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Legal Update
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# A Sisyphean Task: The House of Representatives Passes Tax Reform Legislation

Legend has it that Sisyphus was condemned to an eternity of pushing a boulder uphill, and then being crushed by it as it fell back down, all in retribution for self-aggrandizing craftiness and deceitfulness. In modern times, many folks see such behavior as the typical modus operandi of politicians (most frequently politicians of the *other* political party, whichever one that may be). Whatever your view, it cannot be denied that the US House of Representatives has pushed a large boulder fairly far uphill by passing the Tax Cuts and Jobs Act (the "House Bill" or the "Bill") on November 16, 2017. But only time will tell if the House will suffer the fate like Sisyphus', crushed by failed legislation, or will receive accolades worthy of Homeric heroes, for passing tax reform. This Mayer Brown Legal Update consults the Oracle (well, the text of the Bill) to attempt to discern whether this epic endeavor will end as classic tragedy or comedy.

On November 3, 2017, we released a Legal Update describing the provisions of the Bill initially reported by the Ways & Means Committee.[1] The Bill has undergone some changes in the process of being passed by the House. Instead of just focusing on the changes, however, we provide a succinct and selective synopsis of the House Bill, as passed. Our discussion is divided into nine sections: (1) business tax proposals, (2) international tax proposals, (3) provisions that would affect real estate, (4) financial institution provisions, (5) partnership tax provisions, (6) compensation-related provisions, (7) individual tax reform, (8) provisions that would affect tax-exempt organizations and (9) insurance-related provisions. Bottom line, the most important proposals include a 2018-and-after reduction in the corporate tax rate to 20 percent, immediate expensing of new and used equipment, new limits on the deduction of interest, migration to a territorial tax system, carried interest rules and the denial of capital gain treatment for dispositions of self-developed patents and other intangibles. In other words, all of the elements of a gripping Greek myth are in place.

## Changes That Would Affect Businesses

**Corporate Tax Rate Reduction and Related Changes.** The centerpiece of the House Bill is still the reduced income tax rate for corporations. The rate would be reduced from 35 percent to a flat 20 percent beginning in 2018. Personal service corporations would be subject to a flat 25 percent rate. The House Bill would provide an extended six-year period for income recognition for S corporations converting to C corporations to take advantage of the new low rates. The longer transition period would be available to S corporations that revoke their S corporation election within two years after the enactment of the Bill and that are owned by the same persons in the same proportions when the Bill is enacted and when the S corporation election is revoked. The corporate alternative minimum tax (AMT) would be repealed

beginning in 2018. Taxpayers would be entitled to claim a refund of 50 percent of their remaining AMT credits for each year from 2019 to 2021 and could claim any remaining credits in 2022.

**Immediate Expensing of Capital Expenditures.** An immediate deduction would be allowed for 100 percent of the cost of capital expenditures for property placed in service after September 27, 2017, and before January 1, 2023 (2024 for certain qualified property with a longer production period), provided that the property is acquired in a taxable arm's length transaction from an unrelated party. Thereafter, recovery of capital expenditures would revert to the MACRS cost recovery system as currently in effect. A taxpayer would be entitled to immediate expensing even with respect to the acquisition of used property. This benefit does not apply to property used by a regulated public utility company or in a real property trade or business. For taxpayers that acquire eligible property in their 2017 taxable year, the expense deduction would be applied against income taxable at a 35 percent rate.

**Repeal of Domestic Production Deduction.** Effective for tax years beginning after December 31, 2017, the House Bill would repeal the deduction for income attributable to domestic production activities under Section 199 of the Internal Revenue Code of 1986, as amended (US Tax Code).

**Small Business Expensing.** Current law permits taxpayers to expense up to $500,000 of qualifying property placed into service in a given year. The deduction is phased out if the taxpayer places more than $2 million of property in service. The House Bill would increase these amounts to $5 million and $20 million, respectively, beginning in 2018 and ending in 2022. In addition, the House Bill would expand the provision to include improvements to nonresidential real property placed in service after November 2, 2017.

