availability of a deduction for state and local taxes for individual taxpayers. Under current law, taxpayers may claim as an itemized deduction certain state and local taxes including real property taxes, personal property taxes, and either income taxes or sales taxes.

2. **New Law:** Under the new law, individual taxpayers may continue to deduct these state and local taxes, but will be subject to a limitation of $10,000. This limitation will apply to the aggregate amount of all such taxes claimed as a deduction, but the limitation will not apply to any taxes that are paid or accrued in carrying on a trade or business, or activities described in section 212 of the IRC (relating to ordinary and necessary expenses incurred in the production of certain types of income). In addition, taxes paid before January 1, 2018 imposed for a taxable year beginning after December 31, 2017 will be treated as paid on the last day of the taxable year for which the tax is imposed.

An additional interesting note relating to Texas tax has to do with the interplay between the IRC and the Texas franchise tax given that some aspects of the Texas franchise tax are closely tied to the IRC. For Texas franchise tax purposes, any references to the "IRC" means the IRC of 1986 in effect for the federal tax year beginning on January 1, 2007, not including any changes made by federal law after that date. Consequently, representatives from the Texas Comptroller's office recently announced at a conference in Austin, Texas that changes to the IRC under the new Act should not have a significant effect on a taxpayer's franchise tax liability. Nevertheless, the full effect of the Act on the Texas franchise tax may remain in question for some time to come.

D. **Repeal of Deduction for Personal Casualty & Theft Losses.**

1. **Prior Law:** Taxpayers were generally allowed to claim a deduction for any personal losses, (including those arising from fire, storm, shipwreck, or other casualty, or from theft, sustained during the taxable year,) not compensated by insurance of otherwise.

2. **New Law:** For tax years beginning after December 31, 2017 and before January 1, 2026, the personal casualty and theft loss deduction is suspended, except for personal casualty losses incurred in a Federally-declared disaster. In addition, where a taxpayer has personal casualty gains, the loss suspension doesn't apply to the extent that such loss doesn't exceed the gain.

E. **Limitation of Wagering Losses**.

1. **Prior Law:** Taxpayers can claim a deduction for wagering losses to the extent of wagering winnings. Other deductions connected to wagering, including transportation and admission fees, could be claimed regardless of wagering winnings.

2. **New Law:** For tax years beginning after December 31, 2017 and before January 1, 2026, the limitation on gambling losses is modified to provide that all deductions for expenses incurred in carrying out gambling transactions, and not just gambling losses, are limited to the extent of gambling winnings.

F. **Modifications to the Deduction for Charitable Contributions**.

1. **Prior Law:** The deduction for an individual's charitable contribution is limited to prescribed percentages of the taxpayer's "contribution base". The applicable percentages are 50%, 30%, or 20%, and depends on the type of organization to which the contribution is made, whether the contribution is made "to" or merely "for the use of" the donee organization, and whether the contribution consists of capital gain property. The 50% limitation applies to public charities and certain private foundations.

In addition, no charitable deduction is allowed for contributions of $250 or more unless the donor substantiates the contribution by a contemporaneous written acknowledgment (CWA) from the donee organization. The IRS is authorized to issue regulations that exempt donors from this substantiation requirement if the donee organization files a tax return that contains the same required information; however, IRS has not issued any such donee reporting regulations.

2. **New Law:** For tax years beginning after December 31, 2017 and before January 1, 2026, the 50% limitation for cash contributions to public charities and certain private foundations is increased to 60%. Contributions exceeding the 60% limitation are generally allowed to be carried forward and deducted for up to five years, subject to the later year's ceiling.

For contributions made in tax years beginning after December 31, 2016, the donee-reporting exemption from the CWA requirement is repealed.

G. **Deduction for Medical Expenses**.

1. **Prior Law:** Individuals may claim a deduction for unreimbursed medical expenses, but only to the extent that the medical expenses exceed 10% of adjusted gross income. The 10% threshold is reduced to 7.5% when a taxpayer reaches the age of 65 before the end of the tax year, or in the case of married taxpayers, when one of taxpayers reaches the age of 65 before the end of the tax year. For alternative minimum tax (AMT) purposes, the medical expenses deduction rules are modified such that medical expenses were only deductible to the extent they exceeded 10% of AGI.

2. **New Law:** For tax years beginning after December 31, 2016 and ending before January 1, 2019, the threshold on medical expense deductions is reduced to 7.5%

for all taxpayers. In addition, the rule limiting the medical expense deduction for AMT purposes to 10% of AGI does not apply to tax years beginning after December 31, 2016 and ending before January 1, 2019.

H. **Repeal of Deduction for Alimony Payments.**

1. **Prior Law:** When viewed together, sections 215 and 71 permit income splitting with respect to alimony – Section 215 of the Code provides that there shall be allowed as a deduction an amount equal to the alimony paid during a year, and section 71 of the Code provides that gross income includes amounts received as alimony. This well-established concept has been reflected in the Code since 1942, and Treasury Regulations since 1957.

2. **New Law:** The Act repeals the deduction for alimony by striking sections 215 and 71 from the Code. Going forward, alimony will be viewed as nondeductible personal expenses of the payor spouse (and, thus, more burdensome to that person), and the recipient spouse will not be required to recognize alimony as income. In other words, income used for alimony is taxed at the rates applicable to the payor spouse rather than the recipient spouse.

3. **Effective Date:** This change generally applies to divorce instruments executed after December 31, 2018.

I. **Repeal of Deduction for Moving Expenses.**

1. **Prior Law:** Individuals are permitted an above-the-line deduction for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work. The taxpayer must be a full–time employee at the new location and the new place of work must be at least 50 miles farther from the taxpayer’s former place of residence than was the taxpayer’s former place of work.

2. **New Law:** For tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for moving expenses is repealed, except for members of the Armed Forces, and the spouses and dependents, on active duty that move pursuant to a military order and incident to a permanent change of station.

J. **Denial of Charitable Deduction for College Athletic Event Seating Rights.**

1. **New Law:** No charitable deduction is allowed for any amount paid to an institution of higher education the payor receives the right to purchase tickets or seating at an athletic event.

K. **Repeal of Certain Itemized Deductions Subject to the 2% Floor.**

1. **Prior Law:** Taxpayers are allowed to deduct certain miscellaneous itemized deductions to the extent they exceeded, in the aggregate, 2% of the taxpayer’s adjusted gross income.

2. **New Law:** For tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for miscellaneous itemized deductions that are subject to the 2% floor is repealed.

V. **Exclusions from Gross Income.**

A. **Repeal of Exclusion for Qualified Moving Expense Reimbursement.**

1. **Prior Law:** Qualified Moving Expenses (QME) reimbursements are excluded from an employee's gross income. QME are defined as any amount received (directly or indirectly) from an employer as payment for or reimbursement of expenses which would be deductible as moving expenses if directly paid or incurred by the employee. These amounts are also excluded from wages for employment tax purposes.

2. **New Law:** For tax years beginning after December 31, 2017 and before January 1, 2026, the exclusion from gross income and wages for qualified moving expense reimbursements is repealed, expect for members of the Armed Forces, and the spouses and dependents, on active duty who move pursuant to a military order and incident to a permanent change of station.

VI. **Retirement Plans and IRAs.**

A. **Recharacterization of Roth IRA Contributions.**

1. **Prior Law:** Under current law a taxpayer is allowed to recharacterize conversion contributions made to a Roth IRA back to a traditional IRA, thereby effectively reversing the conversion.

2. **New Law:** A conversion contribution to a Roth IRA may no longer be recharacterized during a tax year as a contribution to a traditional IRA, thereby reversing the conversion. The new law is effective for tax years beginning after December 31, 2017.

3. **Comment:** Prior to the new law, the process of reversing a Roth IRA conversion was known as recharacterization. Several reasons existed as to why a taxpayer would want to reverse a Roth IRA conversion. For example, the assets in the converted Roth IRA may have declined in value or perhaps the taxpayer did not have sufficient cash on hand to pay the taxes associated with the conversion. A taxpayer could recharacterize (or reverse) a Roth IRA conversion back to a traditional IRA at any time before the due date, with extension, for filing a return (i.e., October 15, 2017). For example, assume taxpayer converted a traditional IRA into a Roth IRA on December 31, 2016 when the value of the account was $100,000. Taxpayer had until October 15, 2017 to recharacterize this transaction back to a traditional IRA. If the value of the assets appreciated to $150,000, taxpayer would not recharacterize and would pay tax on $100,000 (i.e., the value of the account on December 31, 2016). If, however, the account dropped in value to $50,000, taxpayer's tax liability would have been less if taxpayer would have converted then and thus taxpayer would reverse the transaction to avoid paying tax on a $100,000 conversion and would then reconvert the traditional IRA back

to a Roth IRA at the lower account value. This effectively allowed the taxpayer to "play the market."

B. **<u>Extended Rollover Period for Rollover of Plan Loan Offset Amounts</u>.**

1. **<u>Prior Law</u>:** In general, unless waived by the Secretary under a hardship exception, amounts paid to an employee in an eligible rollover distribution are not included in the gross income of the employee if the distributee employee contributes such property to an eligible retirement plan within sixty days.

2. **<u>New Law</u>:** The time frame for contributing a "qualified plan loan offset amount" to an eligible retirement plan as a rollover contribution is extended from sixty days to the due date (including extensions) for filing the federal income tax return for the tax year the loan offset occurs. A qualified plan loan offset amount is one that is treated as having been distributed from a qualified employer plan to a participant (or beneficiary) solely by reason of (i) the termination of the qualified employer plan or (ii) the failure to meet the repayment terms of the loan from such plan because of the severance from employment of the participant. A "plan loan offset amount" is the amount by which the participant's accrued benefit under the plan is reduced in order to repay a loan from the plan. The law is applicable for plan loan offset amounts treated as distributed in taxable years beginning after December 31, 2017.

3. **<u>Comment</u>:** The new law gives an eligible plan participant (or beneficiary) additional time to contribute the plan loan offset amount to a retirement plan without having such amount characterized as a taxable distribution to such individual.

C. **<u>Retirement Fund Distributions for 2016 Disaster Areas</u>.**

1. **<u>Prior Law</u>:** Generally, an early withdrawal from a retirement account is subject to inclusion in gross income plus a 10% penalty.

2. **<u>New Law</u>:** A taxpayer whose principal place of abode at any time during 2016 was located in an area for which the President declared a major disaster in 2016 and who sustained an economic loss by reason of such major disaster is allowed to take an early withdrawal up to $100,000 from a qualified retirement plan, a section 403(b) plan or an IRA without being subject to the 10% early withdrawal penalty. Moreover, the income from the early withdrawal may be included ratably in income over a three year period. The new law allows the taxpayer to recontribute the amount of the early withdrawal to another eligible retirement plan within three years.

3. **<u>Comment</u>:** The new law allows taxpayers limited early access to retirement funds without penalty to assist with post major disaster rebuilding efforts of various sorts.

D. **<u>Modification of Rules Applicable to Length of Service Award Plans for Bona Fide Volunteers</u>.**

1. **<u>Prior Law</u>:** An amount up to $3,000 annually was specifically exempted under section 457 for length of service awards to bona fide volunteers.

2. **<u>New Law</u>:** The amount specifically exempted under a section 457 plan related to bona fide volunteers was increased to $6,000 annually with a cost of living adjustment applied to such amount for tax years beginning after December 31, 2017. In the case of a defined benefit plan, the $6,000 is applied to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service. The new law is applicable for tax years beginning after December 31, 2017.

VII. <u>Estate and Gift Taxes</u>.

A. **<u>Unified Credit for Federal Estate, Gift, and GST Taxes</u>.**

1. **<u>Prior Law</u>:** Prior to the Act, the basic exclusion amount for an individual was $5,000,000 indexed for inflation.

2. **<u>New Law</u>:** The Act doubles of the section 2010(c) basic exclusion amount from $5,000,000 to $10,000,000 for transfers made and decedents dying after December 31, 2017 and before January 1, 2026. The exclusion remains subject to an annual inflation adjustment which results in an exclusion for 2018 of $11,200,000. This change applies for estate and gift tax and causes the GST Exemption to increase by the same amount.

3. **<u>Comment</u>:** According to the estimates of the Urban-Brookings Tax Policy Center, this change is expected to initially reduce the number of taxable estates from 5,500 estates to only 1,700 taxable estates per year and reduce revenue from the Federal estate tax from $20.4 billion in 2017 to $12.6 billion in 2018. The change opens the door to a new round of planning for those taxpayers who have fully utilized their pre-act existing exclusion amounts especially because the current increase sunsets in 8 years. These planning opportunities are enhanced by the absence of any provisions aimed at reducing discounts for family controlled business interests that were included in the proposed 2704 regulations withdrawn by the IRS in late 2017. Finally, it is important to note that although up to $22,400,000 of assets per couple can now pass without estate tax, there was no change to the application of section 1014 which allows assets in the gross estate to receive a new basis for income tax purposes equal to fair market value.

VIII. <u>Alternative Minimum Tax (AMT)</u>.

A. **<u>Alternative Minimum Tax (AMT)</u>.**

1. **<u>Prior Law</u>:** For individuals, the exemption amounts for 2017 for purposes of calculating the individual AMT were $84,500 for married filing jointly and surviving spouses, $54,300 for other unmarried individuals and $24,100 for trusts and estates. The exemption amounts are phased out by 25% of the amount by which AMTI

exceeds $160,900 for married filing jointly and surviving spouses, $120,700 for other unmarried individuals and $80,450 for married filing separately, trusts and estates.

2. **New Law:** The Act increases both the exemption amounts and phase-out amounts for tax years beginning after December 31, 2017 and beginning before January 1, 2026. The new exemption amounts are $109,400 for married filing jointly, $54,700 for married filing separately and $70,300 for other taxpayers. The exemption for trusts and estates was unchanged. The new phase-out amounts are $1,000,000 for married filing jointly and $500,000 for all other taxpayers, except trusts and estates. The new amounts are also indexed for inflation.

B. **Alternative Minimum Tax - Corporations.**

1. **Prior Law:** Corporations were subject to a corporate AMT.

2. **New Law:** The Act repeals the corporate AMT. Additionally, the Act provides that any corporation may utilize any existing AMT credit to offset its regular tax liability. The AMT credit also becomes refundable for tax years beginning after 2017 and before 2022 in an amount equal to 50% of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability.

3. **Effective Date:** Taxable years beginning after December 31, 2017.

IX. Pass-Through Entities.

A. **20% Deduction for Certain Pass-Throughs and Sole Proprietorships**

1. **Prior Law:** Prior to the Act, items of income, gain, loss, deduction and credit of a partnership[1] or S corporation generally passed through to the partner or shareholder without any deduction at the partner or shareholder level. Similarly, such items of a sole proprietor were reported on his or her Form 1040 without further deduction.

