MAYER • BROWN

Legal Update
December 7, 2017

Senate Bill Passage Takes Tax Reform One Step Closer to Reality

Introduction

Following intense last-minute negotiations, on December 2, 2017, the US Senate voted 51-49 to pass its amended tax reform bill, H.R. 1 (the Senate Bill). Previously, on November 9, 2017, the Joint Committee on Taxation released a lead sheet on the "Tax Cuts and Jobs Act," described as a "conceptual mark" of tax reform legislation proposed by the Senate Finance Committee (the Senate Tax Reform Proposals). With complete bills passed by both houses of Congress, the path to final legislation now must run through a conference committee.[1]

In a prior Legal Update, we asked whether the Senate's "conceptual mark" is like a good piece of music, borrowing a quote from former President Barack Obama.[2] The bill that passed the Senate just before 2 a.m. on Saturday is full of transpositions—and even a few handwritten notes in the margins—but it strikes essentially the same tune.

Notable changes from the earlier Senate Tax Reform Proposals include increasing the deduction for qualified business income of pass-through entities to 23 percent, restoring itemized deductions up to $10,000 for individual state and local property taxes, maintaining the existing corporate AMT and increasing individual AMT exemptions and thresholds, and increasing the deemed repatriation toll tax to 14.49 percent for cash and equivalents and 7.49 percent for illiquid assets.

In any event, like the House Bill, the Senate Bill would represent a sweeping overhaul of the US Tax Code. We have divided our discussion into 10 sections: (i) business generally, (ii) international taxation, (iii) financial institutions, (iv) compensation taxation, (v) individuals, (vi) partnerships, (vii) real estate, (viii) tax-exempt organizations, (ix) insurance and (x) the life settlement industry.

Tax Changes Proposed for Business

20 Percent Corporate Tax Rate. The Senate Bill would tax income earned by C corporations at a flat 20 percent for tax years beginning after December 31, 2018. (The House Bill would impose the same rate, but for tax years beginning after December 31, 2017.)

As a general matter, it is thought that the delayed effective date, coupled with the new allowance for expensing equipment purchases (described below), which would apply to purchases made as early as September 21, 2017, could result in significant capital investments in the US economy. Specifically, the expensing deduction would be much more valuable in a 35 percent tax rate environment than it is in a 20 percent tax rate environment, which may compel taxable corporations considering capital investments to accelerate such investments into the remainder of 2017 and 2018. That said, the retention of the corporate alternative minimum tax (AMT), as described below, may make it harder to realize the benefit resulting from the expensing of equipment purchases.

Retention of Corporate AMT. Unlike the Senate Tax Reform Proposals, the Senate Bill maintains the current 20 percent corporate AMT. Given the reduction in the regular tax rate, it is expected that more corporations would be subject to the AMT.

Accelerated Tax Income Recognition. The Senate Bill requires taxpayers (even if not publicly traded) who prepare financial statements to include items of income at the earlier of the time that the income accrues for tax purposes and the time that the income is taken into account for financial statement purposes. The rule would override the rules for OID (original issue discount) and interest. Income recognized based on special methods of accounting, such as the long-term contracts method, would be exempt. In addition, the Senate proposal would codify the one-year deferral rule of Revenue Procedure 2004-34, which is applicable to advance payments for goods and services. Other than the OID rules, which are effective for tax years beginning after 2018, the accelerated tax income rules are effective for tax years beginning after 2017.

5-Year Expensing for New Property. The Senate Bill permits full expensing (that is, 100 percent bonus depreciation) of new property placed in service on or after September 27, 2017, and before 2023 (2024 for property with longer production periods and certain aircraft). The Senate Bill phases out bonus depreciation by stepping the amount of bonus depreciation down by 20 percent per year for property placed in service between 2023 and before 2027 (2028 for property with longer production periods), at which point no bonus depreciation is available. The Senate Bill allows taxpayers to elect to claim a 50 percent allowance. Public utility property would be excluded.