**Reduction in the DRD.** The US Tax Code provides a tax deduction for a portion of the dividends received by a corporation, recognizing that without such a deduction, dividends would be subject to triple or greater taxation. This deduction is referred to as the dividend received deduction (DRD). The House Bill would reduce the DRD to 50 percent for portfolio dividends (down from 70 percent), that is, dividends paid on stocks in which the recipient owns less than 20 percent of the payer. The DRD on stocks in which the recipient owns at least 20 percent but less than 80 percent would be reduced to 65 percent (from 80 percent). Both proposals would be effective for tax years ending after December 31, 2017, and have the effect of reducing the DRD to take into account the lower corporate income tax rate. The 100 percent DRD for dividends from companies owned 80 percent or more by the payee would not be affected.

**Cash Method Accounting Expansion.** The US Tax Code currently restricts the use of the cash method of accounting for C corporations and partnerships with C corporation partners. The House Bill would expand the ability to use the cash method of accounting to businesses with average annual gross receipts of $25 million or less for the prior three years. (Qualified personal service companies and other businesses that can use the cash method of accounting without regard to average annual gross receipts would continue to be able to use the cash method.) In addition, the proposal would expand the ability of C corporations engaged in farming to use the cash method. The House Bill would also simplify inventory accounting and provide exemptions from the uniform capitalization rules for businesses eligible to use the cash method. These changes would be effective for tax years beginning after December 31, 2017.

**Limitations on Interest Expense Deduction.** The House Bill would introduce a new cap on interest expense deductions. The limitation would be effective for tax years

beginning after December 31, 2017, with no grandfathering for preexisting debt.

Specifically, the legislation would revamp Section 163(j) of the US Tax Code, which caps the deduction for net business interest expense. Under the House Bill proposal, net business interest expense (notably, both to related and unrelated parties) would be disallowed to the extent it exceeds 30 percent of adjusted taxable income, an amount similar to EBITDA (which ignores net operating losses (NOLs)). Any disallowed amounts could be carried forward for five years.

In the case of partnerships and S corporations, the disallowance would be determined at the partnership (rather than partner) level. This rule would not apply to "small businesses" (taxpayers with average annual gross receipts of $25 million or less), certain regulated public utilities, and certain real property trades or business.

**Limitation on Deductibility of NOLs.** Beginning in 2018, taxpayers would only be able to use NOLs to offset up to 90 percent of their taxable income. The House Bill would also generally eliminate all carrybacks of NOLs arising in 2018 and thereafter but would not limit the ability to carry forward NOLs. The amount of NOL carryforwards, in turn, would be increased by an interest factor to account for time value of money. Note that the reduction to the corporate income tax rate would likely result in an impairment in the value of pre-2018 NOLs for financial accounting purposes.

**Contributions to Capital.** State and local governments have made a practice of making non-taxable contributions to the capital of corporations relocating in their jurisdictions. The House Bill would make such contributions taxable to the recipient corporation (or partnership) if made after the date of enactment. Specifically, the House Bill provides that a contribution to capital is includible in gross income unless the recipient corporation issues stock with a fair market value equal to the contributed property. The legislative report accompanying the House Bill, however, makes clear that *pro rata* contributions made by shareholders do not result in taxable income to the recipient corporation regardless of whether it actually issues shares to the contributing shareholders.

**Fringe Benefits.** The House Bill would disallow deductions for qualified transportation fringe benefits, any entertainment activities, club membership dues and facilities associated with entertainment or clubs (specifically including in-house gymnasiums) beginning in 2018, except to the extent that the fringe benefit is included in the income of an employee. A 50 percent deduction would still be permitted for food and beverage expenses associated with operating the trade or business.

**Research & Development Expenditures.** Beginning in 2023, research and experimental expenditures incurred in the United States would be required to be amortized over five years instead of deducted immediately. Research and experimental expenditures incurred outside of the United States would be required to be amortized over 15 years. Even if a taxpayer abandoned research, the unrecovered basis would still be required to be amortized over the remaining schedule.

## International Tax Proposals

**Transition to a Territorial System – The Participation Exemption.** Effective beginning in calendar year 2018, the House Bill would introduce a "participation exemption" for foreign-source dividends received from non-US subsidiaries. Similar to the "participation exemption" found in many European countries, dividends attributable to non-US source income paid by a foreign corporation to a US corporate shareholder that owns 10 percent or more of the stock of the distributing corporation would be effectively exempt from US tax (through a 100 percent dividend-received deduction). No direct

or indirect foreign tax credits would be allowed with respect to the exempt dividends. To benefit from this exemption, the US shareholder must meet a minimum holding period with respect to the stock of the foreign subsidiary (more than 180 days during the 361-day period beginning on the date that is 180 days before the *ex dividend* date).