2. **New Law: a) Section 199A Deduction for Qualified Business Income of Pass-Through Entities.**

The Act adds new section 199A. Individuals (including trusts and estates), are, in general, allowed a deduction of 20% of their qualified business income from partnerships, S corporations and sole proprietorships, for taxable years beginning after December 31, 2017 and before January 1, 2026. The deduction is also allowed for qualified REIT dividends and qualified cooperative dividends and qualified publicly traded partnership income. However, the actual deduction computation for taxpayers with taxable income in excess of certain threshold amounts

[1] All references herein to a partnership include a limited liability company treated as a partnership for federal income tax purposes.

is much more complicated than that and is subject to a morass of limitations and exceptions.

The deductible amount is the *lesser of*: (a) the taxpayer's combined qualified business income amount, or (b) 20% of the *excess*, if any, of (i) the taxpayer's taxable income for the taxable year over (ii) the sum of: [1] the taxpayer's net capital gain and aggregate qualified cooperative dividends for the taxable year, *plus* [2] the *lesser of*: [A] 20% of the taxpayer's qualified cooperative dividends or [B] taxable income (determined without regard to 199A), reduced by capital gain, of the taxpayer for the tax year. However the deduction may not exceed the taxable income of the taxpayer (reduced by net capital gain) for the taxable year. The deduction is available to taxpayers who take the standard deduction, as well as taxpayers who itemize deductions. For partnerships and S corporations the deduction is taken at the partner or shareholder level.

The deduction is not taken into account in computing adjusted gross income. Instead, it is treated as a deduction that reduces taxable income.

b) **<u>Combined Qualified Business Income Amount</u>**. The "combined qualified business income amount" is an amount which is equal to the sum of (a) the deductible amount determined for each qualified trade or business of the taxpayer and (b) 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

c) **<u>Qualified Trade or Business</u>.** A "qualified trade or business" means any trade or business other than (a) a specified service business (discussed below) or (b) the trade or business of performing services as an employee.

d) **<u>Deductible Amount Determined for Each Qualified Trade or Business.</u>** The deductible amount for each qualified trade or business is the *lesser of* (a) 20% of the qualified business income for such qualified trade or business or (b) the Wages Limitation amount, discussed below, if applicable.

e) **<u>Qualified Business Income</u>.** Qualified business income ("QBI") is the net amount of qualified items of income, gain, deduction or loss which relate to any qualified trade or business of the taxpayer that is effectively connected with the conduct of a trade or business in the United States under section 864(c) and which items are included or allowed in computing taxable income for the year.

If the net amount of such items is less than zero, the amount is treated as a loss for the qualified trade or business in the following taxable year.

Excluded from QBI are: (a) short-term capital gain or loss, long-term capital gain or loss, dividend income and interest income, (b) reasonable compensation paid to the taxpayer by the qualified trade or business for services rendered to such trade or business, and (c) any guaranteed payments under section 707(a) paid to a partner for services rendered with respect to the trade or business. QBI also does not include qualified REIT dividends, qualified cooperative dividends or qualified publicly traded partnership income.

f) **Wages Limitation.** The allowable deduction, subject to a phase-in, is limited to the *greater of*: (a) 50% of W-2 wages with respect to the qualified trade or business or (b) the sum of (i) 25% of W-2 wages paid with respect to the qualified trade or business, *plus* (ii) 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property, (the "Wages Limitation"). Qualified property is limited to tangible, depreciable property held by, and available for use in the qualified trade or business at the end of the taxable year, which is used at any point during the taxable year in the production of qualified business income, and for which the depreciable period has not ended before the close of the taxable year. The depreciable period with respect to qualified property is the period beginning with the date the property is first placed in service by the taxpayer and ending on the later of (a) the date 10 years after such date or (b) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (without regard to section 168(g)). In the case of trusts and estates which are eligible for the deduction, rules similar to current section 199 (regarding domestic production activities) will apply for purposes of apportioning W-2 wages and unadjusted basis of qualified property between the fiduciaries and beneficiaries.

W-2 wages are defined as wages subject to wage withholding, elective deferrals and deferred compensation paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the taxable year.

g) **Application of the Wages Limitation to Partnerships and S Corporations.** Each individual partner or S corporation shareholder's allocable share of W-2 wages is determined in the same manner as his or her allocable share of wage expenses. Also, each partner or shareholder's allocable share of the unadjusted basis in qualified property is determined in the same manner as his or her allocable share of depreciation. An S corporation shareholder's allocable share is his or her pro rata share of the item.

h) **Phase-In of Wages Limitation.** If the taxable income of the taxpayer does not exceed a threshold amount of $315,000 for married individuals filing jointly (or $157,500 for other taxpayers), the Wages

Limitation does not apply. The Wages Limitation is phased in over the next $100,000 of taxable income above such threshold for married individuals filing jointly (or the next $50,000 of taxable income for other taxpayers.

i) **<u>Exclusion of Deduction for Specified Services Trade or Businesses</u>.** In the case of a taxpayer's interest in a specified services trade or business, the section 199A deduction will be phased out beginning at threshold levels of taxable income in excess of $315,000 for married taxpayers filing jointly ($157,500 for other taxpayers) over the next $100,000 of taxable income for married taxpayers filing jointly ($50,000 for other taxpayers) (the "Specified Services Limitation"). A specified services trade or business is a trade or business described in section 1202(e)(3)(A), and thus includes the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services (but notably excluding engineering and architecture) and any trade or business the principal asset of which is the reputation or skill of one or more if its owners or employees, or any business that that involves the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interests, or commodities.

j) **<u>Specified Agricultural or Horticultural Cooperatives</u>.** The deduction for pass-through income is also available to specified agricultural or horticultural cooperatives in an amount which is equal to the lesser of: (a) 20% of the cooperative's taxable income for the taxable year, or (b) the greater of (i) 50% of the W-2 wages of the cooperative with respect to its trade or business, or (ii) the sum of [A] 25% of the W-2 wages of the cooperative with respect to its trade or business, plus [B] 2.5% of the unadjusted basis immediately after acquisition of qualified property of the cooperative.

k) **<u>Summary Analysis</u>:**

Under new section 199A taxpayers will be required to first determine the deductible amount for each qualified trade or business in which they have an interest, which is the *lesser of* 20% of the QBI from such qualified trade or business or the Wages Limitation amount (if applicable). The combined qualified business income amount is computed by adding (a) the deductible amount determined for each of the taxpayer's qualified trade or businesses, and (b) 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year. The resulting deduction is the *lesser of* the combined qualified business income amount or 20% of the amount by which the taxpayer's taxable income exceeds any net capital gain and aggregate qualified cooperative dividend plus the *lesser of* 20% of qualified cooperative dividend or total income reduced by capital gain. However, the Specified Services Limitation must be considered in determining the taxpayer's QBI for the taxable year.

It should be noted that in determining the Wages Limitation W-2 wages are defined as wages paid to an employee, including elective deferrals or other deferred compensation. Wages do not include payments to an independent contractor or management fees. Note also that while the taxable income threshold for application of the Wages Limitation, as well as the Specified Services Limitation, is determined at the taxpayer level, W-2 Wages are determined at the pass-through entity level.

The section 199A deduction is a modified version of the Senate proposal, whereas the House approach was a rate reduction. The Act expanded the deduction to include trusts and estates. Also, the Senate version limited the deduction to only a specified percentage of W-2 wages, which would have favored labor intensive businesses over capital intensive businesses. However, the Act expanded the deduction available under the Wages Limitation to include an alternative combination of wages and unadjusted basis of tangible depreciable property, which favors capital intensive businesses, such as the real estate industry.

Service industries such as legal and accounting services are the most limited as to available deduction, with an unlimited deduction available only for taxpayers with taxable income of no more than $315,000 for married taxpayers filing jointly (or $157,500 for other taxpayers). Also, businesses which are neither labor intensive (including businesses which treat workers as independent contractors) nor have substantial tangible depreciable property will derive little benefit from this deduction except for taxpayers whose taxable income does not exceed the threshold amount.

For many pass-through entities which do not fall into the modified section 1202(e)(3)(A) list of services businesses the determination as to whether its principal asset is nevertheless the reputation or skill of one or more of its owners or employees (thereby making it a qualified services business) will be problematic. Even with the aid of regulations, this provision will likely be a major point of contention in application of section 199A. Indeed, this provision may prompt a change in how such pass-throughs characterize their business.

The idea behind the section 199A deduction was apparently to provide tax relief to noncorporate businesses that loosely aligns with the rate cut provided to C corporations. However, the deduction for pass-through entities is subject to certain limitations that are phased-in above designated threshold amounts, unlike the 21% rate for C corporations which applies across the board to taxable income of the corporation. Also, due to limitations of the Byrd rule, the deduction for pass-through entities is for a limited time (for taxable years beginning after December 31, 2017 and before January 1, 2026), whereas the corporate rate cut apparently has no built-in sunset date.

The effective tax rate for taxpayers in the highest tax bracket who are able to fully take advantage of the deduction is 29.6% on their qualified business income. Since the tax rate on C corporations is now 21% there may be some who will consider conversion of their partnerships or S corporations to C corporations. However, consideration must be given to the impact of double taxation inherent to C corporations, including potential application of the accumulated earnings tax or personal holding company tax. Conversion to a C corporation, however, may warrant consideration for Partnerships and S Corporations that plow earnings back into the business with no short-term plan for a significant partner or shareholder liquidity event. On the other hand, some corporations may consider taking advantage of the lower 21% corporate rate on section 311(b) gain to convert to a partnership, depending on the extent to which the partners would benefit from the section 199A deduction, particularly where the corporation has significant net operating loss carryovers available to offset any corresponding section 311(b) gain.

In order to be included in QBI, the items of income and deduction must be derived from the conduct of a trade or business. There is no definition of "trade or business" in the IRC. However, it is likely that section 199A will be interpreted to mean a section 162 trade or business. In that case, passive income, such as rent from a triple net lease, with minimal other activity, may not qualify for the deduction. Many pass-through entities may need to become more active in order to take advantage of section 199A.

Expect regulations to follow which will flesh out the scope and limitations of this new deduction. For instance, the IRS is directed to issue regulations for requiring or restricting the allocation of items and wages for this provision, as well as reporting requirements as are determined to be appropriate.

The IRS is also directed to issue guidance for determining the limitation based on W-2 wages and capital in cases of a short taxable year or where the taxpayer acquires or disposes of a major portion of the trade or business or the major portion of a separate portion of a separate unit of a trade or business during the taxable year.

The IRS is further directed to provide guidance (a) applying rules similar to section 179(d)(2) for acquisitions of property from a related party, as well as in a sale-leaseback or other transaction as needed to carry out the purposes of the provision; (b) prescribing rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary exchanges; and (c) and providing anti-abuse rules, including with respect to the Wages Limitation.

For qualified business income from sources in Puerto Rico, the taxpayer's qualified business income is determined by treating Puerto Rico as part of the U.S. if all of the income is taxable in the U.S. for purposes of section 1 of the IRC.

B. **Carried Interest of Partnership Interests – Section 83; New Section 1061.**

1. **Prior Law:** Partnerships may issue a profits interest (sometimes referred to as a "carried interest"), to incentivize an employee, referred to as a "service provider," in exchange for the continued performance of services. A profits interest allows a service provider to participate in future profits of the partnership. The service provider, however, does not receive a right to participate in liquidating distributions of cash or property as do partners holding capital interests in the partnership. In connection with the performance of services, section 83 generally dictates the timing and amount of compensation income to be recognized by the service provider and deducted by the employer, or "service recipient." The service provider typically includes such income in the first tax year in which the property received is either transferable or not subject to a substantial risk of forfeiture, (i.e., vested). Alternatively, the service provider can make an election under section 83(b) to accelerate income recognition to the tax year in which the profits or carried interest is received even though such interest is not vested. The section 83(b) election must be made within 30 days of the service provider's receipt of the profits interest, which reported as ordinary income equal to the fair market value of such interest, less any purchase price paid. The fair market value of a profits interest is oftentimes extraordinarily difficult to determine and would typically be zero[2]. Thus, the service provider has no income to recognize, and any appreciation of the profits interest in future years is capital in nature. There has been ongoing controversy in this area[3] and, in 2005, the IRS provided additional administrative guidance through the issuance of proposed regulations (70 Fed. Reg. 29675), with respect to the application of section 83 to transfers of partnership interests as compensation. Pursuant to the proposed regulations, the service provider and service recipient could elect a safe harbor that would result in the fair market value of the profits interest to be equal to the liquidation value of such interest, which was most likely zero since the service provider was not entitled to liquidation proceeds as a holder of a profits interest.

2. **New Law:** The new law adds new section 1061, which imposes a three-year holding period in order for a taxpayer's recognition of net gain to be classified as long-term capital gain with respect to "any applicable partnership interest," which is defined as a partnership interest transferred to or held by the taxpayer in connection with

[2] Note that the same outcome would ensue from the safe harbor election under the proposed regulations discussed further herein below.

[3] In response to divergent court decisions, the IRS in Rev. Proc. 93-27 (1993-2 C.B. 343), stated the issuance of a profits interest would not be a taxable event to either the service recipient or the service provider, subject to the exceptions of determinable stream of income, disposition within two years of receipt or limited partnership interest in a publicly traded partnership.

the performance of substantial services by the taxpayer, or a person related to the taxpayer, in any "applicable trade or business." A person "related to" the taxpayer follows the typical family attribution rules,[4] but with an addition of "colleague," defined as a person who performed a service in conjunction with the taxpayer within the calendar year or the previous three calendar years in or for such "applicable trade or business." The transfer of any applicable partnership interest to a related person by the taxpayer will result in short-term capital gain recharacterization of any long-term capital gain with respect to the sale or exchange of an asset held for less than three years that is allocable to such partnership interest. To fall within the definition of an "applicable trade or business." the endeavor must be conducted on a regular, continuous and substantial basis that consists of (i) raising or returning capital and (ii) either (A) investing in or disposing of certain "specified assets" or identifying "specified assets" for investing or disposition, or (B) developing "specified assets." The definition of "specified assets" includes securities, commodities, real estate held for rental or investment, and cash or cash equivalents, as well as options, derivatives or a partnership interest (other than a widely held or publicly traded partnership interest) to the extent of the partnership's proportionate interest in any of the foregoing.

3. There are two exceptions that exclude certain partnership interests from application of new section 1061: (i) partnership interests held by corporations, and (ii) capital interests with rights to participate proportionate to (a) the capital contributed, or (b) the amount taken into income pursuant to section 83(a) upon vesting, or upon receipt in conjunction with an election under section 83(b). Note, however, that the Act clarified that the three-year holding period requirement applies notwithstanding the rules of section 83. In calculating the taxpayer's net long-term capital gain, the taxpayer's long-term capital losses must also be calculated as if a three-year holding period applies. Any net long-term capital gain with a holding period of less than three years will be treated as short-term capital gain and taxed as ordinary income tax rates.

