CLIENT ALERT

Tax Cuts & Jobs Act – Conference Agreement

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On Friday, December 15, 2017, the House and Senate released their final compromise version of the Tax Cuts and Jobs Act (H.R. 1) (the "Conference Agreement"). The bill was passed by the House today, is expected to be voted on favorably by the Senate later today or tomorrow, and is expected to be signed by the President before Christmas. The Conference Agreement largely follows the Senate version of the bill but with a number of substantial changes.

If it is passed, the Conference Agreement would be the most wide-ranging piece of tax legislation to be passed in over 30 years. Below is a brief summary of some of the major provisions of the bill. Unless otherwise noted, the provisions apply to taxable years beginning after December 31, 2017.

I. General Corporate and Business

a. ***Rate change and alternative minimum tax*** – The Conference Agreement lowers the corporate income tax rate to 21% for taxable years beginning after December 31, 2017. The Conference Agreement also repeals the corporate alternative minimum tax.

b. ***Changes to depreciation rules*** – The Conference Agreement generally follows the Senate's proposals which include an immediate full expensing of property placed in service after September 27, 2017 and before January 1, 2023.

c. ***Dividend received deduction ("DRD")*** – The 80% DRD for dividends paid from one eligible corporation to another is reduced to 65% (and the 70% DRD is reduced to 50%).

d. ***Interest deductibility*** – The Conference Agreement generally provides that the net interest expense deduction (for interest paid to both related and unrelated parties) is limited to 30% of the taxpayer's "adjusted taxable income" for the taxable year. Under the Conference Agreement, adjusted taxable income would be computed without regard to depreciation, amortization and depletion for taxable years beginning after December 2017 and before January 1, 2022. Thereafter, adjusted taxable income is computed taking into account these amounts, thereby lowering the threshold for disallowance to an amount closer to EBIT. The new limitation does not apply to any electing real estate trade or business or to small-business taxpayers meeting a gross receipts test of less than $25 million. Although the new limitation is broader in certain respects than the existing earnings stripping rules that it replaces, it appears that a taxpayer exempt from the new rules may be able to deduct interest that would have been disallowed under the old section 163(j) rules – *e.g.*, interest paid to a related foreign party even if the interest is not subject to U.S. tax. Note that unlike the House and Senate bills, the Conference Agreement does not include the additional interest expense limitation that would have been imposed through a worldwide debt cap.

e. ***Net operating losses*** – For taxable years beginning after December 31, 2017, the net operating loss ("NOL") deduction is limited to 80% of taxable income. In addition, the Conference Agreement eliminates for most corporate taxpayers the ability to carryback NOLs and permits an indefinite carryforward. Notably, property and casualty ("P&C") insurance companies are not subject to the 80% limitation and are permitted to carryback NOLs for two years (and carryforward for 20 years, rather than indefinitely).

f. ***Provisions affecting insurance companies*** – The Conference Agreement generally retains the Senate proposals with respect to insurance companies not summarized elsewhere in this memorandum. The changes include:

i. Repeal of the special NOL carryback and carryforward rules for life insurance companies. As noted above, P&C insurers retain the two-year carryback and 20-year carryforward rules.

ii. Changing the 10-year spread for changes in computing life insurance company reserves to a four-year spread.

iii. Modification to the "proration" rules for both life and P&C companies.

iv. Changes to the discounting rules for P&C insurers.

v. Changes to the computation of life insurance tax reserves – generally providing that life reserves may not exceed 92.81% of statutory reserves with any increase or decrease in taxable income as a result of such change in the first taxable year after December 31, 2017 being spread ratably over eight years.

vi. Changes to the deferred acquisition cost ("DAC") rules. Under the Conference Agreement, DAC would be spread over 15 years (rather than 10), and the percentage of net premiums subject to the spread would be 2.09% for annuity contracts, 2.45% for group life insurance contracts and 9.2% for all other specified contracts.