This participation exemption would also apply to gains from the sale of stock of foreign subsidiaries to the extent such gain is characterized as a dividend under Section 1248 of the US Tax Code.

Notwithstanding the participation exemption, US corporations would still be subject to US tax on any foreign income earned through a branch or disregarded entity.

Consistent with the shift to a territorial system, the House Bill would repeal the "deemed dividend" rules under Section 956 of the US Tax Code for US corporate shareholders that are shareholders of a controlled foreign corporation (CFC). As a result, those US corporate shareholders would not be subject to US tax on the CFC's earnings that are invested in US property (e.g., when a CFC holds a debt obligation of its US shareholder). The House Bill would instruct the IRS to issue regulations to also effectively repeal the Section 956 rules for shareholders of a CFC that are US partnerships with corporate partners.

**Deemed Repatriation Tax or "Toll Charge."** As part of the transition to a participation exemption regime, the House Bill would impose a one-time tax on the untaxed post-1986 earnings of foreign subsidiaries. Under the House Bill, this "deemed repatriation tax" would apply to US corporations that own 10 percent or more of the stock of any foreign corporation and to US individuals who own 10 percent or more of the stock of a CFC. The earnings of the foreign subsidiaries would be measured as of November 2, 2017, or December 31, 2017, whichever amount is greater.

This one-time tax would be imposed at reduced rates:

- A 14 percent rate would apply to the foreign earnings attributable to the US shareholder's "aggregate foreign cash position" as of November 2, 2017 (generally, an average of the US shareholder's *pro rata* share of cash and cash equivalents held by its foreign subsidiaries in the three preceding years). Certain cash positions would be disregarded to the extent they could not be distributed by reason of currency or other foreign law restrictions.
- A 7 percent rate would apply to the remainder of the earnings (i.e., earnings that are treated as reinvested in illiquid assets).

Foreign tax credits would be allowed for the attributable portion of the foreign subsidiaries' foreign tax pools, subject to haircuts to account for the reduced rates at which the deemed repatriation tax is imposed. An extended 20-year carryover period would be allowed for foreign tax credits resulting from this deemed repatriation.

US shareholders may offset the earnings of their foreign subsidiaries with post-1986 accumulated deficits of other foreign subsidiaries that they owned as of November 2, 2017. In addition, US shareholders may offset their net earnings inclusion to the extent that other US shareholders in their affiliated group have an aggregate net deficit attributable to their foreign subsidiaries.

The one-time income inclusion would occur in the US shareholder's last tax year beginning before January 1, 2018. However, taxpayers may elect to pay the resulting US tax liability in up to eight equal annual installments with no interest. This installment payment election would be made by the due date for filing the return for the tax year of the inclusion.

In the case of S corporations that own 10 percent or more of a foreign subsidiary, the S corporation shareholders may elect to defer the payment of the deemed repatriation tax until they transfer

the shares of the S corporation, the S corporation terminates its S corporation status, or the S corporation liquidates or sells substantially all of its assets.

**Excise Tax on Non-Interest Payments to Foreign Affiliates.** In an effort to address base erosion through outbound payments, the House Bill would introduce a 20 percent excise tax on non-interest payments from domestic corporations to foreign affiliates. This excise tax would cover payments that are deductible, as well as payments that are includable in cost of goods sold, in inventory or in the basis of a depreciable or amortizable asset. Thus, payments for both tangible and intangible property would be subject to the excise tax regime.

The House Bill provides that the excise tax would not apply if the foreign payee agrees to pay US net income tax on those payments, treating them as effectively connected income (ECI) (this "ECI election" would also result in those amounts being subject to the branch profit tax). In that case, the taxable net income of the foreign payee would be determined based on the profit margins reported on the group's financial statements for the relevant product line but only taking into account revenues and expenses of the foreign members of the group in transactions with unrelated parties.

In an important amendment to the original Bill released by the Ways & Means Committee, the House Bill would now allow a foreign tax credit equal to 80 percent of the amount of taxes paid or accrued by the foreign payee if the foreign payee makes the ECI election.