4. **Comment:** New section 1061 is clearly aimed at addressing the tax treatment of a profits interest, as well as resolving previous controversy over earlier attempts to include a corporation's ownership of a partnership interest by its exclusion from application. Unfortunately, the Act did not address whether S corporations are included in the reference to "corporations" generally, which would thereby exclude them from application of the new Code provision. Additional confusion is generated by the exclusion of taxpayers who hold capital interests in partnerships to the extent that the partnership agreement provides that the capital contributed for such interest was commensurate with the taxpayer's percentage interest at the time so contributed. While the apparent goal was to provide service provider-partners with the ability to earn long-term capital gain with respect to their capital interests, uncertainty arose from language indicating that a service partner's contribution to capital will not by itself exclude such partnership interest from application of the new Code provision, followed by a direction to the Treasury to promulgate guidance on such matter. Therefore, it remains unclear what amount of income associated with contributed capital will be exempt from application of the newly enacted three-year holding period. Further confusion is created

[4] See section 318(a)(1).

by the provision focused upon transfers to related parties as the language results in short-term capital gain recognition with respect to assets held more than one-year and less than three-years, and it may go so far as to result in capital gain or loss recognition even in nonrecognition transactions. Lastly, the new Code provision would modify section 1222(3) and (4) by requiring a holding period for capital assets of more than three years to qualify for long-term capital gain or loss recognition; however, the provision does not account for the numerous other provisions within the Code that result in taxation of long-term capital gain without referring to section 1222, such as section 1231. Apparently the Treasury will need to provide quite a bit of guidance and clarification in the form of regulations in the (hopefully) not too distant future.

C. **Modification of Definition of Substantial Built-In Loss on Disposition of Partnership Interest.**

1. **Prior Law:** Generally, a partnership does not adjust the basis in partnership property following a partner's disposition of a partnership interest unless the partnership has a section 754 election in effect. If a section 754 election is in effect, or if the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner in order to account for the difference between the transferee partner's basis in his or her partnership interest ("outside basis") and his or her corporate share of the partnership's basis in its assets ("inside basis").

Under current provisions, a substantial built-in loss exists if the adjusted basis of the partnership's property exceeds the fair market value of the partnership property by more than $250,000.

2. **New Law:** Modification of section 743(b).

The definition of substantial built-in loss in section 743(d) is modified to provide that a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition of all partnership assets in a fully taxable transaction for cash equal to the fair market value of the assets immediately after the transfer of the partnership interest.

3. **Comment:** This provision is apparently to plug a perceived loophole in the current statute which permitted the effective transfer of a loss in excess of $250,000 to the transferee in certain instances, even though the aggregate basis in the partnership assets did not exceed fair market value by more than $250,000.

D. **Basis Limitation on Partner Losses from Partnership**

1. **Prior Law:** A partner's distributive share of losses, including capital losses, is allowed only to the extent of the adjusted basis (before reduction by the current year's losses) of the partner's interest in the partnership at the end of the taxable year in which the loss occurred. The disallowed amount is allowable as a deduction at the end of the first succeeding partnership taxable year, and subsequent taxable years to the extent that the partner's adjusted basis for its partnership interest at the end of any such year

exceeds zero (before reduction by the loss for the year). See Section *704(d)* and Reg. section 1.704-1(d)(1).

With respect to application of the basis limitation to partnerships, Treasury Regulations do not take into account the partner's share of partnership charitable contributions and foreign taxes paid or accrued. However, the IRS had taken the position in Private Letter Ruling 8405084 that the basis limitation does not apply to limit the partner's deduction for its share of partnership charitable contributions.

On the other hand, the S corporation rules limiting losses and deductions to the shareholder's basis in stock and debt of the corporation, the shareholder's pro rata share of charitable contributions and foreign taxes are taken into account.

2. **New Law:** The basis limitation on partnership losses is modified to provide that the limitation takes into account a partner's distributive share of charitable contributions (as defined in section 170(c)) and taxes (described in section 901) paid or accrued to foreign countries and to possessions of the United States. Therefore, the amount of the basis limitation on partner losses is decreased to reflect these items. With respect to charitable contributions by a partnership the amount of the basis limitation on partner losses is decreased by the partner's distributive share of the adjusted basis of the contributed property. In the case of a charitable contribution by a partnership of property whose fair market value exceeds its adjusted basis, a special rule provides that the basis limitation on partner losses does not apply to the extent of the partner's distributive share of the excess. This provision applies to taxable years beginning after December 31, 2017.

3. **Comment:** This provision applies the same basis limitation treatment to partners as to S corporation shareholders with respect to charitable contributions and foreign taxes paid or accrued.

E. Repeal of Partnership Technical Termination

1. **Prior Law:** Under prior section 708(b)(1)(B), a partnership was considered terminated if within any 12-month period there was a sale or exchange of 50% or more of the interests in capital and profits of the partnership. This so-called "technical termination" resulted in a deemed contribution of the partnership assets and liabilities to a new partnership in return for a partnership interest, which the old partnership was then deemed to have distributed to its partners in liquidation. This technical termination rule posed a trap for the unwary in that, while the new partnership continued with the old EIN, the rule required a cut off of the partnership taxable year and existing partnership elections did not automatically carry over to the new partnership. In addition, the new partnership was required to reset depreciable lives of the partnership depreciable assets.

2. **New Law:** The partnership technical termination rule has been repealed effective for taxable years beginning after December 31, 2017. However, this repeal does not affect the provisions of section 708(b)(1)(A, which provide for a termination of the partnership if nor part of any business, financial operation or venture of the partnership continues to be carried on by its partners in a partnership.

3. **Comment:** Repeal of the partnership technical termination rule eliminates a trap in subchapter K which really did not serve a significant purpose.

F. **Qualified Beneficiary of Electing Small Business Trust ("ESBT") – Section 1361.**

1. **Prior Law:** For a corporation to qualify as an S corporation, ownership of its stock is limited to certain permitted shareholders, one of which is an electing small business trust or "ESBT." To qualify as an ESBT, a trust must also meet certain requirements. For example, a nonresident alien individual may not be a potential current beneficiary of such ESBT, which is consistent with the S corporation's prohibition on having a nonresident alien individual as a shareholder.

2. **New Law:** The Act allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

3. **Comment:** The addition of allowable shareholders may expand the number of corporations that might elect S corporation status.

4. **Effective Date:** Tax years beginning after December 31, 2017.

G. **Charitable Contribution of Electing Small Business Trust ("ESBT") – Section 170 and Section 642.**

1. **Prior Law:** An ESBT's allocable share of the S corporation's income is taxed to the trust, which is subject to the highest individual tax rate. The charitable contribution deduction allowed to an ESBT is for any amount up to its gross income without a carryover to the following tax year. In comparison, an individual's charitable contribution deduction is limited to certain percentages of adjusted gross income, with a carryforward of amounts in excess of such limitation.

2. **New Law:** The Act provides the charitable contribution deduction allowed for the portion of an ESBT holding S corporation stock is determined under the rules applicable to individuals rather than trusts.

3. **Comment:** The amendment appears appropriate given that ESBTs are subject to taxation at the highest individual rate.

4. **Effective Date:** Tax years beginning after December 31, 2017.

H. **S Corporation Conversions to C corporations.**

1. **Prior Law:** Presently, section 481 dictates the rules to be followed in computing taxable income in situations in which a taxpayer changes its method of accounting from a prior year, e.g., from the cash method to the accrual method. The taxpayer must take into account such adjustments that are determined to be necessary solely by reason of such change in order to prevent items of income or expense from being duplicated or omitted. Adjustments that have a net effect in decreasing taxable

income are generally taken into account entirely in the year such change occurs. Adjustments that have a net effect of increasing taxable income are generally taken into account ratably during the four-year tax period beginning with the year of change. When an S corporation converts to a C corporation, distributions of cash by the C corporation to its shareholders during the one-year period following the S corporation termination are tax-free to the extent of the accumulated adjustments account or "AAA," since such account reflects income of the S corporation that has already been subject to income tax but remains undistributed. If the AAA is depleted by the distribution, then the excess distribution is treated as coming from the earnings and profits, or "E&P," of the corporation when it was a C corporation or inherited from a C corporation under section 381, if any. If an S corporation election terminates, special rules apply to distributions made by the resulting C corporation during the post-termination transition period ("PTTP").

2. **<u>New Law</u>:** The Act contains two provisions with respect to an "eligible terminated S corporation," which is defined as any C corporation that is an S corporation on the day before enactment of the Act and, during the two-year period beginning on the date of enactment of the Act, revokes its S corporation election under section 1362(a) and all shareholders on the date of revocation are the same shareholders (and hold the same proportionate number of shares of stock) as on the date of enactment. The first provision requires that any section 481(a) adjustment of such eligible terminated S corporation attributable to the revocation of its S corporation election, e.g., a change from the cash method to the accrual method of accounting for income, is taken into account ratably during the six-taxable year period beginning with the year of change. The second provision requires that in the case of a distribution of cash by an eligible terminated S corporation, the AAA shall be allocated to the distribution and it shall be chargeable to the accumulated E&P in the same ratio as the amount of the AAA bears to the amount of the accumulated E&P.

3. **<u>Comment</u>:** The Act would allow eligible terminated S corporations to extend the time period over which income must be recognized due to a change in its accounting method by an additional two years (i.e., from four years to six years). Further, the Act would allow cash distributions by an eligible terminated S corporation following the PTTP to be treated as coming out of the AAA or E&P in the same ration as the amount of the corporation's AAA bears to the amount of the corporation's E&P. Therefore, even after expiration of the corporation's PTTP, some portion of any cash distribution may be treated as a reduction in the shareholder's basis in its stock followed by capital gain. This would hopefully lessen the pressure by the former S corporation shareholders to distribute cash equal to the AAA in the PTTP and ease liquidity concerns of the corporation.

X. **Corporate Tax Rate.**

A. **Corporation Income Tax Rate.**

1. **Prior Law:** Under Pre-Act law, section 11(b) provided that corporate taxable income is taxed at graduated rates from 15% to 35% with a flat rate of 35% for qualified personal service corporations.

2. **New Law:** Corporate income taxed a flat rate of 21% under section 11(b).

B. **Dividend-Received Deductions for Corporations.**

1. **Prior Law:** Under Pre-Act law, section 243 provided a corporate deduction for dividends received from domestic corporations, with the deduction ranging from 70% to 100% in certain cases.

2. **New Law:** Section 243 is amended by reducing the 70% deduction to 50%, unless the payer corporation is a 20% owned corporation and then the deduction is 65%.

C. **Contributions of Capital to Corporations.**

1. **Prior Law:** Under Pre-Act law, section 118 provided that gross income of a corporation does not include any contribution to the capital of the corporation but does include any contribution in aid of construction or any other contribution as a customer or a potential customer as provided in section 118(d); section 118(a), however did exclude from income under section 118(c) amounts received by a regulated public utility that provides water or sewage disposal services under certain conditions.

2. **New Law:** Section 118 is amended to delete subsections (b), (c) and (d) and exclude from the term "contribution to the capital of the taxpayer" any contribution in aid of construction or other contribution as a customer or potential customer and any contribution by any governmental entity or civic group, with the Secretary having the authority to issue regulations and other guidance.

3. **Effective Date:** The amendments to section 118 apply to contributions made after the date of enactment of the Act with the exception of contributions made by a governmental entity after the date of enactment of the Act which are made pursuant to a master development plan that has been approved by a governmental entity prior to the date of enactment of the Act.

XI. **Depreciation and Expensing.**

A. **Bonus Depreciation.**

1. **Prior Law:** Under Pre-Act law, section 168(k) allowed for an additional first-year depreciation deduction equal to 50% of the adjusted basis of qualified property acquired and placed in service before January 1, 2020.

2. **New Law:** Additional first-year depreciation is continued with an increase of the deduction to 100% for property placed in service after September 27, 2017, and before January 1, 2023, and decreasing in percentage for property placed in service after December 31, 2025, and before January 1, 2027.

For property with longer production periods or certain aircraft, the decrease in percentages is less and the period is extended through 2027.

In addition, the amendments to section 168(k) allow the first-year depreciation deduction to be taken for property whose original use began with the taxpayer or the taxpayer acquired the property but the original use of the property did not begin with the taxpayer if certain conditions are met.

B. **Section 179 Expensing.**

1. **Prior Law:** Under Pre-Act law, section 179 provided an election to expense up to $500,000 per year of the cost of "qualifying property" for the taxable year with a phase out by the amount by which the cost of qualifying property placed in service during the taxable year exceeded $2,000,000.

2. **New Law:** The annual cap is increased to $1,000,000 and the phase out begins at $2,500,000. In addition, qualifying property includes depreciable tangible personal property used predominately to furnish lodging or in connection with furnishing lodging. In addition, qualifying property includes the following improvements to nonresidential real property placed in service after the improved property was placed in service: roofs, heating, ventilation, air-conditioning, fire protection, alarm systems and security systems.

C. **Expensing of Costs of Replanting Citrus Plants.**

1. **Prior Law:** Under Pre-Act law, section 263A(d)(2) provided an exception to the Uniform Capitalization rules for costs incurred for replanting edible crops damaged or lost due to certain events. This exception applied to the taxpayer who owned the damaged crops as well as another person who paid the costs of replanting if the taxpayer had a greater than 50% equity interest in the land on which the damaged crops were located and the other person owned any part of the remaining equity interest and materially participated as determined under section 2032A(e)(6).

2. **New Law:** The exception is retained but the taxpayer must own not less than 50% of the equity interest and the other person is not required to materially participate or the other person acquires all of the equity interest of the taxpayer in the land on which the damaged crop was located and the replanting occurs on that same land.

3. **Effective Date:** Applies to cost incurred during 10 year period beginning with date of enactment of the Act.

D. **Acceleration of Cost Recovery for Certain Farm Property.**

1. **Prior Law:** Section 168 required use of the 150% declining balance method rather than the 200% declining balance method for depreciation of property used in a farming business. Section 168 also defined any machinery or equipment used in a farming business as 5-year property for purposes of depreciation recovery; however, this definition only applied to property placed into service during the 2009 calendar year.

2. **New Law:** The Act repeals the required use of 150% declining balance method for depreciation of property used in a farming business and treats machinery and equipment placed in service after December 31, 2017 in a farming business as 5-year property for purposes of depreciation recovery.

3. **Comment:** Before this change, farm machinery and equipment was generally 7-year property, and taxpayers were required to recover their basis using the 150% declining balance method. The change in treatment to 5-year property from 7-year and the use of the 200% declining balance method (rather than the 150% declining balance method) accelerates depreciation deductions to earlier years for taxpayers engaged in farming businesses.