II. Funds and Pass-through Businesses

a. ***20% deduction for certain pass-through business owners*** – The Conference Agreement generally provides for a deduction of 20% of the taxpayer's "qualified business income" from pass-through entities (partnerships and S corporations) or sole proprietorship, as well as 20% deduction for REIT dividends (other than capital gain dividends) and qualified publicly traded partnership income. Income eligible for the 20% deduction does not include certain investment-related income, dividends, interest (other than interest allocable to a trade or business), and guaranteed payments, or income with respect to a non-U.S. trade or business. The 20% deduction is generally limited to 50% of W-2 wages (or, if greater, 25% of W-2 wages, plus 2.5% of the cost of tangible depreciable property), in each case, with respect to the qualified trade or business. This limitation does not apply to REIT dividends and PTP income. The deduction is disallowed for certain professional service businesses above a threshold amount (phase-ins begin at $157,500 for individual taxpayers and $315,000 for joint returns over a $50,000 or $100,000 range, respectively). Such professional service businesses include health, law, consulting, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

b. ***Gain from the sale of partnerships engaged in a U.S. trade or business*** – The Conference Agreement overrules a recent Tax Court case, *Grecian Magnesite,*[1] and provides that any gain or loss from the sale of a partnership interest by a foreign partner on or after November 27, 2017, is treated as effectively connected with a U.S. trade or business to the extent that the foreign partner would have had effectively connected gain or loss from the sale of the partnership's underlying assets.[2] For sales after December 31, 2017, the transferee of the partnership interest is required to withhold 10% of the amount realized on the sale from a foreign person, and if the transferee fails to withhold, the partnership is required to withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.

1 See Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3 (July 13, 2017).

2 Rev. Rul. 91-32, 1991-1 C.B. 107.

c. ***Carried Interest*** – The Conference Agreement imposes a three-year holding period requirement for gains on a carried interest with respect to an applicable trade or business, which generally consists of raising or returning capital and investing in certain assets including stock, debt, commodities and real estate. If the three-year holding period requirement is not met, any capital gain would be treated as short-term capital gain and taxed at ordinary income rates. The special holding period requirement would not apply to any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed. Special rules apply to a transfer of such partnership interest to a related party. It does not appear that the provision would apply to allocations of qualified dividend income.

d. ***Management Fees*** – *The* Conference Agreement suspends all miscellaneous itemized deductions through 2025, so that investors will not be able to deduct investment fees and expenses. This essentially applies AMT limitations to the regular income tax.

e. ***RICs Investing in REITs and MLPs*** – As noted above, the Conference Agreement treats all ordinary REIT dividends and certain publicly traded partnership income as "qualified business income," subject to tax at a maximum effective rate of 29.6% (37% top rate applied to income after 20% deduction). The Conference Agreement does not contain a provision permitting a RIC to pass the special character of this income through to its shareholders. Thus, direct investors in REITs and MLPs, for example, will enjoy the lower rate, but investors in RICs that invest in REITs and MLPs will not.

f. ***No FIFO Provision*** – The Conference Agreement does not include the Senate proposal that would have required all taxpayers other than RICs to determine the cost of securities sold on a "first-in first-out" basis, rather than based on specific identification. This proposal would have affected private funds as well as individuals.

III. International

The Conference Agreement provisions are generally designed to move towards a more "territorial" tax system, by creating a DRD for foreign corporation dividends to a U.S. corporate shareholder holding at least 10% of its stock (by vote or value) ("10% U.S. Corporate Shareholder" or for both corporate and non-corporate shareholders "10% U.S. Shareholders") and applying a one-time "repatriation" tax on 10% U.S. Shareholders in certain foreign corporations based on the foreign corporation's accumulated foreign earnings. The Conference Agreement also creates provisions designed to decrease "base erosion" transactions that reduce the U.S. tax base.

a. ***100% DRD for foreign source dividends to 10% U.S. Corporate Shareholders*** – Under new section 245A in the Conference Agreement establishing a "participation exemption system," a 10% U.S. Corporate Shareholder (other than a RIC or REIT) may deduct 100% of the foreign-source portion of dividends received from such foreign corporation (other than a PFIC that is not a CFC), including its share of otherwise eligible dividends allocated to it by a partnership, as long as the 10% U.S. Corporate Shareholder meets a one-year holding period requirement. The Conference Agreement provisions also contain the following:

i. *Deductible gains on stock sales*. Gains on the disposition of stock in a CFC with undistributed earnings, including lower-tier CFCs, are generally deemed to be a dividend that would qualify for the DRD.

ii. *Hybrid dividends*. No deduction is permitted for "hybrid dividends." A "hybrid dividend" is an amount otherwise eligible for the DRD for which the distributing CFC received a deduction (or other tax benefit) with respect to any income taxes imposed by any foreign country or possession of the United States. A hybrid dividend paid from one CFC to another may also result in subpart F income to a 10% U.S. Corporate Shareholder in such CFCs.

iii. *Adjustment to stock basis for loss*. Solely for determining a loss on the stock's disposition, the deduction reduces the stock basis.

iv. *No foreign tax credit*. No foreign tax credit or deduction is permitted for foreign taxes paid or accrued with respect to the dividend qualifying for the DRD.