The excise tax would not apply to the extent an otherwise covered payment is subject to US withholding tax. In addition, the excise tax would not apply to payments for intercompany services charged at cost (i.e., with no markup) or to payments for the acquisition of securities and certain commodities.

The excise tax regime would only apply to the extent that the US corporations of a group make payments covered by the tax that total at least $100 million on an annual basis, based on the past three-year average.

The excise tax would apply to amounts paid or accrued after December 31, 2018.

**"Foreign High Returns" Regime.** In an effort to curtail profit shifting to low-tax jurisdictions, the House Bill would provide for current taxation of "foreign high returns." These rules would mainly affect US multinationals earning significant income from intellectual property in low-tax jurisdictions.

US shareholders would be required to include in income 50 percent of their *pro rata* share of their CFCs' foreign high return amount (given the 50 percent inclusion, foreign high returns are effectively taxed at a reduced 10 percent rate). Similar to Subpart F income, foreign high returns would be taxed on a current basis, regardless of whether the earnings are distributed to the United States.

The foreign high return amount is the excess of (1) the US shareholder's aggregate "tested income" from its CFCs[2] *over* (2) a "routine return" amount, determined by applying a specified rate (7 percent plus the short-term applicable federal rate) to the aggregate adjusted bases in the CFCs' depreciable *tangible* property minus the interest expense allocable to the CFCs.

Income inclusions of foreign high returns would carry foreign tax credits equal to 80 percent of the foreign taxes attributable to the tested income. The House Bill would create a separate foreign tax credit basket for foreign high returns income, with no carryforward or carryback for excess credits.

The foreign high returns regime would apply for tax years of foreign corporations beginning after December 31, 2017.

**Limit on Deduction of Interest Expense for US Members of Multinational Group.** The House Bill includes a provision that would disallow interest expense deductions for US

corporations that are overleveraged compared to their worldwide affiliated group. For tax years beginning after December 31, 2017, this provision would limit the deduction for interest expense to the extent the US corporation's share of the group's global net interest expense exceeds 110 percent of the US corporation's share of the group's EBITDA. The limitation would apply to US corporations and partnerships that are members of an "international financing reporting group," that is, a group that (1) includes at least one foreign corporation and one domestic corporation (or a foreign corporation engaged in a US trade or business), (2) prepares consolidated financial statements and (3) reported average aggregate annual gross receipts in excess of $100 million for the preceding three-year period.

This limitation would only apply to the extent it is greater than the 30 percent of EBITDA limitation under the revised Section 163(j) of the US Tax Code, as described above.

The amount of any interest disallowed as a deduction can be carried forward for up to five years.

**Modifications to CFC/Subpart F Regime.** The House Bill would incorporate a number of modifications to the Subpart F regime. Foreign base company oil-related income would no longer constitute Subpart F income subject to current US taxation. A change would be made to the stock attribution rules for the determination of CFC status so that a US shareholder of a foreign corporation may be deemed to constructively own other stock in such foreign corporation owned by the US shareholder's foreign parent (i.e., downward attribution). The House Bill would also eliminate the requirement that a corporation be a CFC for 30 uninterupted days during the year for the Subpart F regime to apply. In addition, the "look-through" exception for dividends, interest, rents and royalties received from related CFCs would be made permanent (this look-through exemption is currently scheduled to expire after 2019).

**Sourcing of Inventory Sales.** The House Bill would no longer treat as foreign source income up to 50 percent of the income from the sale of inventory produced within the United States and sold abroad (or vice versa). Instead, such income would be sourced solely based on the location of the production activity.

## Provisions That Would Affect Real Estate

**Like-Kind Exchanges Limited to Real Property.** Beginning in 2018, tax-free "like-kind exchanges" would only apply to real property. A transitional rule would apply for non-real property like-kind exchanges that begin in 2017 but are not completed until 2018.

**REIT Dividends.** Beginning in 2018, a 25 percent rate would apply to ordinary REIT dividends (not including capital gain dividends and qualified dividends) paid by real estate investment trusts to US individuals. The tax rate applicable to non-US persons (generally 30 percent) would not be changed.