E. **Modification to Cost Recovery for Certain Real Property.**

1. **Prior Law:** Section 168 defined 15-year property to include, among other things, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

2. **New Law:** For tax years beginning after December 31, 2017, the Act eliminates qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property and creates qualified improvement property subject to the straight line method of recovery. The Act also requires real property trade or businesses that have elected out of the interest limitations to use alternative depreciation system for taxable years beginning after December 31, 2017.

3. **Comment:** The Act replaces 15-year recovery for certain improvements with a single category of qualified improvement property. As discussed elsewhere in this outline, the newly created qualified improvement property is eligible for the additional first-year depreciation deduction. However, the Act also subject to real property trades or businesses to the alternative depreciation system (30-year recovery period for residential rental property and 40-year recovery period for nonresidential property) if they elect out of the new section 163(j) limitation on business interest.

F. **Electing Farm Businesses Subject to Alternative Depreciation System.**

1. **New Law:** The Act imposes the alternative depreciation system on any property with a recovery period of 10 years or more which is held by farm businesses that elect out of the new section 163(j) limitation on business interest. This change also applies to taxable years beginning after December 31, 2017.

G. **Cash Method Accounting for Small Businesses.**

1. **Prior Law:** Under Pre-Act law, section 263A set forth uniform capitalization rules that require certain direct and indirect costs to be included in inventory costs if the property is inventory in the hands of the taxpayer or capitalized for any other property subject to section 263A. Real or tangible personal property produced by the taxpayer and real and personal property acquired by the taxpayer for resale is included under section 263A unless the personal property acquired for resale is acquired by a taxpayer whose average annual gross receipts for the 3 taxable year periods ending with the prior year does not exceed $10,000,000.

Section 447 provides that the taxable income from farming of a corporation engaged in the trade or business of farming or a partnership engaged in the trade of business of farming who has a corporation as a partner shall be computed on the accrual method of accounting, except for this purpose a corporation will not be treated as a corporation if it is a S corporation or a corporation the gross receipts which meet certain requirements set forth in section 447(c).

Section 448 provides that the cash method of accounting cannot be used to compute taxable income by a C corporation, a partnership which has a C corporation as a partner or a tax shelter, with exceptions for a farming business, a qualified personal service corporation, and entities with gross receipts of not more than $5,000,000.

Section 460 provides that the taxable income from long term contracts is to be determined under the percentage of completion method with the exception for home construction contracts or any other construction contract expected to be completed within a 2 year period beginning on the contract commencement date of the contract and the average annual gross receipt of the taxpayer for 3 taxable years proceeding such year do not exceed $10,000,000.

Section 471 and the Treasury Regulations thereunder generally provide that the accrual method of accounting must be used for inventories if the production, purchase or sale of merchandise is an income-producing factor to the taxpayer, with an exception for taxpayers whose average annual gross receipts do not exceed $1,000,000 and taxpayers in certain industries whose annual gross receipts do not exceed $10,000,000.

2. **New Law:** Section 263A is amended by providing an exemption from the capitalization rules for any taxpayer (other than a tax shelter) which meets the gross receipt test under section 448(c) for any taxable year (i.e., $25,000,000 for the 3-taxable year periods ending with the taxable year that precedes the taxable year in question). For this purpose, a sole proprietorship is treated as though the trade or business of the sole proprietorship were a corporation or partnership. In addition, the change in method of accounting pursuant to this amendment is treated for section 481 as initiated by the taxpayer and made with the consent of the Secretary. In addition, the exception for personal property acquired for resale by a taxpayer with gross receipt of $10,000,000 or less is deleted.

Section 447 is amended to provide that a corporation meeting the \$25,000,000 gross receipt test of section 448(c) will not be treated as a corporation for purposes of section 447 and, thus, will not be required to use the accrual method of accounting. The change in method of accounting pursuant to this amendment will be treated for purposes of section 481 as initiated by the taxpayer and made with the consent of the Secretary.

Section 448(c) is amended to allow the use of the cash method of accounting for any taxable year in which the average annual gross receipts of the entity for the 3-taxable-year period ending with the preceding year does not exceed \$25,000,000. In addition, the \$25,000,000 is adjusted for inflation beginning after 2018. A change in the method of accounting pursuant to this amendment is treated for purposes of section 481 as initiated by the taxpayer and made with the consent of the Secretary.

Section 460 is amended to exclude from the requirement to use the percentage of completion method of accounting any taxpayer (other than a tax shelter) who meets the gross receipts test of section 448(c) (\$25,000,000) for the taxable year in which the contract is entered into. For this purpose, a trade or business operated by a sole proprietorship is to be treated in the same manner as if the trade or business were conducted by a corporation or a partnership. Any change in method of accounting made pursuant to this amendment will be treated for purposes of section 481 as initiated by the taxpayer and made with the consent of the Secretary if such change will be effected on a cut-off-basis for all similarly classified contracts entered into on or after the year of change.

Section 471 is amended to provide that any taxpayer (other than a tax shelter) that meets the gross receipts test of section 448(c) (\$25,000,000) for any taxable year is not required to use the accrual method of accounting for inventory but may use a method of accounting that either treats inventory as non-incidental materials and supplies or conforms to the taxpayer's method of accounting reflected in its financial statement or, if it does not have the required type of financial statements, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures. This amendment includes sole proprietorships meeting the gross receipts test of section 448(c) by treating the trade or business of the sole proprietorship in the same manner as if that trade or business were conducted by a corporation or a partnership. Furthermore, any change in method of accounting pursuant to this amendment will be treated for purposes of section 481 as initiated by the taxpayer and made with the consent of the Secretary.

3. **Effective Date:** These amendments generally are effective for taxable years beginning after December 31, 2017, and the amendments made to section 460 apply to contracts entered into after December 31, 2017.

XII. Business Deductions and Exclusions.

A. Interest Expense Deduction for Businesses; Floor Plan Financing.

1. **Prior Law:** Taxpayers may deduct interest paid or accrued on indebtedness allocable to a trade or business, subject to certain limitations. Section

163(j) provides one such limitation. Section 163(j) currently limits the deduction of business interest paid or accrued by corporate taxpayers where certain earnings stripping rules are triggered.

Section 163(j) currently disallows "disqualified interest" paid or accrued by a corporation during a taxable year if (1) the corporation's debt-to-equity ratio exceeds 1.5 to 1.0 (the safe harbor ratio), and (2) the payor's net interest expense exceeds 50% of its adjusted taxable income. Adjusted taxable income is generally taxable income computed without regard to net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, or depletion.

"Disqualified interest" includes interest paid or accrued to (i) related parties when no federal income taxes imposed with respect to such interest, (ii) unrelated parties where a related party guarantees the debt, or (iii) to a real estate investment trust by a taxable real estate investment trust subsidiary of that trust.

These requirements under section 163(j) seek to disallow deductions for interest payments by highly leveraged, multinational corporations that would otherwise "strip" their U.S. earnings from the U.S. tax base and transfer the taxable earnings via interest payments to a lower-tax jurisdiction.

While section 163(j) limits business interest deductions, any amounts disallowed under section 163(j) may be carried forward indefinitely. Conversely, any excess limitation (the excess, if any, of 50% of adjusted taxable income over net interest expense) that do not limit business interest deductions in a given tax year can be carried forward three years.

2. **New Law:** The new law repeals the section 163(j) earning stripping limitation that currently applies only to corporations, and replaces it with a limitation on the deduction of business interests that applies to all taxpayers. Thus, the application of the revised 163(j) expands well beyond earnings stripping by large corporations. It applies to any trade or business interest expense paid or accrued by all taxpayers. If the limitation applies, it generally limits the same amount of business interest expense deductions for corporations and partnerships alike. However, its mechanical application differs substantially as applied to partnerships and partners. While the revised limitation under 163(j) applies to all taxpayers, it provides some exceptions for small businesses and certain business types.

a) **Limitation on Deduction for Business Interest**

The new law limits the amount a taxpayer may deduct for business interest paid or accrued during any taxable year. The deduction allowed for business interest cannot exceed the sum of (1) business interest income; (2) 30% of the taxpayer's adjusted taxable income for the taxable year; *plus* (3) the floor plan financing interest of the taxpayer for the taxable year.[5]

For purposes of the limitation, "business interest" is any interest paid or accrued on indebtedness allocable to a trade or business.[6] "Business interest income" is interest includable in the gross income of the taxpayer for the taxable year properly allocable to a trade or business.[7] Business interest and business interest income do not, however, include "investment interest" or "investment interest income" as defined under section 163(d).[8]

"Adjusted taxable income" is a taxpayer's taxable income computed without regard to any income that is not allocable to a trade or business, business interest or business interest income, net operating losses, deductions allowable under section 199A, or any deductions allowable for depreciation, amortization, or depletion.[9] For purposes of the limitation, adjusted taxable income shall not be less than zero.[10]

"Floor plan financing interest" is interest paid or accrued on indebtedness used to finance the acquisition of motor vehicles held as for sale or lease to retail customers, which is secured by the motor vehicles acquired as inventory.[11]

A carryforward is allowed for business interest not deductible due to the limitation. Under section 163(j)(2), business interest amounts subject to the limitation are treated as business interest paid or accrued in the following tax year. Taxpayers may carryforward disallowed business interest amounts indefinitely.[12] However, certain restrictions apply to the carryforward of disallowed interest with respect to partnerships.

In short, a taxpayer's deduction for *net* business interest is limited to 30% of their adjusted taxable income, with an indefinite carryover for disallowed amounts. Any floor plan financing interest is fully deductible under the rule.

b) **Application to Pass-through Entities**

Section 163(j)(4) provides special rules for the business interest limitation's application to partnerships (and S corporations in some instances). With regard to partnerships, the special rules provide how the

[5] IRC section 163(j)(1).
[6] IRC section 163(j)(5).
[7] IRC section 163(j)(6).
[8] IRC section 163(j)(5),(6).
[9] IRC section 163(j)(8).
[10] IRC section 163(j)(1).
[11] IRC section 163(j)(9).
[12] IRC section 163(j)(2).

limitation applies to the partnership and partners, the treatment of a carryforward of disallowed amounts, and basis adjustments arising from excess business interest allocations.

> **Limitation on Partnership Business Interest**. As applied to partnerships, section 163(j)'s business interest limitation is determined at the partnership level.[13] Business interest deductions are accounted for when determining a partnership's non-separately stated taxable income or loss. This amount is the "ordinary business income or loss" on Form 1065.[14] Each partner's adjusted taxable income is determined without regard to the partner's distributive share of any items of income, gain, deduction, or loss of the partnership; and then increased by the partner's distributive share of the partnership's excess taxable income.[15] A partnership's "excess taxable income" is the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30% of the adjusted taxable income of the partnership, over the amount (if any) by which the business interest of the partnership (reduced by floorplan financing interest) exceeds the business interest income of the partnership, bears to 30% of the adjusted taxable income of the partnership.[16]
>
> Where business interest exceeds a partner's adjusted taxable income limit, the partnership provisions prevent partners from double counting the same dollar of adjusted taxable (flow-thru) income to generate excessive interest deductions. Conversely, where business interest does not exceed a partner's applicable business interest limitation, the rules allow a partner to deduct additional interest expense to the extent the partnership could have deducted more business interest. These rules also apply to S Corporations and their shareholders.[17]
>
> **Carryforward of Disallowed Partnership Interest**. Special rules also apply to the carryover of disallowed business interest not allowed as a deduction to partnership. Business interest disallowed as a deduction to the partnership for the taxable year is not treated as business interest paid or accrued by the partnership in the following year, but instead is allocated to each partner in the same

[13] IRC section 163(j)(4)(A)(i).
[14] Committee Report, n.446.
[15] IRC section 163(j)(4)(A)(ii).
[16] IRC section 163(j)(4)(C).
[17] IRC section 163(j)(4)(D).

manner as non-separately stated taxable income or loss of the partnership.[18]

Excess business interest allocated to a partner from a partnership is treated as business interest paid or accrued by the partner in the next succeeding tax year in which the partner is allocated excess taxable income from the partnership, but only to the extent of such excess taxable income.[19] Thus, a partner may deduct its share of partnership excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership whose activities gave rise to the excess business interest carryforward. Any part of the excess business interest remaining after the carryover is treated as business interest paid or accrued in later years, subject to the same limitation.[20] This carryforward rule only applies to partnerships. It does not apply to S Corporations or their shareholders.[21]

Basis Adjustments. Under the carryforward rules applicable to partnerships, when excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of such allocation. This basis reduction applies even though the carryforward does not give rise to a deduction by the partner in the year of the partner's basis reduction. However, a partner's deduction in a future year for an interest carryforward does not reduce the partner's basis in the partnership interest.

If a partner disposes of a partnership interest, the basis of which is reduced under these basis adjustment rules, the partner's basis in the partnership interest is increased, immediately prior to the disposition, by any excess of the amount of the basis reduction over the party of any excess business interest allocated to the partner previously treated as business interest paid or accrued by the partners.[22]

The basis adjustment applies to transfers of partnership interest (including by reason of death) in a transaction in which gain is not recognized in whole or in part.[23] No

[18] IRC section 163(j)(4)(B)(i).
[19] IRC section 163(j)(4)(B)(ii).
[20] IRC section 163(j)(4)(B)(ii).
[21] *See* IRC section 163(j)(4)(D).
[22] IRC section 163(j)(4)(B)(iii).
[23] IRC section 163(j)(4)(B)(iii).

deduction is allowed to the transferor or transferee for any excess business interest resulting in a basis increase.[24]

c) **Exception for Certain Businesses**

Section 163(j) provides an exemption for certain small businesses. Small businesses that meet the $25 million gross receipts test under section 448(c) are excluded from the business interest expense limitation.[25] Where a taxpayer is not a corporation or partnership, the gross receipts test under section 448(c) is applied as if the taxpayer were a corporation or partnership.