v. *Income from transferred loss amounts*. A 10% U.S. Corporate Shareholder eligible for the above DRD on a foreign corporation's dividends that transfers substantially all of a foreign branch's assets to the foreign corporation includes a "transferred loss amount" as U.S. sourced income, subject to certain limitations.

vi. *Repeal of active trade or business exception for U.S. corporate section 367 transfers to foreign corporations.* The Conference Agreement also eliminates an exception under section 367(a)(5) of the Code to gain recognition by a U.S. person transferring property in an active conduct of a trade or business to a non-U.S. corporation in certain reorganizations or liquidations.

b. ***One-time deemed repatriation tax*** – The Conference Agreement requires a one-time tax on a 10% U.S. Shareholder's share of post-1986 undistributed earnings (other than subpart F income or income effectively connected to a U.S. trade or business ("ECI")) of either a CFC or any foreign corporation that has at least one 10% U.S. Corporate Shareholder. The rate of tax is 15.5% on accumulated foreign earnings held in cash or cash equivalents and 8% on the remaining amount (*i.e.*, earnings invested in illiquid assets). A partial foreign tax credit is permitted generally in proportion to the taxable amount of income inclusion by the 10% U.S. Shareholder. Regulatory authority for appropriate basis adjustments relating to the inclusions is provided.

i. *Post-1986 undistributed earnings*. These earnings are determined as of November 9, 2017 or December 31, 2017, whichever results in a greater amount. Post-1986 undistributed earnings do not include previously included subpart F income, ECI, or earnings from periods prior to the existence of a 10% U.S. Shareholder. Deficits as of November 2, 2017 of other related specified foreign corporations may reduce post-1986 undistributed earnings of a 10% U.S. Shareholder, including the *pro rata* share of deficits of another 10% U.S. Shareholder in the same affiliated group.

ii. *Installment payment of tax*. The 10% U.S. Shareholder may elect to pay the net tax liability over eight years.

iii. *Inverted foreign corporations*. If a foreign corporation engaged in a section 7874 inversion (an "expatriated entity") not resulting in U.S. corporate status within 10 years of the bill's enactment, a full 35% deemed repatriation tax is instead applied without the benefit of a foreign tax credit offset.

iv. *Anti-abuse provisions.* The bill's language authorizes Treasury to provide regulations or other guidance to disregard transactions a principal purpose of which was to reduce the aggregate foreign cash position and to prevent the avoidance of the purposes of the deemed repatriation tax, including through a reduction in earnings and profits, changes in entity classification or accounting methods or otherwise.

c. ***CFC status/Subpart F income*** – The Conference Agreement contains the following provisions relating to CFCs and Subpart F income:

i. *Attribution rules expanded*. Stock owned by a foreign person is attributed downward to a U.S. person, effective for the last taxable year of a CFC beginning before January 1, 2018. For example, if a foreign parent corporation owns stock in a foreign corporation and a U.S. corporation, the U.S. corporation will be attributed the foreign parent's stock in the subsidiary foreign corporation.

ii. *United States Shareholder status*. The definition of a United States Shareholder for purposes of the Code is changed to include any United States person who owns 10% of the value (as well as vote) of the stock of the foreign corporation.

iii. *Elimination of 30-day rule*. CFC status is no longer dependent on the foreign corporation being a CFC for 30 days of the tax year.

iv. *Section 956 retained*. Subpart F income continues to include under section 956 of the Code a CFC's investment in U.S. property (including a loan to a U.S. subsidiary or certain credit support to such subsidiary), although originally eliminated in the House and Senate bill.

v. *Elimination of certain income inclusions*. Subpart F income no longer includes foreign base company oil related income and inclusion of income is eliminated for the withdrawal of previously excluded subpart F income from a qualified investment in foreign base company shipping operations.

vi. *Look-thru payment rule still sunsets*. A provision permitting a look-thru to income underlying related party dividend, interest or royalty payment continues to expire after 2019.

d. ***Foreign tax credits*** – The section 902 deemed-paid foreign tax credit with respect to dividends received by a U.S. corporation that owns 10% or more of the voting stock of a foreign corporation is repealed. Foreign branch income is also required to be allocated to a specific foreign tax credit basket.