In contrast to the House Bill, the Senate Bill does not extend bonus depreciation to used property.

Small Business Expensing. Current law permits taxpayers to expense up to $500,000 of qualifying property placed into service in a given year.[3] The deduction is phased out if the taxpayer places more than $2 million of property in service. The Senate Bill increases these amounts to $1 million and $2.5 million, respectively, beginning in 2018. In addition, the Senate Bill expands the provision to include improvements to nonresidential real property.

Repeal of Domestic Production Deduction. The Senate Bill repeals the deduction for income attributable to domestic production activities for tax years beginning after December 31, 2017.

Revised NOL Rules. The Senate Bill follows the House Bill by (i) limiting the use of net operating losses (NOLs) to 90 percent (which is reduced to 80 percent for tax year beginning in 2023) of taxable income, (ii) eliminating any ability to carry-back such losses (except for certain insurance companies) and (iii) providing for an indefinite carry-forward. The 90 percent limitation would apply to losses arising in taxable years beginning in 2018. The latter two rules would apply to NOLs arising in taxable years ending after 2017.

New Limits on the Deduction of Interest. The Senate Bill limits the ability to deduct business interest expense to the sum of (i) business interest income and (ii) 30 percent of adjusted taxable income. For this purpose, taxable income would be reduced by non-business income, NOLs and business interest income. Notably, in contrast to the current Code § 163(j) and the House Bill, "adjusted taxable income" would factor depreciation and amortization deductions (i.e., the Senate Bill uses EBIT rather than EBITDA). This would generally result in a more stringent limitation. Any business interest disallowed in a given year could be carried forward indefinitely. Because the limitation only applies to net interest expense, banks generally should not be disproportionately affected.

The limitation would apply at the partnership level when interest expense is incurred by a partnership. Rules are provided so that income is not double counted (once when earned by the partnership and again when it is passed through to the partner). In addition, income that is not

counted by a partnership in determining its interest deduction may be taken into account by the partner in determining its interest expense in subsequent years. Similar rules apply to S corporations.

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.[4] This deduction is referred to as the dividend received deduction (DRD). The Senate Bill reduces the DRD from 70 percent to 50 percent for portfolio dividends, that is, dividends paid on stocks in which the recipient owns less than 20 percent of the payor. The DRD on stocks in which the recipient owns at least 20 percent but less than 80 percent would be reduced from 80 percent to 65 percent. Both proposals would be effective for tax years beginning after December 31, 2018, 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.[5] The Senate Bill expands the ability to use the cash method of accounting to businesses with average annual gross receipts of $15 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 Senate Bill would expand the ability of C corporations engaged in farming to use the cash method. The Senate Bill also simplifies inventory accounting, and provides exemptions from the uniform capitalization rules, for businesses eligible to use the cash method. These changes would be effective beginning in 2018

Fringe Benefits. The Senate Bill disallows deductions for qualified transportation fringe benefits, any entertainment activities, club membership dues and facilities associated with entertainment or clubs (presumably including in-house gymnasiums) beginning in 2018. The Senate Bill would continue to allow a 50 percent deduction for food and beverage expenses related to a trade or business beginning in 2018 but would eliminate deductions for meals provided to employees for the convenience of the employer or through employer-operated eating facilities. The rules eliminating deductions for employer-provided meals are applicable to amounts incurred or paid beginning in 2026.

International Tax Proposals

Transition to a Territorial System—The Participation Exemption. Like the House Bill, the Senate Bill introduces a "participation exemption" for foreign-source dividends received from non-US subsidiaries beginning in 2018. Specifically, dividends attributable to non-US source income paid by a foreign corporation to a US corporation 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 exempt dividends. To benefit from this exemption, the US shareholder must meet a minimum holding period (more than 365 days during the 731-day period beginning 365 days before the *ex dividend* date).[6] In addition, the dividend-received deduction would not be available if the payer received a tax benefit or other deduction from the foreign country (a "hybrid dividend"). Dividends distributed by passive foreign investment companies would not benefit from the participation exemption.