Section 163(j)(7) also excludes a select few categories of trade or business from the business interest limitation. Businesses excluded from the limitation include any trade or business performing services as an employee, any electing real property trade or businesses under section 469(c)(7)(C), any electing farming business, or certain regulated public utilities.[26]

d) **Interest Carryovers in Corporate Acquisitions**

Section 381 provides a list of carryover items in corporate acquisitions. To coordinate with revisions to 163(j), sections 381 and 382 have also been amended. As amended, section 381 lists disallowed business interest among the items carried over to tax years ending after the date of distribution or transfer of corporate assets.[27] But carryovers of disallowed business interest are treated as items of pre-change loss subject to the section 382 limitation.[28] Section 382 also defines a "loss corporation" to include a corporation with a carryover of disallowed interest.[29]

3. **Comment:** The limitation on business interest expense deductions may significantly impact the business operations of some highly-leveraged taxpayers. The limitation applies uniformly to all businesses, regardless of business type or circumstances. "Trade or businesses" may differ substantially, however, with regard to borrowing. Some businesses require greater levels of leverage while others, such as financial service businesses, may generate substantial business interest income from

[24] IRC section 163(j)(4)(B)(iii).
[25] IRC section 163(j)(3). The small business exception does not apply to tax shelters prohibited from using the cash method of accounting under section 448(a)(3).
[26] IRC section 163(j)(7).
[27] IRC section 381(c)(20).
[28] IRC section 382(d)(3).
[29] IRC section 382(k)(1).

investments. 163(j) does not adjust the limitation benchmarks based on business practices. Accordingly, taxpayers with indebtedness allocable to their trade or business should determine how the section 163(j) business interest limitations apply to their business. The new limitations may substantially alter the after-tax benefits of debt financing for some taxpayers. It is also unclear exactly how the new section 163(j) limitations will apply with respect to other interest deferral and provisions.

B. **Limitation on Losses for Taxpayers other than Corporations.**

1. **Prior Law**: Passive loss rules.

The passive loss rules limit deductions and credits from passive trade or business activities. The passive loss rules apply to individuals, estates and trusts, and closely held corporations. A passive activity for this purpose is a trade or business activity in which the taxpayer owns an interest, but in which the taxpayer does not materially participate. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer makes a taxable disposition of his entire interest in the passive activity to an unrelated person. Also, excess farm losses of taxpayers other than corporations in excess of a threshold amount are limited if the taxpayer received an applicable safety of the taxable year.

2. **New Law**:

For taxable years beginning after December 31, 2017 and before January 1, 2026, excess business losses of a taxpayer other than a corporation are not allowed for the taxable year under new section 461(l). Such losses are carried forward and treated as part of the taxpayer's net operating loss ("NOL") carryforward in the following taxable year.

An excess business loss for the taxable year is the excess of the aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. The threshold amount for a taxable year is $250,000 (or twice the otherwise applicable threshold amount in the case of a joint return). The threshold amount is indexed for inflation.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner's distributive share and each S corporation shareholder's pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation are taken into account in applying the limitation under the provision for the taxable year of the partner of S corporation shareholder. Regulatory authority is provided to apply the provision to any other passthrough entity to the extent necessary to carry out the provision. Regulatory authority is also provided to require any additional reporting as the Secretary determines is appropriate to carry out the purposes of the provision.

For taxable years beginning after December 31, 2017, and before January 1, 2026, the present-law limitation relating to excess farm losses does not apply.

3. **Comment:** The new section 461(l) limitation on Excess Business Losses adds a further temporary limitation until 2026 on the deductibility of trade or business losses in excess of the threshold amount by taxpayers other than corporations. This limitation is imposed after application of the passive loss rules. At least more generous threshold amounts are provided for these purposes than those applicable to section 199A. The threshold amounts for the excess business loss limitation are $500,000 for married taxpayers filing jointly or $250,000 for other taxpayers. It appears that this limitation applies to the aggregate of the taxpayer's losses from all trades or businesses in excess of the applicable threshold amount. Whereas the passive loss rules apply to passive activities, this limitation is applicable to losses from a trade or business, but is applied after application of the passive loss rules.

Losses disallowed by this limitation are treated as NOLs which can be carried forward indefinitely under the new NOL rules.

While this loss limitation provision states that it applies to taxpayers other than corporations, section 461(l)(a)(4)(B) specifically provides that losses of an S corporation are taken into account by the shareholders based on their pro rata share of the item.

C. **Modification to Net Operating Loss (NOL) Deductions.**

1. **Prior Law:** Generally, NOLs may be carried back two years and carried forward 20 years to offset income in those years. Special carryback provisions apply for certain casualty losses and disaster losses.

2. **New Law:** The Act limits the NOL deduction to a carryback year or carryforward year to 80% of the taxable income of that year determined without regard to the NOL deduction. In addition, NOLs may be carried forward indefinitely. NOLs arising after tax years beginning after December 31, 2017 are indexed for inflation. The Act repeals the two-year carryback provisions except for certain losses incurred in the trade or business of farming and provides a one-year carryback for certain small businesses.

3. **Effective Date:** Tax years beginning after December 31, 2017.

D. **Repeal of Deduction for Domestic Production Activities.**

1. **Prior Law:** Section 199 provides for a deduction equal to 9% of the lesser of qualified production activities income or taxable income. This was designed to reward domestic production of products and incentivize foreign investment in U.S. production.

2. **New Law:** The new law repeals section 199 for tax years beginning after December 31, 2018.

3. **Comment:** It would appear that section 199 was repealed as a result of the overall reduction in the corporate tax rate which accomplished a similar result.

E. **Limitation on Deduction of Meals and Entertainment Expenses.**

1. **Prior Law:** Under the current law, section 274(a) allows taxpayers to take a deduction for certain meal and entertainment expenses that are directly related to, or directly preceding or following a discussion of, the taxpayer's trade or business.

2. **New Law:** The Act changes section 274, concerning the disallowance of deductions for certain entertainment expenses, by limiting the circumstances in which a deduction may be taken. Under the new law, the carve-out language allowing deductions related to the taxpayer's trade or business has been stricken, preventing taxpayers from taking any deductions for entertainment, amusement, or recreation expenses, regardless of the circumstances under which the expenses arise. The Act also strikes several related provisions, including provisions related to the substantiation of deductions, which are no longer necessary with respect to entertainment expenses.

The Act did not eliminate the 50% deduction for food and beverage expenses incurred with respect to a trade or business. The Act expands the 50% limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minims fringes and for the convenience of the employer. Expenses associated with providing food & beverage to employees for the convenience of the employer paid or incurred after December 31, 2025 are not deductible.

Finally, the Act eliminates an employer's deduction for the expense of any qualified transportation fringe. This includes any employer-provided costs for public transportation to and from work, transit passes, and qualified parking. Additionally, the Act disallows deductions for any payments or reimbursements provided by employers for transportation, except as necessary for "ensuring the safety of the employee", a phrase which is not further explained or defined by the Act.

3. **Comment:** While it is unclear how impactful these changes will be on business activities, it is likely that small businesses will be affected the most, as larger businesses are more easily able to accept the cost of meal, entertainment, and travel expenses. It is also unclear to what extent these costs will be passed on to employees, who in certain circumstances may no longer receive the benefits associated with employer-provided services that are contingent on the employer's ability to deduct its expenses.

F. **Repeal of Deduction for Local Lobbying Expenses – Section 162.**

1. **Prior Law:** Generally, business taxpayers are allowed a deduction under section 162 for ordinary and necessary expenses that are incurred in carrying on such

taxpayer's trade or business; however, there is an exception, i.e., a disallowance, for certain lobbying and political expenditures with respect to legislation and candidates for office. Presently, there is an exception (or an exception to the exception) for lobbying at the local level of governmental activities and affairs, so local lobbying expenditures have been deductible as ordinary and necessary expenses.

2. **New Law:** The Act followed the Senate's bill and repealed the deduction for local lobbying expenses, including lobbying to Native American Indian tribal governments, which conforms such provision with the disallowance of lobbying expenses at other levels of government.

3. **Comment:** Other expenses associated with local governmental affairs, such as monitoring legislation, influencing rules and regulations, building relationships and bolstering reputations at the local level will continue to be deductible as ordinary and necessary business expenses.

G. Deduction of FDIC Premiums – Section 162.

1. **Prior Law:** Generally, insured depository institutions, known by most consumers simply as "banks", are allowed to deduct premiums assessed by the Federal Deposit Insurance Corporation ("FDIC") pursuant to section 162 as ordinary and necessary business expenses as a means to support the Deposit Insurance Fund ("DIF").

2. **New Law:** The Act would amend section 162 to limit the available deduction for FDIC premiums to depository institutions whose total consolidated assets exceed $10 billion and are less than $50 billion at the close of the relevant tax year. The determination of non-deductible premiums would be the premium assessed multiplied by a percentage, which is equivalent to the quotient of the entity's total consolidated assets in excess of $10 billion divided by $40 billion. Banks with total consolidated assets in excess of $50 billion will not be allowed a deduction for FDIC premiums.

3. **Comment:** This provision has been touted as a correction for the FDICs calculation of assessments that are determined on a pre-tax basis; therefore, the deductions for the premium payments are not taken into account in making such calculation. In reality, the deductions reduce the U.S. Treasury's General Fund; therefore, the end-result is a transfer from the General Fund to the DIF. It is thought that the large depository institutions whose total consolidated assets exceed $50 billion will simply pass the cost of their inability to deduct the premiums onto their customers and other users of their services.

H. Deduction of Settlements Subject to a Nondisclosure Agreement.

1. **Prior Law:** Prior to the Act, corporations were able to deduct as an expense amounts paid to settle sexual harassment and abuse claims under section 162.

2. **New Law:** Under newly revised section 162(q) the Act prohibits deductions for any settlement, payment or attorney's fees related to sexual harassment or abuse if the settlement is subject to a nondisclosure agreement.

3. **Comment:** The original intent of section 162(q) was seemingly to penalize secrecy (i.e. NDAs) in the context of sexual harassment settlements by prohibiting corporations from deducting these payments as business expenses. However, some scholars have argued that the new legislation may have unintended consequences on victims of sexual harassment as well. Specifically, section 162(q) as written appears to disallow a deduction to the victim who signs a NDA for the portion of settlement proceeds that are used to pay legal fees. In addition, if corporations are unable to deduct payments when using an NDA, the corporation may be less inclined to settle if it believes the settlement will be viewed as public admission of the allegations.

I. **Deduction of Penalties and Fines.**

1. **Prior Law:** No deduction for a fine or penalty paid to a government for the violation of any law was allowed under section 162(f).

2. **New Law:** Congress has expanded the reach of section 162(f) to deny a deduction for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government, governmental entity, or certain self-regulatory nongovernmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law.

The new law provides an exception to otherwise nondeductible payments for amounts paid (1) for restitution (including remediation of property) for damage or harm caused by violation of any law or (2) to come into compliance with any law, provided such restitution or compliance payment is identified as such in a settlement agreement or a court order in a suit to which a government or governmental entity is a party. The new law applies to amounts paid or incurred on or after the date of enactment of the new Act, and such amounts must be made pursuant to a binding court order or settlement agreement entered into after such enactment.

The Act also adds a new reporting requirement for amounts paid pursuant to a court order or settlement. Under newly added section 6050X. A governmental entity must submit a form to the IRS and any party to the suit or agreement setting forth (1) the amount that is a nondeductible penalty and (2) the amount that is deductible restitution, remediation of property, or related to compliance with any law. The governmental entity must file this form at the time the agreement is entered into. As with the amendments to section 162(f), the reporting requirements of section 6050X apply only to amounts paid or incurred on or after the date of enactment of the new Act pursuant to a binding court order or settlement agreement entered into after such enactment.

3. **Comment:** The new law expands the definition of payment of nondeductible fines and penalties to include amounts paid not only to a government, but now also to a governmental entity and certain nongovernmental entities. Furthermore, while the old law denied deductibility for amounts paid to a government, the new law also denies deductibility for amounts paid "to, *or at the direction of*, a government or governmental entity."

The new law adds much needed Congressional clarity to a previously murky area of the tax law. First, it explicitly carves out three exceptions to nondeductibility for amounts paid for restitution, remediation, and compliance. Next, the new law requires the government or nongovernmental entity involved in a suit or settlement agreement to file a form with the IRS that specifically states the amount paid as a (nondeductible) fine and the amount related to (deductible) restitution, remediation, or compliance. Previously, disputes arose between taxpayers and the IRS over what portion of a payment was deductible in the absence of a tax characterization agreement entered into between the parties. For more on this issue, see Christopher Weeg, *Deducting False Claims Act Settlements: The Silver Lining to the Whistle-Blower Cloud*, BNA Daily Tax Report (April 4, 2016).

J. **Elimination of Deduction for Living Expenses for Members of Congress.**

1. **New Law:** The Act provides that beginning in 2018, members of Congress may no longer deduct up to $3,000 of expenses for living away from their home state.

K. **Like-Kind Exchanges of Real Property.**

1. **Prior Law:** Under current law, taxpayers may defer tax on the sale of property (with enumerated exceptions for property including stock, securities, and partnership interests) as long as the taxpayer purchases "like-kind" property within 180 days of the original sale.

2. **New Law:** The Act changes section 1031, concerning like-kind exchanges, to a provision that applies only to real property. Under the new law, taxpayers are no longer eligible for this deferral unless the exchange concerns real property. Accordingly, the new section 1031 is far simpler and shorter, with the Act striking several subsections related to like-kind exchanges of various types of personal property. One important change is the insertion of a new subsection relating to partnerships. Under the new section 1031(e), any partner holding an interest in a partnership which has made a valid section 761 election (to exclude the partnership from taxation under Subchapter K) will be treated as holding an interest in the partnership assets, rather than the partnership. Because the interest in a partnership is treated as personal property, this new provision will allow partners of certain partnerships to utilize the benefits of the new section 1031 to a certain extent, despite its limitation to real property.

It is also important to note that the Act includes a "transition rule" that permits the like-kind exchange of personal property under the current rules, so long as the sale or receipt of property to be exchanged under section 1031 occurs on or before December 31, 2017. Therefore, many businesses may be incentivized to make related purchases or sales prior to the end of the year in the interest of receiving deferral treatment prior to the imposition of the new section 1031.

L. **<u>Repeal of Rollover Gain From Certain Publicly Traded Securities</u>.**

1. **<u>New Law</u>:** For tax years beginning after December 31, 2017, taxpayer may no longer defer capital gain treatment on sale of publicly traded securities by "rolling over" the proceeds into a "specialized small business investment corporation" (SSBIC).

M. **<u>Gain or Loss from Patents and Other Self-Created Properties</u>.**

1. **<u>Prior Law</u>:** Section 1235 provides that the gain or loss from the sale or exchange of a patent is capital gain or loss.

2. **<u>New Law</u>:** The Act repeals Section 1235 and thus the holder of a patent may not receive capital gain or loss treatment on its sale.

3. **<u>Effective Date</u>:** Dispositions after December 31, 2017.

N. **<u>Accounting for Income</u>.**

1. **<u>New Law</u>:** The Act requires an accrual method taxpayer to recognize income no later than the taxable year in which such income is taken into account as revenue in an applicable financial statement. Such income is subject to the all events test. The Act also directs accrual method taxpayers with applicable financial statements to apply the income recognition rules under Section 451 before applying the special rules under Part V of subchapter P. The Act also codifies Rev. Proc. 2004-34 by allowing an accrual method taxpayer to elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes.