**Principal Residence Gain Exclusion.** The House Bill generally would extend the length of time that a taxpayer must live in a residence before he or she can take advantage of the residence sale exclusion to five of the eight years ending in the year in which the residence is sold. A taxpayer would only be entitled to make use of the exclusion once every five years. In addition, the exclusion would be phased out for taxpayers with adjusted gross income in excess of $500,000 ($250,000 for single filers).

## Provisions That Would Affect Financial Institutions

**FDIC Premiums.** Beginning after 2017, banks with consolidated assets in excess of $50 billion would not be entitled to deduct FDIC deposit insurance premiums. Banks with assets in excess of $10 billion, but less than $50 billion, would be required to scale back their deductions for FDIC premiums. Financial institutions with

consolidated assets of less than $10 billion would remain entitled to deduct FDIC premiums in whole.

## Provisions That Would Affect Partnerships

**3-Year Rule for Carried Interests.** The House Bill contains a modified version of the various iterations of the "carried interest" proposals that have been floating around for many years. As with the prior versions, implementation looks like it will be a major challenge. Although the proposed legislative text lacks specificity, it appears that the proposal would deny long-term capital gain treatment to individuals for both flow-through items and gains from dispositions of "applicable partnership interests" unless the partner has held the interest for at least three years. Applicable partnership interests are interests received by a partner in connection with performance of services related to an "applicable trade or business." Applicable trades or businesses include raising capital, investing and developing "specified assets." Specified assets include stock, securities, commodities, real estate held for rental or investment, and pass-through investments by private equity partnerships.

The provision would be effective for 2018 and later taxable years. This provision would require substantial IRS guidance on transition rules, interpretative issues and anti-abuse rules.

**25 Percent Tax Rate on Pass-through "Business Income."** Under the House Bill, a 25 percent maximum rate would apply to owners of sole proprietorships and pass-through entities (e.g., partnerships and S corporations) with respect to their "qualified business income."

Net income from a passive business activity would be treated entirely as qualified business income eligible for the 25 percent rate. For active businesses, the rules require an allocation between qualified business income and services income taxable at the ordinary rates. A safe harbor would allow small businesses to classify 30 percent of the pass-through income as qualified business income and 70 percent as services income. Alternatively, the owners of capital-intensive businesses may elect to apply a "capital percentage" formula in order to have a larger portion treated as qualified business income subject to the preferential 25 percent rate. Service businesses, such as health, law, engineering, financial services, brokerage services, accounting and consulting, generally would not benefit from the 25 percent rate, but they could elect to apply the "capital percentage" formula if the result exceeds the 10 percent threshold.

This provision would be effective January 1, 2018, even for taxpayers with non-calendar tax years.

**Repeal of Technical Termination Rule.** The House Bill would repeal the rule on technical terminations of partnerships by reason of a sale of 50% or more of the partnership interests. A partnership would still be considered terminated if the partners no longer carry on any business, financial operation or venture of the partnership.

## Provisions That Would Affect the Taxation of Compensation

**Reversal on the Repeal of Section 409A.** The original Ways & Means Committee bill would have repealed Section 409A of the US Tax Code, and as a result, compensation deferred under a nonqualified deferred compensation plan would have been included in income by the employee upon vesting. This provision was deleted during the markup, and thus, the House Bill would preserve current law treatment for nonqualified deferred compensation under Section 409A.

**Deduction Limits for Highly Compensated Employees of Public Companies.** Current law limits the amount of annual compensation that may be deducted by a publicly traded corporation to $1 million for CEOs and the other

four most highly compensated officers, except to the extent the compensation is performance-based. The House Bill would repeal the current law exception for performance-based compensation and commissions. The House Bill would also expand the scope of the rule to include compensation paid to a publicly traded corporation's principal financial officer (CFO). In addition, the House Bill would limit the US compensation deduction for foreign corporations with stock traded in the United States through ADRs.

**Non-Traded Stock Awards.** The House Bill would provide deferral opportunities for employees who receive options and restricted stock units (RSUs) in private companies. The relief is limited to private companies that have issued options or RSUs to at least 80 percent of the employees who provided services in the United States. When the provision is applicable, an eligible employee receiving a stock option or RSU may defer the tax on stock received upon exercise of the option or RSU until the earliest of (1) when the stock becomes transferable, (2) when the employee becomes an excluded employee, (3) when stock of the employer becomes publicly traded, (4) five years after the stock becomes substantially vested and (5) the date the employee revokes the deferral election. Excluded employees include those that hold 1 percent or more of the employer stock, CEOs, CFOs and highly compensated employees.