e. ***Base erosion anti-abuse tax ("BEAT")*** – An additional tax applies to certain corporate taxpayers (other than RICs, REITS, or S-corporations) with average annual gross receipts for the three-taxable-year period ending with the preceding taxable year of at least $500 million. Taxpayers meeting that test that have a "base erosion percentage" – which generally is determined by the amount of deductions from base-eroding payments (defined below) to related parties – of 3% or higher for the tax year (2% in the case of banks and certain security dealers) must pay a tax equal to the excess of (a) 10% (or 5% for tax years beginning in 2018) of "modified taxable income" for the tax year, determined by adding back to taxable income "base erosion payments" and a portion of allowable NOLs, over (b) an amount equal to the taxpayer's "regular tax liability" for the tax year.

i. *Base erosion payment.* A "base erosion payment" generally includes a payment or accrual to a foreign-related party of a deductible amount, certain acquisitions of depreciable or amortizable property, and premium or other consideration for certain reinsurance payments. A base erosion payment does not include payments for certain services provided at cost, reductions in gross receipts, including payments for costs of goods sold, and certain qualified derivative payments.

ii. *Certain tax credits may increase BEAT*. The potential amount of BEAT may be increased by otherwise allowed credits, other than research credits and a portion of other section 38 business credits for low-income housing, renewable electricity production and certain investments allocable to energy, by reducing "regular tax liability" by such credits when calculating the tax.

iii. *Post- 2025 BEAT rate increase.* For tax years beginning after December 31, 2025 the 10% BEAT rate increases to 12.5% and the exception preventing research credits and a portion of other credits from increasing the BEAT is eliminated.

iv. *Banks and certain security dealers.* The BEAT rate is 1% higher for banks and certain security dealers.

f. ***Global and Foreign Derived Intangible Income – GILTI and FDII*** – The Conference Agreement provides for (i) the inclusion by 10% U.S. Shareholders of (and, thus, a tax on) "global intangible low-taxed income" or "GILTI" earned by CFCs, which is taxable at a lower rate and (ii) a deduction for certain "foreign-derived intangible income" or "FDII."

i. *GILTI inclusions from CFCs*. Under a new section 951A, 10% U.S. Shareholders in a CFC must include in income 50% of their share of "GILTI" (rising to 62.5% in 2026). GILTI is generally determined as the excess of aggregate net income (other than certain excluded income) over an assumed 10% rate of return on tangible business assets.

1. *GILTI calculation.* GILTI is generally a CFC's modified gross income (excluding ECI, subpart F income, related party dividends, certain high-tax income and certain other income) reduced by the excess of (a) 10% of the average of the aggregate of the CFC's adjusted basis in specified depreciable tangible property used in its trade or business over (b) certain allocated interest expenses.

2. A deemed-paid foreign tax credit is permitted to be reduced generally by applying 80% of the corporation's GILTI inclusion percentage to the applicable foreign income taxes.

ii. *FDII deductions*. A U.S. corporation (other than a RIC or REIT) may deduct an amount equal to 37.5% of its FDII (decreasing to 21.875% after 2026).

iii. *FDII determination*. Similar to the GILTI formula, FDII is determined by assuming a rate of return on tangible business assets to determine foreign source deemed intangible income.

1. *FDII calculation*. To calculate FDII, "deemed intangible income" is multiplied by a percentage determined by the amount of "deduction eligible income" considered foreign source.

a. *"Deemed intangible income"* is "deductible eligible income" in excess of a deemed tangible income return. The deemed tangible income return is generally determined as 10% of the average aggregate adjusted tax basis in specified tangible depreciable property.

b. *"Deduction eligible income"* is the corporation's gross income, excluding certain income including subpart F income, GILTI, certain financial services income, CFC dividend income to a 10% U.S. Shareholder, reduced by allocable deductions (including taxes).

c. *"Foreign source deduction eligible income"* is generally deductible eligible income derived in connection with (i) the sale of property to a non-U.S. person that the taxpayer establishes is for foreign use or (ii) taxpayer-provided services established to be provided to any person, or with respect to property, located outside the United States. Certain exceptions apply for transactions with related foreign parties or U.S. intermediaries.

g. ***Other provisions aimed at base erosion*** – The Conference Agreement contains other provisions designed to address "base erosion" transactions that reduce the U.S. tax base.

i. *Denial of deduction for "hybrid" interest or royalty payments.* The Conference Agreement denies a deduction for certain interest or royalty payments paid to a related party either (i) pursuant to a "hybrid transaction" involving inconsistent treatment under applicable foreign tax law or (ii) by or to a "hybrid entity" to the extent under applicable foreign tax law there is either no corresponding inclusion of income, or a deduction is permitted with respect to the amount. An entity that is fiscally transparent for U.S. federal income tax purposes but not for foreign tax purposes, or *vice versa*, is a hybrid entity.