2. **<u>Effective Date</u>:** Generally applicable to tax years beginning after December 31, 2017.

O. **<u>Small Business Accounting.</u>**

1. **<u>New Law</u>:** Several miscellaneous changes modify accounting method rules for small businesses. The threshold for the annual average gross receipts limit would be increased from $5 million to $25 million. Accordingly, a C corporation or a partnership with a C corporation may use the cash method of accounting if for each prior tax year the average annual gross receipts do not exceed $25 million.

In addition, the threshold amounts for qualifying businesses that are required to use an inventory method and in turn are required to use the accrual method are increased thereby allowing more businesses to qualify for cash method. The new threshold is $25 million. The Act provides that certain producers of inventory are exempt from the uniform capitalization rules if annual gross receipts are $25 million or less. This was increased from $10 million.

2. **Effective Date:** These provisions are effective for tax years beginning after December 31, 2017.

XIII. Business Tax Credits.

A. Orphan Drug Credit (IRC section 45C, section 280C).

1. **Prior Law:** Section 45C provides a 50-percent tax credit for qualified clinical testing expenses incurred in testing certain drugs for rare diseases or conditions. The drugs are referred to as "orphan drugs." Qualified clinical testing expenses are costs incurred after the FDA has approved the drug for human testing, but before the FDA has approved the drug for sale. A rare disease or condition is a disease or condition that (i) affects less than 200,000 persons in the U.S., or (ii) affects more than 200,000 persons in the United States but for which there is no reasonable expectation that the cost of developing and making available in the United States a drug for such disease or condition will be recovered from sales in the United States of such drug.

2. **New Law:** The new law reduces the section 45C orphan drug credit to 25-percent of qualified clinical testing expenses for the tax year.[30] Additionally, section 280C allows for an election of reduced credit for orphan drug testing expenses.[31]

3. **Effective Date:** Effective as to amounts paid or incurred in taxable years beginning after December 31, 2017

B. Rehabilitation Credit.

1. **Prior Law:** The rehabilitation credit is an incentive to encourage real estate developers to renovate, restore and reconstruct old buildings. Under current law, rehabilitation expenses for buildings placed in service before 1936 are eligible for a 10% credit, and certified historic structures are eligible for a 20% credit.

2. **New Law:** Beginning in 2018, a credit will be allowed only for expenses incurred in connection with the rehabilitation of certified historic structures. Additionally, the taxpayer will not be able to utilize the credit all in one year. Rather, the credit must be claimed ratably over a five-year period beginning in the tax year in which the rehabilitated structure is placed in service.

3. **Comment:** The JCT estimates that the revised provision would increase revenue by approximately $3.1 billion over 10 years.

C. Employer Credit for Paid Family and Medical Leave.

1. **Prior Law:** There is no current employer credit for paid family and medical leave.

[30] IRC section 45C(a).
[31] IRC section 280C(b).

2. **New Law:** Under new section 45S, certain employers would be allowed a credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave ("FMLA") so long as the rate of payment under the employer's FMLA program is at least 50% of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.

3. **Comment:** This credit applies only to wages paid after December 31, 2017 and before December 31, 2019.

XIV. Insurance Companies.

A. Change to Net Operating Loss Deduction.

1. **Prior Law:** Generally, a net operating loss (NOL) may be carried back two years and carried forward 20 years to offset taxable income in such years. There are exceptions to this general rule depending on the circumstances that created the NOL. For example, there are extended carryback periods for NOLs attributable to certain casualty and disaster losses and limitations placed on the carryback of certain corporate equity reduction transactions.

2. **New Law:** Current law is preserved for NOLs of property and casualty insurance companies. In all other circumstances, the new law (i) limits the NOL deduction to 80% of taxable income, determined without regard to the deduction; (ii) repeals the two year carryback with the exception of certain disaster losses incurred in the trade or business of farming or by certain small businesses; (iii) extends the carryforward indefinitely; and (iv) repeals the special carryback provisions.

A small business is defined as one whose average annual gross receipts for a three-year taxable period ending with such taxable year does not exceed $5,000,000.

The new law applies to taxable years beginning after December 31, 2017.

3. **Comment:** Current NOL carryforwards (i.e., those arising in tax years beginning before January 1, 2018) are not subject to the 80% limitation and remain subject to the 20 year carryforward period.

B. Repeal of Small Life Insurance Deduction.

1. **Prior Law:** A small life insurance company (less than $500 million of assets) may deduct 60% of its life insurance company taxable income up to $3 million. A company with $15 million of life insurance taxable income is not a small life insurance company. The maximum deduction under this section is $1.8 million.

2. **New Law:** The Act repeals the small life insurance company deduction.

3. **Effective Date:** Taxable years beginning after December 31, 2017.

C. **Change in Accounting Method.**

1. **Prior Law:** Life insurance companies may currently use a 10-year spread for adjustments to income or loss resulting from a change in accounting method under section 807(f). A non-life insurance company must generally include income from a change in accounting method ratably over four taxable years under section 481(a).

2. **New Law:** The special rule under section 807(f) is changed to cause income from a change in accounting method for a life insurance company to be included in income ratably over four years instead of 10 years.

3. **Effective Date:** Taxable years beginning after December 31, 2017.

D. **Taxation of Pre-1984 Policyholder Surplus Account.**

1. **Prior Law:** Section 815 allowed continued deferral of certain policyholder surplus accounts resulting from tax laws allowing deferral between 1959 through 1983. The Deficit Reduction Act of 1984 eliminated further deferral, but provided that accumulated surplus accounts would not be taxed unless the amounts were treated as distributed to shareholders or subtracted from the policyholder's surplus account.

2. **New Law:** For stock life insurance companies with existing policyholder surplus accounts, a tax will be imposed as of December 31, 2017. The income will be reported ratably over eight (8) years.

3. **Effective Date:** Taxable years beginning after December 31, 2017.

E. **Coordination Proration Rules for Property and Casualty Insurance Companies with New Corporate Tax Rate.**

1. **Prior Law:** A property and casualty insurance company must prorate its deduction for reserves for losses incurred by reducing the amount of losses by 15% of tax exempt income, the deductible portion of dividends received, and the increase in cash value of life insurance, endowment, or annuity contracts for the taxable year.

2. **New Law:** Due to the reduction in the corporate rate to 21%, the proration percentage will be automatically adjusted so that the product of the proration percentage and the top corporate tax rate will equal 5.25%.

3. **Effective Date:** Taxable years beginning after December 31, 2017.

F. **Discounting Rules for Property and Casualty Insurance Companies.**

1. **Prior Law:** A property and casualty insurance company must discount unpaid losses in determining its deduction for such losses. The discount is calculated using AFR, and incorporates a loss payment pattern determined by the Treasury

Department. An election is available whereby a company can use its own historical loss pattern.

2. **New Law:** The Act changes the interest rate that must be used from an AFR based calculation to a corporate bond yield curve calculation, modifies the way loss payment pattern is calculated and repeals the election whereby a company can use its own historical loss pattern.

3. **Effective Date:** Generally applicable for taxable years beginning after December 31, 2017 with transitional rules.

G. **Repeal of Certain Estimated Tax Payments.**

1. **Prior Law:** Section 847 provides special rules for insurance companies' deductions related to the discount of its reserves. The deduction requires establishment of a special loss discount account and requires special estimated tax payments on the accounts.

2. **New Law:** The Act repeals section 847 and the special deduction, the special account, and the special estimated tax payments. The balance of existing accounts will be included in income for a company's first taxable year beginning after 2017.

3. **Effective Date:** Taxable years beginning after December 31, 2017.

H. **Computation of Life Insurance Tax Reserves.**

1. **Prior Law:** The taxable income of life insurance companies is determined by income and deductions based on net increase or net decrease in reserves.

2. **New Law:** The Act prescribes changes to the manner of calculating the reserves of life insurance companies based on the type of contract and provides new limitations on the maximum reserve under the calculation.

3. **Effective Date:** Generally applicable for taxable years beginning after December 31, 2017 with transitional rules.

I. **Modification of Determining Dividends Received Deductions for Life Insurance Companies.**

1. **Prior Law:** Section 805(a)(4) provides a life insurance company proration for reducing (i) dividends received deductions (from affiliates) and (ii) calculating reserve deductions related to its tax exempt income.

2. **New Law:** In calculating the proration rule for a life insurance company, the life insurance company's share is reduced to 70% (from 90%) and the policyholder's share is 30%.

3. **Effective Date:** Taxable years beginning after December 31, 2017.

J. **Capitalization of Certain Pricing Acquisition Expenses.**

1. **Prior Law:** Certain specified policy acquisition expenses of an insurance company are required to be capitalized. They may be amortized over a 120-month period specified in section 848. The specified acquisition expenses are generally 1.75% for annuity contracts, 2.05% for group life insurance contracts, and 7.7% for all other specified insurance contracts.

2. **New Law:** The Act extends the amortization period to a 180-month period determined in section 848 and increases the specified acquisition expenses required to be capitalized to 2.09% for annuity contracts, 2.45% for group life insurance contracts, and 9.20% for all other specified insurance contracts.

3. **Effective Date:** Taxable years beginning after December 31, 2017.

K. **Reporting Requirements for Existing Life Insurance Contracts and Transfers in Value.**

1. **Prior Law:** There are currently no reporting requirements for a person who acquires a life insurance contract if such person has no substantial family, business, or financial relationship with the insured.

There are currently no special reporting requirements for an issuer of a life insurance contract with respect to a transfer of a life insurance contract or with respect to the payment of death benefits.

Revenue Ruling 2009-13 provides that income recognized on surrender to a life insurance company of a life insurance contract with cash value is ordinary income. On the sale of a life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance, and the gain on the sale is ordinary income to the extent of inside buildup. The excess gain would be capital gain.

2. **New Law:** The Act imposes several return and notice requirements related to a "reportable policy sale." A reportable policy sale is the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business or financial relationship with the insured.

Acquirer's Requirements: An acquirer of a contract in a reportable policy sale must now file a return with the IRS setting forth the name; address and TIN of the acquirer; the name, address and TIN of each recipient of a payment from the acquirer; the date of the sale; the name of the policy issuer; and the amount of each payment.

In addition, the acquirer shall send notice to the seller and the issuer with the acquirer's information.

Issuer's Requirements. Upon receipt of the acquirer's notice above, the issuer of a policy shall file a return with the IRS setting forth the name, address, and TIN of the seller of the contract, and the investment in the contract as defined in section 72(e)(6), and the policy number of the contract.

The issuer shall also send a notice to the seller setting forth the issuer's information and all of the information required to be stated in the return. In the year that death benefits are paid from a policy subject to a reported policy sale, the issuer shall file a return with the IRS and send a notice to both the recipient and the buyer of the policy similar to the returns and notice associated with a sale, but included payment information.

Tax Basis in Life Insurance Contracts. The Act clarifies that in determining the basis of a life insurance or annuity contract no adjustment is to be made for mortality expense or other reasonable charges incurred under the contract.

Exception to Transfer for Value. Section 101 is amended to add a paragraph that a reported policy sale is not an exception to the transfer for value rules.

3. **Effective Date:** The reporting requirements are effective for sales of policies after December 31, 2017 and death benefits paid after December 31, 2017. The change to the basis rules is applicable to transactions entered into after August 25, 2009. The change to the transfer for value rules is effective for transfers after December 31, 2017.

XV. Compensation.

A. Deduction for Excessive Employee Compensation – Section 162(m).

1. **Prior Law:** A publicly-held corporation may not deduct compensation of a "covered employee" in excess of one million U.S. dollars in any one tax year, excluding any remuneration for commissions payable on the basis of such individual's generation of income and such other remuneration payable on account of one or more performance goals as determined by a compensation committee comprised of two or more outside directors. The term "publicly-held corporation" means any corporation issuing any class of common equity required to be registered under section 12 of the Securities Exchange Act of 1934. The term "covered employee" means a chief executive officer and the next four highest compensated officers, i.e., excluding the chief executive officer.

2. **New Law:** The Act would repeal the exception for commissions and performance based compensation under sections 162(m)(4)(B) and (C); and clarifies the definitions of (i) "covered employee" as including the principal executive officer, the principal financial officer and the three other highest paid employees; and (ii) "publicly-held corporation" to include foreign companies publicly traded through American Depository Receipts, or ADRs, and the suggestion that some large privately held C or S corporations may also be included. There is also the addition of a "covered employee" becoming tainted by its treatment as such; therefore, once a covered employee, always a covered employee, including payments after such employee's death. Further, the changes to section 162(m) will not apply to written, binding contracts in effect as of November 2, 2017, as well as the right to participate in a deferred compensation plan as in effect as of

November 2, 2017, even if employee was not a participant on such date, and which are not materially altered thereafter.

3. **Comment:** The removal of the exception for performance-based compensation is a considerable shift from previous law, and, in practical terms, the exception will no longer be available to bolster a publicly-held corporation's assertion for its deduction. Further, expansion of the definition of "covered employee" to include an employee's permanent label as such and its application after such officer's termination is unclear, as well as the impact of the deduction limitation post-merger or acquisition. In addition, to the extent that the covered employee is also a "disqualified individual" under section 4985, the deduction allowed as a compensation shall be reduced by the amount of any payment of the excise tax, including reimbursements to the employee for payments of the excise tax and any gross-up of the excise tax to maintain the employee's net after-tax position. Payment of the excise tax will have no subsequent tax effect on the basis of the stock or any effect with respect to the individual employee's tax treatment upon the exercise of the options (or other stock rights), payment of any stock compensation, or upon the lapse or forfeiture of such stock compensation.

B. **Excise Tax on Tax-Exempt Organization Executive Compensation.**

1. **Prior Law:** Sections 4941 and 4958 impose excise taxes on unreasonable or excess compensation paid to employees of certain tax-exempt organizations. Additionally, the use of income or assets of a tax-exempt organization by any closely related individual or shareholder of a non-profit corporation is strictly forbidden, and the violation of such "private inurement doctrine" could result in the loss of tax-exempt status, thereby acting as a deterrent against the payment of unreasonable compensation to insiders.

2. **New Law:** The Act would impose an excise tax equal to the corporate income tax rate, which will be 21% with the Act's enactment, on compensation in excess of one million U.S. dollars and on "excess parachute payments" paid to any of the five highest paid current or prior (beginning after December 31, 2016) employees by an organization that is exempt from tax pursuant to section 501(a); exempt farmer's cooperatives pursuant to section 521(b)(1); political organizations pursuant to section 527; or a state and local governmental entity pursuant to section 115(1). Compensation shall include cash and any benefits paid in a form other than cash, which are treated as paid when no longer subject to a substantial risk of forfeiture (as defined in section 457(f)(3)(B)); and excluding from the definition of "parachute payment", compensation paid to not "highly compensated employees" (as defined in section 414(q)) and to licensed medical professionals, such as doctors, nurses or veterinarians, whose compensation is directly related to the performance of such professional services.