## Provisions That Would Affect the Taxation of Individuals

**New Tax Rate Brackets and Related Changes.** The current seven income tax brackets would be reduced to four: 12 percent, 25 percent, 35 percent and 39.6 percent. For married taxpayers filing jointly, the 39.6 percent bracket threshold would be $1 million. The thresholds for single filers would generally be one-half of those stated above. The 12 percent bracket would phase out for high income taxpayers, resulting in an applicable marginal rate of 45.6 percent until an additional $414,000 has been taxed at the 45.6 percent rate. The new brackets would be effective for tax years beginning after 2017. The "kiddie tax" would be simplified by generally applying the rates for trusts and estates instead of the parents' marginal rate. The standard deduction would be increased to $24,400 for married individuals and $12,200 for most other taxpayers. The deduction for personal exemptions and the personal exemption phase-out would be repealed effective for tax years beginning after 2017. In addition, the individual AMT would be repealed beginning in 2018.

**Patents, Copyrights, Artistic Works and Patents.** Beginning in 2018, persons who created intangible property (or acquired such property in a carryover basis transaction) would no longer be entitled to treat gains and losses from the disposition of such property as capital gains and losses. Instead, such gains and losses would be treated as ordinary gains or losses. While this provision would apply to corporations as well as individuals, its major impact will be on individuals. Concomitantly, the special provision that allowed patent holders to treat the gain from a disposition of less than the entire interest in a patent as a capital gain would be repealed beginning in 2018.

**Repeal of the Pease Limitation.** The US Tax Code limits the deduction for miscellaneous itemized deductions to the lesser of 3 percent of the excess of adjusted gross income over a specified amount or 80 percent of the amount of miscellaneous itemized deductions. This limitation would be repealed beginning in 2018 tax years.

**Attorney Contingent Fees.** Beginning in tax years after enactment, amounts advanced by attorneys in contingent fee arrangements would no longer be deductible. The House is seeking to override the result in *Boccardo v. Comm'r*, 56 F.3d 1019 (9th Cir. 1995).

**Small Business Investment Companies.** Under the House Bill, beginning in 2018, gain from the sale of publicly traded stock could no longer be rolled over into stock (or a partnership interest) in a small business investment company. This provision would apply to corporate, as well as individual, sellers of publicly traded stock.

**Mortgage Interest Deduction.** Beginning in 2018, for debt incurred after November 2, 2017, the deduction for mortgage interest would be limited to the interest on acquisition indebtedness of not more than $500,000 on the taxpayer's principal residence only. Contrast this with current law, which permits the deduction of mortgage interest on up to $1 million in acquisition indebtedness for a principal residence and one other residence, as well as interest on up to $100,000 of home equity indebtedness.

**No Deduction for State Income Taxes.** For tax years beginning after 2017, individuals would not be allowed to deduct foreign, state and local income taxes or sales taxes. Property and sales taxes (but not income taxes) would continue to be deductible, however, if paid or incurred in carrying on a business or producing income. Real property taxes would remain deductible up to $10,000 per year without regard to whether such taxes were incurred in a trade or business and in addition to taxes incurred in a trade or business.

**Expansion of Limitation on Gambling Losses.** The House Bill would expand the items subject to the limitation on gaming losses to include expenses incurred in connection with gaming, such as transportation. Thus, beginning in 2018, costs incurred in connection with gaming activities would be deductible only to the extent that, when added to gaming losses, such amounts are less than gaming income.

**Tax Return Costs.** The House Bill would deny a deduction for any costs incurred for tax return preparation paid in tax years beginning after 2017. Query whether the House understands that its proposal simplifies taxes to the point that virtually no one will have to hire an accountant to prepare their return.

**Repeal of Other Deductions.** The House Bill would deny deductions for unreimbursed medical expenses, contributions to medical savings accounts, student loan interest, qualified tuition payments, casualty losses (other than losses incurred in Hurricanes Harvey, Irma or Maria), moving expenses and alimony, and expenses of being an employee, in each case, beginning in tax years after 2017. These items affect many middle-income taxpayers and have received (and likely will continue to receive) significant press coverage.