The Senate Bill states that the participation exemption would also apply to gain 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.

Dividends that qualify for the participation exemption would reduce the domestic corporation's basis in the stock of the foreign corporation solely for purposes of determining a loss on the sale of such stock.

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 Senate Bill would repeal the Section 956 "deemed dividend" rules for US corporations that are shareholders of a controlled foreign corporation (CFC), including through a domestic partnership. 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).

Deemed Repatriation Tax or "Toll Charge." Similar to the House Bill, the Senate Bill imposes a one-time tax on the non-previously taxed post-1986 earnings of foreign subsidiaries. The tax would apply to US shareholders (corporate and non-corporate) that own 10 percent or more of the voting power in (i) a CFC or (ii) in a foreign corporation that has at least one corporate US shareholder that owns 10 percent or more of the foreign corporation's voting power (each, a "specified foreign corporation").

The earnings of specified foreign corporations would be measured either as of November 9, 2017 or as of December 31, 2017, whichever is greater, and would be includible in income by the US shareholder in the last tax year that begins before January 1, 2018.

For US corporate shareholders, this one-time tax would be imposed at a 14.5 percent rate for foreign earnings attributable to cash and other liquid assets and at a 7.5 percent rate for the remainder of the earnings (that is, earnings that are treated as reinvested in illiquid assets).[7] The US shareholder's "cash position" is the greater of its pro rata share of the cash position of all specified foreign corporations as of the last day of the mandatory inclusion or the average of the cash position for the preceding tax years.

Corporate shareholders would be allowed foreign tax credits 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.

US shareholders may offset the earnings of their foreign subsidiaries with post-1986 accumulated deficits of other foreign subsidiaries as of the measurement date.

As in the House Bill, taxpayers may elect to pay this deemed repatriation tax in up to eight annual installments. However, while the House Bill provided for equal payments, the Senate Bill would allow taxpayers to backload the installments so that they are required to settle only 40 percent of the tax liability in the first five years.

Finally, a recapture provision would require a US shareholder that becomes an "expatriated entity" in an inversion transaction in the succeeding ten years to pay the repatriation tax at a 35 percent tax rate with no additional foreign tax credits.

The "GILTI" Regime for CFC's Intangible Income. With some resemblance to the "foreign high returns" provisions in the House Bill, the Senate Bill provides that a US shareholder of any CFC would be currently taxed on its "global intangible low-taxed income" or "GILTI." Consistent with its sister provision in the House Bill, this regime would mainly affect US multinationals earning significant income from intellectual property in low-tax jurisdictions.

The GILTI is any excess of (i) the shareholder's aggregate net income from its CFCs (excluding, among others, items of Subpart F income and "effectively connected income") *over* (ii) a "net deemed tangible income return" (a "routine return") equal to 10 percent of the shareholder's *pro rata* share of the aggregate adjusted bases of the CFCs' depreciable tangible property. Thus CFCs that primarily own intangible assets or highly depreciated tangible property would not

present much of a routine return that could serve to reduce the GILTI inclusion.

For corporate shareholders, the Senate Bill offers a 50 percent deduction over the GILTI amount for 2018 through 2025, and a 37.5 percent deduction beginning in 2026. This would result in GILTI being taxed at a 17.5 percent effective rate for 2018, a 10 percent effective rate in 2019 through 2025, and a 12.5 percent rate beginning in 2026. It appears that non-corporate US shareholders would not benefit from a deduction over their GILTI amount.

In addition, inclusions of GILTI by US corporate shareholders would carry foreign tax credits equal to 80 percent of the otherwise allowable amount. The Senate Bill creates a separate foreign tax credit basket for GILTI, with no carry-forward or carry-back for excess credits.