3. **Comment:** The concepts of "parachute payments" (under section 280G) and excise taxes on excess compensation (under section 4985, as further discussed herein below) have been previously applied solely within the confines of for-profit organizations. Generally, "parachute payments" are compensation payable and contingent upon an employee's separation from service if the present value of such

amount equals or exceeds three times the employee's base salary, which excludes payments under a qualified retirement plan, a simplified employee pension plan, a simple retirement account, a tax-deferred annuity or an eligible deferred compensation plan. The excise tax of 21% will be applicable to the excess of the parachute payment over the portion of the employee's base salary allocated to the payment, as well as remuneration in excess of one million U.S. dollars, with the excise tax imposed upon the tax-exempt employer and related organizations. The Act is apparently disregarding the additional complexity another layer of excise taxes will add to the previously enacted excise-tax provisions.

C. **<u>Qualified Equity Grants - Section 83; Section 409A; Section 3401; Section 3402; Section 6051</u>.**

1. **<u>Prior Law</u>:** Presently, section 83(a) provides that an employee must recognize compensation income when certain equity awards have vested and the fair market value of such award is determinable. An employee may make an election under section 83(b) to accelerate the recognition of income in the tax year in which an equity award is granted, rather than deferring recognition until the restrictions have lapsed and the award vests. The benefits of accelerating income recognition under section 83(b) are often two-fold: (i) the fair market value of the equity award is typically lower when it is granted, and (ii) any appreciation in the equity's fair market value afterwards is taxed at the rate imposed upon capital gains if held longer than one year. An employer's written nonqualified deferred compensation plan must meet the requirements of section 409A, unless the plan qualifies as exempt from its application. Failure to comply with section 409A can result in a tax disaster for an employee through immediate recognition of previously deferred compensation, plus interest (at the rate of one percent plus the substantial underpayment rate, which was four percent during the last quarter of 2017) and imposition of a penalty equivalent to 20% of such deferred compensation. Employers are also required to withhold from their employees' compensation and pay over to the Social Security Administration and the Treasury Department the tax imposed under the Federal Insurance Contributions Act ("FICA") and the federal income tax, respectively. FICA imposes tax on both employers and employees and consists of the old age, survivors and disability insurance ("OADSI"), formerly called the Social Security tax, equal to 6.2% of the employee's wages up to a maximum of the OASDI wage base, which was $127,200 in 2017; and the Medicare or hospital insurance tax equal to 1.45% of the employee's wages with no maximum wage base. Employers are also subject to the Federal Unemployment Tax Act ("FUTA"), which is currently 6% up to the maximum FUTA wage base, or $7,000, of the employee's compensation. Generally, section 6051 imposes a requirement on employers to report on or before January 31st of the following calendar year in which the compensation is paid and the taxes are withheld[32], the employee's wages and each of the applicable employee imposed tax amounts that were deducted and withheld.

2. **<u>New Law</u>:** Recently enacted section 83(i) would allow a "qualified employee" (an employee who is not the CEO, CFO or one of the four highest

[32] In the event an employee is terminated before the close of a calendar year, then the employer must provide such information within 30 days of the employee's written request for such information.

compensated officers of the employer within the prior ten-year period and who does not own more than one percent of the outstanding equity of the employer) to make an election (within 30 days of vesting) to defer tax for up to five years on any "qualified equity grant." To fall under the definition of a "qualified equity grant," the stock must be awarded through the exercise of a stock option or a restricted stock unit (or "RSU", the exercise of which is called the "settlement") and in connection with the employee's performance of services. Section 83(i) is only available to employees of certain privately held corporations, or "eligible corporations," who have granted either RSUs or stock options to at least 80% of its employees pursuant to a written plan and whose stock is not readily tradable on an established securities market. It is important to highlight that the Act specifically noted that employers may not issue a combination of RSUs and stock options in a single tax year in an attempt to meet the 80% test. The Act adopted the House's second amendment to the initial version of the Act, which clarified that equity awards in the form of RSUs are not subject to section 83 (with the exception of section 83(i) discussed herein above); therefore, a section 83(b) election is unavailable to holders of RSUs. With respect to notice, withholding and reporting requirements, an eligible corporation that transfers qualified stock, which is the stock received by the qualified employee for the performance of services upon exercise of a stock option or settlement of a RSU, must provide an eligible employee with reasonable notice that the stock is substantially vested and that the resulting compensation income must be recognized absent a section 83(i) deferral election. The employer must report on the employee's Form W-2 the amount of income deferred, both in the year of the deferral election and in the year of inclusion. While withholding of income tax is deferred under section 83(i), FICA and FUTA remain unaffected; therefore, FICA must be withheld and both FICA and FUTA amounts reported in the deferral year.

3. **Comment:** Of particular importance for employers to note is that section 83(i) specifically provides that in order for a RSU to fall within the definition of a "qualified equity grant," the employee may not have the right to receive cash in lieu of the employer's stock upon vesting and settlement of the RSU. Even without the employee's ability to receive cash in lieu of the stock upon settlement of RSUs, the deferral of income for five years may be favorable to employee-shareholders whose plans can meet the many requirements of the newly enacted provision. A distinct drawback, however, is requiring employers to pay both FICA and FUTA and employees to pay FICA on the deferred compensation which may cause liquidity issues for both parties, especially in light of the requirement that 80% of all eligible employees (excluding part time and seasonal workers) must be granted either stock options or RSUs in the year of grant.

D. **Excise Tax on Stock Compensation from Expatriated Corporations.**

1. **Prior Law:** Generally, a U.S. corporation is taxed on its worldwide income. Previously, a U.S. corporation could reincorporate in a foreign jurisdiction with little or no corporate income tax, thereby replacing the U.S. corporation with the foreign corporation as the parent entity. These reorganizations are called inversion transactions and were often carried out as stock for stock transactions. The Treasury doesn't enact Code envision, Congress does. Various Code provisions have been over the past two

decades in an attempt to prevent inversion transactions, one of which was an excise tax under section 4985. Pursuant to section 4985, holders of stock options (and any other stock based compensation granted to a "disqualified individual" in exchange for the performance of services to such corporation or any entity within the "expanded affiliated group") were subject to an excise tax of 15% on the value of the stock compensation held directly or indirectly by or for the benefit of such "disqualified individual" (or a family member of the "disqualified individual") at any time during the six months both prior to and after the corporation's "expatriation," or inversion, provided, that such person recognized a gain by reason of the acquisition that resulted in such inversion. A "disqualified individual" is generally any individual officer (such as the president, principal financial officer, chief accounting officer or controller, and any vice-president in charge of a principal business unit, division or function), director or more than 10% owner of the issuer's equity securities of both publicly-traded and privately held corporations. The definition of "expanded affiliated group" was widened from the section 1504 definition (one or more chains of corporations with a common parent) to be determined without regard to the exceptions for certain corporations under section 1504(b) and substitutes "more than 50%" in place of "at least 80%".

2. **New Law:** The House made no provisions with respect to section 4985 and the Senate proposed an increase in the excise tax from 15% to 20%. The Act followed the Senate's proposition.

3. **Comment:** Multinational corporations with a U.S. corporation as the parent entity have long sought ways in which they could legally reduce the U.S. tax burden imposed upon its income which was "effectively connected" with the U.S. trade or business. The previous two decades have been somewhat similar to a chess match between the multinationals and the Treasury. The latest attempt by the Treasury to provide greater deterrence to inversion transactions is to increase the excise tax under section 4985 from 15 to 20%, which can also be viewed as another way for the Treasury to potentially raise revenue.

XVI. Foreign Income.

A. Deduction for Foreign-Sourced Dividends and Repatriations.

1. **Prior Law:** U.S. citizens, U.S. resident individuals, and U.S. corporations are subject to U.S. tax on their worldwide income as that income is earned. In contrast, a U.S. shareholder of a foreign corporation can generally benefit from deferral of U.S. income tax on that foreign corporation's income until the year in which that income is distributed to that shareholder. In general, the U.S. shareholder is required to report income from the receipt of payment of foreign-source income from the foreign corporation according to the rules applying to corporate distributions, such as Section 301.

2. **New Law:** The Act adds new section 245A, which provides a 100% deduction for the foreign-source portion of a dividend received by a U.S. corporate

shareholder from a "specified 10% owned foreign corporation." This 100% deduction of a dividend of foreign-source income is hereafter referred to as the "DRD."

To be eligible for the DRD, the shareholder receiving the dividend must be a domestic corporation that is a "U.S. shareholder" (i.e., it must own at least 10% of the vote or value) of the distributing foreign corporation. The DRD is available only to Subchapter C corporations that are not RICs or REITs. *See* Joint Explanatory Statement of the Committee of Conference (the "Statement") at 470. Thus, the legislative history suggests that the deduction is not available to a Subchapter S corporation that is a U.S. shareholder of a foreign corporation.

A "specified 10% owned foreign corporation" is generally any foreign corporation owned by a corporate "U.S. shareholder." That term, however, does not include a foreign corporation that is a "passive foreign investment company" (a "PFIC") and not a "controlled foreign corporation" (a "CFC").

The DRD is not allowed unless: (i) the corporate U.S. shareholder has owned stock of the foreign corporation for more than 365 days during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend; and (ii) that foreign corporation has retained its status as a "specified 10% owned foreign corporation" throughout that period.

The DRD is available only for the foreign-source portion of the dividends received from the "specified 10% owned foreign corporation." For this purpose, the foreign-source portion of any dividend is the amount that bears the same ratio to the dividend as the undistributed foreign earnings bears to the total undistributed earnings of the foreign corporation. The undistributed foreign earnings are basically all undistributed earnings of the foreign corporation, except for effectively connected income of a U.S. trade or business and dividend income received from an 80%-owned domestic corporation. The total undistributed earnings are basically all earnings without reduction for any dividends distributed during the tax year.

The DRD is not permitted for any "hybrid dividend," which is basically an amount distributed from a CFC for which the foreign corporation received a deduction or other tax benefit from any income, war profits, or excess profits taxes imposed by a foreign country. In addition, if a CFC for which a domestic corporation is a U.S. shareholder receives a hybrid dividend from another CFC for which the same domestic corporation is also a U.S. shareholder, the hybrid dividend is treated as Subpart F income of the recipient CFC for the taxable year in which the dividends was received, and the U.S. shareholder must therefore include in gross income an amount equal to that shareholder's pro rata share of the Subpart F income for U.S. income tax purposes.

The Act also amends the foreign tax credit limitation under section 904 with the basic effect that the corporate U.S. shareholder will not be entitled to claim any foreign tax credit for any foreign income tax paid in connection with the foreign-source portion of a dividend received by the "specified 10% owned foreign corporation." Thus, if the corporate U.S. shareholder is not subject to U.S. income tax on the foreign-source portion of the dividend from the foreign corporation, that U.S. shareholder also cannot reduce its U.S. income tax liability by the amount of any foreign income tax paid on that foreign-source portion of that dividend.

3. **Comment:** The Act moves the U.S. income taxation of international transactions closer to a "source" system, rather than a "residency" system, but only with respect to domestic corporate shareholders who own at least ten percent (10%) of the vote or value of the distributing foreign corporation. Thus, domestic corporate U.S. shareholders will not be required to pay U.S. income tax on foreign source earnings that are received as distributions from a foreign corporate subsidiary. The foreign source earnings, however, will be subject to U.S. income tax as dividends when those foreign source earnings exit corporate solution.

For other noncorporate U.S. shareholders of foreign corporations, however, the foreign source earnings of the foreign corporations that are not subject to Subpart F will be subject to U.S. income tax when those foreign source earnings are distributed from the foreign corporation to the U.S. shareholder. This appears to be the case for Subchapter S corporations that own stock of a foreign corporation.

4. **Effective Date.** The DRD is effective for distributions made after December 31, 2017. The limitation of foreign tax credit relating to foreign-source dividends is effective for deductions with respect to tax years ending after December 31, 2017.

B. **Deemed Repatriation at Reduced Tax Rates with Electable Deferral.**

1. **Prior Law:** As discussed above, U.S. shareholders are generally not subject to U.S. income tax on the foreign-source earnings of foreign corporations until those foreign-source earnings are distributed to those U.S. shareholders.

2. **New Law:** The Act amends section 965 to require the deemed repatriation to U.S. shareholders of deferred foreign income that has been accumulated by certain foreign corporations since 1986. More specifically, the Act generally requires U.S. shareholders to report tax for their 2017 tax year on their pro rata share of foreign earnings accumulated within foreign corporations since 1986 to the extent those foreign earnings had not previously been subject to U.S. income tax.

The deemed repatriation in 2017 applies to a U.S. shareholder of a foreign corporation (i) that is a CFC; or (ii) in which at least ten percent (10%) of the vote or value of that foreign corporation is owned by at least one domestic corporation. The deemed repatriation, however, does not apply to a U.S. shareholder of a foreign corporation that is a PFIC.

If a U.S. shareholder is subject to deemed repatriation under the Act, the deemed repatriation will apply to the foreign corporation's foreign-source income that has been accumulated post-1986 and that has not yet been subject to U.S. income tax. The U.S. shareholder will be required to report as "Subpart F income" its pro rata share of those previously untaxed foreign-source earnings for the last tax year of the foreign corporation that begins prior to January 1, 2018.

The U.S. shareholder, however, can elect to pay its resulting U.S. income tax liability in connection with the previously deferred foreign-source earnings over an eight-year period. As a further benefit, the U.S. shareholder is allowed to back-load the installment payments by paying eight percent of the net tax liability resulting from the deemed repatriation in each of the first five annual installments, followed by payments of fifteen percent of the net tax liability in the sixth installment, twenty percent in the seventh installment, and twenty-five percent in the eighth and final installment.

The U.S. shareholder is also entitled to deduct an amount sufficient to result in the U.S. shareholder paying a fifteen and one-half percent tax rate on the accumulated foreign earnings held in cash or cash equivalents or an eight percent tax rate on the accumulated foreign earnings held in other less-liquid assets. The U.S. shareholder, however, is not entitled to any foreign tax credit for any foreign income tax paid in connection with the portion of the foreign-source earnings that is deductible for U.S. income tax purposes.

3. **Comment:** This provision requiring the deemed repatriation in 2017 by U.S. domestic corporate shareholders is a mechanism for ensuring that the foreign-source earnings that had been deferred under the previous U.S. income taxation regime are ultimately taxed and do not escape U.S. income taxation altogether. Congress, however, has softened the blow by reducing the applicable income tax rate that applied to the deemed repatriated amount and by allowing U.S. taxpayers to pay the resulting tax over an eight year period, with the payment amounts backloaded to the later years.