**Increase in Charitable Contribution Limit.** The House Bill would increase the limit up to which taxpayers can deduct cash contributions to public charities from 50 percent to 60 percent of the contribution base, beginning in 2018.

**Roth IRA Conversions.** The House Bill would eliminate taxpayers' ability to convert Roth individual retirement accounts (IRAs) into regular IRAs and vice versa beginning in 2018.

**Repeal of Estate Tax.** The proposal would double the exemption for tax-free gifts from $5 million to $10 million (and indexed for inflation from and after 2011) beginning in 2018. The estate tax would be repealed in 2025, but step-up in basis at death would be retained. Beginning in 2025, the top marginal rate on gifts would be reduced to 35 percent.

## Provisions That Would Affect Tax-Exempt Organizations

**Repeal of Private Activity Bonds.** The House Bill would eliminate the tax-advantaged status of "qualified bonds." These are generally categories of bonds where the proceeds of the bonds are used for projects that otherwise contain some level of impermissible non-governmental use but are nevertheless treated as an independent type of approved tax-exempt bonds. The categories

include, among others, 501(c)(3) bonds (e.g., hospital and university), transportation bonds (e.g., airport, dock and highway), waste management bonds and multi-family housing bonds. Interest on qualified bonds issued after December 31, 2017, would not be tax-exempt and would be includible in gross income. On the other hand, under the House Bill, interest payments received after December 31, 2017, on a pre-2018 qualified bond borrowing would remain tax-exempt and would no longer be subject to the federal alternative minimum tax given the repeal of the AMT regime.

**Repeal of Advanced Refunding Bonds.** Under current law, a state and local issuer of governmental tax-exempt bonds may refinance outstanding tax-exempt bonds even where the newly borrowed funds will not redeem the original bonds for more than 90 days. The redemption of bonds with new proceeds more than 90 days after the issuance of those new bonds is called an "advanced refunding." The House Bill views advanced refunding as burdening the federal government with two federally subsidized issuances for a single project. The House Bill would eliminate the tax-exempt treatment of interest received on any advanced refunding bond issued after December 31, 2017.

**UBTI Treatment for Taxable Fringe Benefits.** As discussed above, many fringe benefits provided to employees would not be deductible by employers under the House Bill except to the extent that the value of the fringe benefit is included in the employees' income. Under a parallel provision, a tax-exempt organization would be considered to have earned unrelated business taxable income (UBTI) to the extent that it provides fringe benefits to its employees that are not includible in their income. This provision would apply in the 2018 tax year and after.

**Excise Tax for Compensation Payments More Than $1 Million.** The House Bill includes a provision that would impose a 20 percent excise tax on compensation paid in excess of $1 million to any "covered employee" of Section 501(a) organizations, farmers' cooperatives, governmental entities with income excludable under Section 115(1), and Section 527(e)(1)political organizations in the 2018 tax year and after. A covered employee is one of the five highest paid employees for the year. In addition, the excise tax would apply to employees of a taxable entity if such entity controls, or is controlled by, a tax-exempt entity. No excise tax would be imposed if the taxable entity is limited in the deductibility of the payment under the $1 million rule discussed above. The excise tax would also apply to excess parachute payments.

The House Bill would also impose a 20 percent excise tax on excess parachute payments paid by Section 501(a) organizations and the other organizations listed in the paragraph above. A parachute payment is a payment that is contingent upon an employee's separation from employment if the aggregate present value of such payment equals or exceeds three times the employee's base amount The excess parachute payment tax would also be payable by the exempt organization.

**Excise Tax Based on Investment Income of Private Colleges and Universities.** Section 4969 of the House Bill would impose a 1.4 percent excise tax on the net investment income of private colleges and universities with at least 500 students and assets (other than assets used directly by a college or university in carrying out its exempt purpose) with a value at the close of the preceding year of at least $250,000 per full-time student. For purposes of the tax, the proposal would require a college or university to include assets and income of organizations under its control. The proposed tax would apply to taxable years beginning after December 31, 2017.