ii. *Definition of intangibles expanded.* The Conference Agreement amends the definition of intangibles under section 936(h)(3)(B) to include any goodwill, going concern value, or workforce in place or any other item the value or potential value of which is not attributable to tangible property or the services of any individual. Treasury is provided authority to require valuation on an aggregate basis or on the basis of realistic alternatives to the transfer. This change would have application to section 482 transfer pricing and certain section 367 transfers involving foreign corporations.

iii. *No reduced rate on dividends from inverted corporations*. Dividends received from surrogate foreign corporations defined in section 7874's provisions on inversion transactions that are not treated as U.S. corporations are not entitled to lower rates of tax for qualified dividends.

h. ***PFIC changes affecting insurance companies*** – The Conference Agreement generally limits the application of the active insurance exception to the PFIC rules to companies that would be treated as insurance companies for U.S. tax purposes with (i) losses and loss adjustment expenses, (ii) reserves (other than deficiency, contingency or unearned premium reserves) for life and health insurance risks and (iii) life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks equal to more than 25% of its total assets as reflected on the company's financial statement (with a lower 10% threshold applying in the case of certain run-off or rating-related circumstances, in which case a U.S. taxable investor may elect non-PFIC treatment) (the "Reserves Test"), provided certain other requirements are satisfied. Congress did not include unearned premium reserves in the Reserves Test calculation, despite intense industry lobbying efforts.

IV. Exempt Organizations

a. ***No netting of UBTI*** – The Conference Agreement requires that unrelated trade or business income, including for purposes of determining NOLs, must be computed separately for each unrelated trade or business in which an organization holds an interest. Thus, losses from one business may not be used to offset income from another business. Note, though, that the Conference Agreement does permit NOLs arising in a taxable year beginning before January 1, 2018 that are carried over after January 1, 2018 to be used to offset income from any unrelated trade or business.

b. ***Increase in deduction limit for certain cash contributions*** – The Conference Agreement provides that a taxpayer may claim a charitable contribution deduction with respect to contributions of cash to publicly supported charities in an amount up to 60% of his or her adjusted gross income (up from the current 50% limit for such contributions). This provision is not effective for tax years beginning after December 31, 2025.

c. ***Excise tax on compensation in excess of $1 million*** – A tax-exempt organization will be subject to a 21% excise tax with respect to compensation in excess of $1 million paid by the organization (or by any related party) to any of the organization's five highest paid employees unless the compensation is subject to a substantial risk of forfeiture.

d. ***Excise tax on investment income of private universities*** – The Conference Agreement provides that private universities with at least 500 tuition paying students, more than 50% of whom are located in the United States, will be subject to a 1.4% excise tax on their net investment income if they have investment assets equal to at least $500,000 per student.

e. ***No change in private foundation 4940 tax*** – Note that the proposed changes to section 4940 – to replace the current 1% or 2% excise tax with a flat 1.4% rate – are not included in the Conference Agreement.

f. ***No change to taxation of state pension plans*** – Note that the proposed change to subject state pension plans to unrelated business income tax is not included in the Conference Agreement.

g. ***No additional DAF reporting*** – The Conference Agreement does not include the House proposal to require that donor advised funds provide on Form 990 additional information reporting regarding the average number of grants paid from each account and whether the DAF has a payout policy.

V. Individual

a. ***Rate changes/new standard deduction*** – The Conference Agreement changes the rate brackets, with the top bracket now at 37% for individuals earning in excess of $500,000 and joint returns in excess of $600,000. The Conference Agreement also doubles the standard deduction to $12,000 (single)/$24,000 (joint). These provisions sunset in 2026. The maximum tax rates on long-term capital gains and qualified dividend income remain unchanged.

b. ***Alternative minimum tax*** – The Conference Agreement retains the individual alternative minimum tax with changes to the exemption amount and phaseout thresholds.

c. ***State and local tax deduction*** – The Conference Agreement limits the amount of state and local income, property and sales taxes that may be deducted to $10,000 per year. The Conference Agreement also makes clear that an individual may not prepay 2018 income taxes in 2017 and take a deduction for that prepayment in 2017.

d. ***Mortgage interest deduction*** – The Conference Agreement limits the amount of mortgage debt on which an interest deduction is permitted to $750,000 for mortgages incurred in taxable years beginning after December 31, 2017 and before January 1, 2026. The Conference Agreement also suspends the deduction for interest on home equity loans.

e. ***Retention of charitable contribution deduction*** – The Conference Agreement retains the charitable contribution deduction for individuals under current law with some minor modifications, including an increase in the income-based percentage limitation for contributions of cash to public charities from 50% to 60%.

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