XVII. Foreign Tax Credit.

A. Repeal of Indirect Foreign Tax Credit.

1. **Prior Law:** A domestic corporate shareholder that owns at least ten percent of the voting stock of a foreign corporation is eligible to claim a foreign tax credit for the foreign tax paid by that foreign corporation in connection with earnings that were distributed to the domestic corporate shareholder by that foreign corporation. *See* section 902. This ability of a domestic corporate shareholder to report a foreign tax credit in connection with foreign income tax paid by the foreign corporation is commonly referred to as the "indirect foreign tax credit."

2. **New Law:** The Act repeals the indirect foreign tax credit for tax years beginning after December 31, 2017. The Act, however, still permits a domestic corporate shareholder of a CFC to claim a foreign tax credit in connection with foreign income tax paid by the CFC with regard to income that the domestic corporate shareholder was required to report as income under Subpart F.

XVIII. U.S. Shareholders of CFCs.

A. The Thirty-Day Control Requirement for CFC Status.

1. **Prior Law:** A U.S. shareholder is not required to report and pay tax on Subpart F income unless the foreign corporation is a CFC for an uninterrupted period of

thirty days or more during the tax year. *See* section 951(a)(1). In order to be a CFC, more than fifty percent of the vote or value of the CFC's stock must be owned by U.S. shareholders. *See* section 957(a). Thus, under current law, a U.S. shareholder is not required to report and pay tax on subpart F income unless more than fifty percent of the vote and value of the foreign corporation's stock is owned by U.S. shareholders for an uninterrupted period of at least thirty days during the tax year.

2. **New Law:** The Act eliminates the thirty-day requirement so that a U.S. shareholder will be required to report and pay tax on Subpart F income of a foreign corporation as long as more than fifty percent of that foreign corporation's stock was owned by U.S. shareholders at any time during the tax year. This provision is effective for tax years of foreign corporations beginning after December 31, 2017 and for tax years of U.S. shareholders with or within which those tax years of the foreign corporations end. *See id.*

B. **The U.S. Shareholder Definition.**

1. **Prior Law:** A "U.S. shareholder" is defined as a U.S. person who owns ten percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. *See* section 951(b). A U.S. persons ownership of the value of the stock of the foreign corporation is irrelevant in determining "U.S. shareholder" status.

2. **New Law:** The Act expands the definition of a "U.S. shareholder" so that it would also apply to a U.S. person who owns at least ten percent of the value of the foreign corporation's stock. This is effective for taxable years of foreign corporations beginning after December 31, 2017 and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

C. **Stock Ownership Attribution From Foreign Persons.**

1. **Prior Law:** Certain constructive ownership rules are used to attribute stock ownership to related persons for purposes of determining whether a U.S. person is a U.S. shareholder and whether a foreign corporation is a CFC. *See* section 958(b). Under the current constructive ownership rules, a domestic corporation cannot be attributed stock ownership from its foreign shareholder. *See* section 958(b)(4).

2. **New Law:** The Act allows a domestic corporation to have constructive ownership of stock owned by its foreign shareholder for purposes of determining whether that domestic corporation is a U.S. shareholder of a CFC. This provision is effective for the last tax year of foreign corporations beginning before January 1, 2018 and each subsequent year of such foreign corporations and for the taxable years of U.S. shareholders in which such taxable years of foreign corporations end.

D. **Foreign Base Company Oil Related Income.**

1. **Prior Law:** "Foreign base company oil related income" is a sub-category of Subpart F income. *See* section 954(g). Thus, a U.S. shareholder of a CFC must pay

U.S. income tax on its pro rata share of the "foreign base company oil related income" as it is earned by the CFC, regardless of whether that income is distributed from the CFC to the U.S. shareholder. *See* section 951(a).

"Foreign base company oil related income" is defined by cross-referencing the definition of "foreign oil related income" under section 907(c)(2) and (3). *See* section 954(g). "Foreign oil related income" is basically income from oil and gas "downstream" activities, including the processing, transportation, distribution or sales of minerals or their primary products. *See* section 907(c)(2), (3). "Foreign oil related income," however, does not include income from the extraction of minerals from oil or gas wells. *See* section 907(c)(1).

2. **New Law:** Under the Act, "foreign base company oil related income" is repealed as a category of Subpart F income. This provision applies to tax years of foreign corporations beginning after December 31, 2017 and tax years of U.S. shareholders in which or with which such tax years of the foreign corporations end.

3. **Comment:** As a result, a CFC could generally derive income from "downstream" foreign-source oil and gas activities, such as processing, refining, transporting or reselling the oil and gas, without causing the U.S. shareholder of the CFC to be immediately subject to tax on that oil related income. Instead, that foreign-source oil and gas related income generally would not be subject to tax in the U.S. until that income is distributed to the U.S. shareholder. Alternatively, in the case of a domestic corporation U.S. shareholder, the foreign-source oil and gas related income generally would not be subject to U.S. income tax until the domestic corporate U.S. shareholder distributes the foreign-source oil and gas related income to its shareholders.

E. Congressional Overrule of *Grecian Magnesite* Decision.

1. **Prior Law:** A foreign person engaged in a trade or business in the U.S. is taxed on income that is effectively connected to that U.S. trade or business. In addition, if a partnership is engaged in a U.S. trade or business, the partners in that partnership are also deemed to be engaged in a U.S. trade or business.

In *Grecian Magnesite*, 149 T.C. No. 3 (2017), the Tax Court concluded that a partner who is neither a U.S. citizen nor resident is not subject to U.S. income tax in connection with the redemption of that partner's interest in a domestic partnership that was engaged in a U.S. trade or business. The Tax Court determined that the foreign partner's gain from the redemption of the partnership interest was not U.S. source income and thus was not subject to U.S. tax. In doing so, the Tax Court rejected Rev. Rul. 91-32, in which the IRS took the position that a foreign partner's gain is subject to U.S. income tax to the extent that partner's allocable share of gain from a hypothetical sale by the partnership of all of its assets would be effectively connected to a U.S. trade or business.

2. **New Law:** The Act essentially overrules Grecian Magnesite and adopts the IRS's position in Rev. Rul. 91-32. The Act provides that gain or loss from the sale or exchange of a partnership interest is effectively connected gain or loss to a U.S. trade or business to the extent that the partner would have had effectively connected gain or loss

if the partnership had sold all of its assets at fair market value as of the date of the sale or exchange. The gain or loss from this hypothetical sale would be allocated among the partners in the same manner as nonseparately stated income and loss. The Act applies to sales and exchanges occurring after November 27, 2017.

The Act also requires a transferee of a partnership interest to withhold ten percent of the amount realized on the sale or exchange of the partnership interest, unless the transferor certifies U.S. resident status. This withholding provision would apply after December 31, 2017.

3. **Comment:** Congress has therefore statutory overruled the Tax Court's decision in *Grecian Magnesite* to require foreign partners to pay U.S. income tax on the gain recognized from their sale or exchange of an interest in a U.S. partnership engaged in a U.S. trade or business. This statutory provision prevents a foreign taxpayer from avoiding U.S. income tax in connection with sales or exchanges of domestic partnership interests occurring after November 27, 2017.

For sales or exchange occurring on or prior to November 27, 2017, however, the statutory provision adds further support that U.S. income tax does not apply to the gain recognized from the sale of a domestic partnership interest. Thus, if the statute of limitations for claiming a refund is still open, a foreign taxpayer has an even stronger basis for claiming a refund of any U.S. income tax paid in connection with the sale of a domestic partnership interest that occurred no later than November 27, 2017.

XIX. U.S. Possessions.

A. Insurance Business Exceptions to Passive Foreign Investment Company Income. Repeal of Active Trade or Business Exception to Section 367.

1. **Prior Law:** Shareholders are permitted in some instances to make transfers of built-in gain property to corporations without recognizing that built-in gain. *See, e.g.*, section 351 (permitting tax deferred transfer of built-in gain to a corporation in exchange for stock where the transferors control the corporation immediately after the transfer). Section 367, however, requires taxable gain recognition in connection with certain transfers of built-in gain property by U.S. persons to foreign corporations, but it does not apply to transfers to the foreign corporation of property used in the active conduct of a trade or business. *See* section 367(a)(3).

2. **New Law:** The Act amends section 367 to provide that, if a U.S. person transfers property used in an active trade or business to a foreign corporation in a transaction that would otherwise be tax-deferred under sections 332, 351, 354, 356 or 361, the foreign corporation will not be considered as a corporation for purposes of determining the amount of the U.S. transferor's recognized gain from the transfer. Thus, the Act repeals the active trade or business exception to section 367 that previously prevented U.S. income taxation of transfers of active trade or business built-in gain property to foreign corporations. This amendment is effective for transfers occurring after December 31, 2017.

XX. Tax-Exempt Organizations and Private Foundations.

A. Unrelated Business Taxable Income of Tax-Exempt Organizations.

1. **Prior Law:** The unrelated business income tax ("UBIT") generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the organization's tax-exempt functions. An organization's unrelated business taxable income is determined on an aggregate basis. As a result, an organization may use a deduction from one unrelated trade or business to offset income from another, thereby reducing total unrelated business taxable income.

2. **New Law:** Effective for tax years beginning after December 31, 2017, the Act requires unrelated business taxable income to be computed separately for each trade or business, and losses cannot be used across different unrelated businesses. Note, this does not apply to NOLs arising before January 1, 2018.

3. **Comment:** The IRS will need to provide significant additional guidance as to what constitutes a separate trade or business.

B. Excise Tax on Investment Income of Colleges and Universities.

1. **Prior Law:** Universities were not subject to any net investment income tax.

2. **New Law:** Effective for tax years beginning after December 31, 2017, under new section 4968, there is a 1.4% excise tax on the investment income earned by private colleges and universities that have (a) more than 500 students and (b) endowments in excess of $500,000 per student.

3. **Comment:** There are attribution rules concerning endowment funds; however, they focus on control and do not preclude coordinated cooperation.

XXI. Excise Tax on Taxable Transportation by Air (Aircraft Management Services).

1. **Prior Law:** The IRS had taken the position that aircraft management companies were required to collect a 7.5% excise tax for payments relating to the maintenance and support of the owner's aircraft or services relating to flights on the owner's aircraft. The IRS abandoned this position in 2013.

2. **New Law:** The Act provides clarity by exempting payments from aircraft owners to management companies from the excise tax. An owner includes individuals who lease an aircraft for more than 31 days.

3. **Comment:** The lease must be for more than 31 days, but it does not specify that such days are sequential. Accordingly, one could arguably take the position that a non-contiguous time-share lease could satisfy the rule.

XXII. Qualified Opportunity Zones.

1. **Prior Law:** The Code has encouraged economic growth and investment in distressed communities through favorable tax treatment.

2. **New Law:** Effective upon enactment, the Act promotes investment in low-income areas with capital gain deferral or exclusion in "qualified opportunity funds." The relevant provisions are found in sections 1400Z-1 and 1400Z-2.

A qualified opportunity fund is an investment vehicle that holds 90% of its assets in qualified opportunity zone property, which includes any qualified opportunity zone stock, partnership interest, or business property. Generally speaking, qualified opportunity zones are low-income population census as nominated by the governor of the state where the property is located. Governors may nominate the greater of (a) 25% of the number of low-income communities within the state or (b) twenty-five low-income communities.

Subject to certain significant holding period limitations, the Act provides for the temporary deferral of capital gains for assets reinvested in a qualified opportunity fund and the permanent exclusion of capital gains upon the sale of an investment in the qualified opportunity fund.

3. **Sunset:** There is no gain deferral available for any sale or exchange made after December 31, 2026, and there is no exclusion available for investments in qualified opportunity zones made after December 31, 2026.

XXIII. Tax Practice and Procedure.

A. Extension of the Time for Filing an Administrative Claim Related to a Wrongful Levy.

1. **New Law:** Section 6343(b) authorized the IRS to return property that has been wrongfully levied upon. Prior to the passage of the Act section 6343 also provided that an amount equal to the amount of money levied upon or received from the sale of property could be returned at any time before the expiration of 9 months from the date of the levy. The associated Treasury Regulations required administrative claims for return of property wrongfully levied to be filed before the expiration of 9 months.

Section 11071 of the Act extends the time for the IRS to return wrongfully levied property under section 6343(b) from 9 months to 2 years. The extended deadline applies to levies made after the date of enactment and levies made before the date of enactment if the 9-month period has not expired as of such date.

2. **Comment:** This change makes the limitations period for filing administrative claims related to a wrongful levy consistent with the 2-year limitation period under section 6532 for filing of civil suits by taxpayers. This change was likely in response to the National Taxpayer Advocate's request for an amendment to section 6343 to allow taxpayers additional time to request a return of levied funds.

B. **Extension of Time for Third Parties to File Civil Suits Against the IRS.**

1. **Prior Law:** Section 6532 provided a 9-month limitation period for third-parties to file a civil suit for wrongful levy of property.

2. **New Law:** The Act extends the time to file a civil suit for wrongful levy of property from 9 months to 2 years. The extended deadline applies to levies made after the date of enactment and levies made before the date of enactment if the 9-month period has not expired as of such date.

3. **Comment:** This change makes the limitations period applicable to civil suits by third-parties consistent with the 2-year limitation period under section 6532 for civil suits by taxpayers.

XXIV. Taxes on Beer, Wine, and Distilled Spirits.

A. **Exceptions from UNICAP Rules For Aging Beer, Wine, and Distilled Spirits.**

1. **Prior Law:** Under the Uniform Capitalization Rules, interest expenses associated with to be capitalized, prior law required that expense incurred during the aging process for beer, wine, and distilled spirits was included in the rule.

2. **New Law:** The aging period for beer, wine, and distilled spirits is excluded from the time used to determine the interest costs required to be capitalized or added to inventory.

3. **Comment:** Given the fact that some spirits are aged for up to 20 years, excluding this aging period benefits those producers.

4. **Effective Date:** Effective for tax years beginning after December 31, 2017 and ceases to apply to tax years after December 31, 2019.

B. **Excise Taxes and Bond Requirements for Beer Reduced.**

1. **Prior Law:** Domestically brewed beer and imported beer were subject to the following excise taxes: $18 per barrel with the first 60,000 taxed at $7 per barrel.

2. **New Law:** The excise tax for the first 60,000 barrels is reduced to $3.50 and the tax for barrels up to 6 million is reduced to $16.00 per barrel. For beer produced or imported in excess of 6 million barrels, the tax remains at $18 per barrel.

3. **Effective Dates**: The provision is applicable to beer removed from the brewery after December 31, 2017 and before January 1, 2020.

DISCLAIMER

The information included in this outline is a general summary. It is not intended as tax, financial, or legal advice. Matters may change or have different meanings based on specific fact patterns. Consult appropriate, tax, financial or legal counsel before relying on any matters contained herein.