**Extension of UBIT to State Pension Plans.** Most tax exempt organizations are subject to unrelated business income tax (UBIT). While state retirement funds are not expressly excluded

from the unrelated business income tax, some have taken the position that they are not subject to UBIT because they perform an essential government function and are therefore exempt from UBIT pursuant Section 115 of the US Tax Code. The House Bill would clarify that state retirement funds are subject to UBIT. The proposal would be effective for taxable years beginning after December 31, 2017.

**Simplification of the Private Foundation Excise Tax.** Under the House Bill, the private foundation excise tax would be simplified from its current 1 percent or 2 percent tax, with its cumbersome mechanics for managing the tax rate, to a uniform rate of 1.4 percent. The proposal would be effective for taxable years beginning after December 31, 2017.

**Section 501(c)(3) Organizations Permitted to Engage in *De Minimis* Political Campaign Activity.** Under the House Bill, political campaign statements made by a Section 501(c)(3) organization in the ordinary course of its activities and which do not result in the organization incurring more than *de minimis* additional expenses will not jeopardize its exempt status and the ability of contributors to deduct their contributions, and will not trigger the excise tax on political expenditures by Section 501(c)(3) organizations. The provision would be effective for taxable years beginning after December 31, 2018, and would not apply to taxable years beginning after December 31, 2023.

## Provisions That Would Affect Insurance

**Modification of the PFIC Exception for Insurance Income.** Current law provides an exception to the passive income treatment for purposes of the passive foreign investment company (PFIC) rules for income from the active conduct of an insurance business provided that the company is predominantly engaged in the insurance business. The House Bill would replace the predominantly engaged test with a requirement that the company's "applicable insurance liabilities" constitute more than 25 percent of the company's total assets as reported on the company's financial statements. Applicable insurance liabilities include loss and loss adjustment expenses and reserves for life and health (other than deficiency, contingency or unearned premium reserves). If the foreign insurance company fails the 25 percent test, the exception may still apply if the company's applicable insurance liabilities exceed 10 percent and the company failed the 25 percent test "solely due to runoff-related or rating-related circumstances."

**Surtax on Life Insurance Company Taxable Income.** One major change for life insurance companies between the version of H.R. 1 approved by the Ways & Means Committee and the version passed by the House has to do with raising revenue. The House Bill includes an 8 percent tax on life insurance company taxable income in place of three insurance proposals in the Committee's version (a major overhaul of life insurance company reserving methods, a change in life insurance proration for purposes of determining the dividends received deduction and an increase in the capitalization of certain policy acquisition expenses (DAC)). The Ways & Means Committee explained that the surtax on life insurance company taxable income "is intended only as a placeholder," and the Committee intends to continue working on rewriting the rules on life insurance reserves, proration and DAC "as the bill moves through the legislative process."

**Revision of Discounting of P&C Company Reserves.** The House Bill significantly revises the way property and casualty (P&C) companies calculate their reserves in three ways that are scored as raising $13.2 billion in tax revenue over 10 years. P&C companies currently are required to discount the tax deduction they take for loss reserves to take account of the true value of money between the date the reserve is established and the date the loss is actually paid. The House Bill would change the interest rate

used in that discounting from a rate based on the US government's borrowing rate to a rate based on the corporate borrowing rate and require discounting over a longer period than under current law. In addition, the House Bill eliminates the P&C companies' option to compute discounting periods over company-specific rather than industry-wide historical loss payment patterns.

**The Anti-Base Erosion Excise Tax Will Impact the Insurance Industry.** The provision in the House Bill imposing a 20 percent excise tax on certain amounts paid by a domestic corporation to a related foreign corporation (described above) apparently will apply to related party reinsurance transactions in which US insurers pay reinsurance premiums to related foreign insurers. Because payment of reinsurance premiums by a US insurer is a deductible amount, the excise tax would apparently apply to the US payor. This provision would have the same effect on related party reinsurance transactions as the much-proposed-but-never-passed Neal bill.

***Please visit Mayer Brown's US Tax Reform Roadmap.***

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## Endnotes

[1] Please see https://www.mayerbrown.com/The-2017-Federal-Tax-Legislation-A-First-Look-11-03-2017/

[2] The "tested income" of a CFC excludes (i) earnings otherwise subject to US taxation (e.g., effectively connected income, Subpart F income); (ii) amounts excluded from Subpart F income under the "look-through," active financing and active insurance exceptions; and (iii) income from the disposition of commodities produced or extracted by the corporation.

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