The GILTI regime would apply for tax years beginning after December 31, 2017.

The Deduction for Foreign-Derived Intangible Income. The Senate Bill also provides a 37.5 percent deduction (reduced to a 21.875 percent deduction starting in 2026) for "foreign-derived intangible income." As a result, foreign-derived intangible income would be taxed at an effective rate of 12.5 percent starting in 2019. Foreign-derived intangible income is income derived directly by a US corporation that, through a complex set of rules, is treated as intangible income from the sale, license or lease of property and the provision of services to foreign persons for foreign use. This provision is intended to encourage retention of intangibles in the United States through taxation at particularly favorable corporate income tax rates.

Special Rule for IP Repatriation. The Senate Bill reduces (and in some cases eliminates) the tax cost of repatriating into the United States intangible property held by a CFC. This incentive seeks to encourage US multinationals to bring their IP onshore in connection with the reduction of the US corporate tax rate and the foreign-derived intangible income deduction.

Specifically, if a CFC distributes certain intangible property to a US shareholder, the fair market value of that property on the date of distribution shall be treated as not exceeding the adjusted basis of the property in the hands of the CFC immediately before the distribution. The US shareholder would then take a carryover basis in the intangible property. For this benefit to apply, the CFC must have held the intangible property as of the date of enactment of the proposal and the distribution must occur during the first three tax years beginning after December 31, 2017.

Expansion of Rules for Outbound Transfers of Intangibles. The Senate Bill expands when outbound transfers of intangibles to foreign corporations would be taxable. In this regard, the Senate Bill generally puts into law the approach recently adopted by the Internal Revenue Service (IRS) in which outbound transfers of workforce in place, goodwill and going concern value are treated as transfers of intangible property subject to tax under the "deemed royalty" regime of Section 367(d).[8] Importantly, the Senate Bill also picks up transfers of domestic, as well as foreign, goodwill.

Repeal of Active Trade or Business Exception for Outbound Transfers of Property. Surprisingly, the Senate Bill repeals the long-standing exception to gain recognition for transfers to a foreign corporation of property that is used in the active conduct of a trade or business outside the United States. This may create incremental US tax costs for incorporation of foreign branches (e.g., by "checking" a foreign disregarded entity to be treated as a corporation).

Limit on Deduction of Interest Expense for Excess Domestic Indebtedness. Along the lines of the House Bill, although using different mechanics, the Senate Bill includes a provision that, beginning in 2018, would disallow interest expense deductions for US corporations that are overleveraged compared to their worldwide affiliated group. For any US corporation that is a member of a worldwide affiliated group, the Senate Bill would disallow the interest expense

attributable to its "excess domestic indebtedness." Excess domestic indebtedness is the amount by which the total indebtedness of the US members of the group exceeds a threshold percentage of the amount of indebtedness those members would hold if their debt-to-equity ratio were proportionate to the worldwide group's debt-to-equity ratio. The threshold percentage is 130 percent for 2018 and would be reduced by 5 percent in each subsequent year until it reaches 110 percent, applicable for 2022 and thereafter. There are no rules grandfathering existing debt for purposes of this provision.

Similar to that of the House Bill, this limitation based on the group's leverage ratio would only apply to the extent it is greater than the 30 percent of EBIT limitation described above. The amount of any interest disallowed as a deduction can be carried forward indefinitely.

The "Base Erosion Minimum Tax." The Senate Bill would introduce a minimum tax regime, to begin in 2018, based on a modified taxable base that adds back deductions for "base erosion payments." The Base Erosion Minimum Tax would equal the excess of (i) 10 percent of the taxpayer's "modified taxable income" for the tax year *over* (ii) the regular tax liability for the year reduced by the excess of certain tax credits over the research credit. Newly added to the Senate Bill, banks and securities dealers would be subject to an 11 percent rate when calculating their Base Erosion Minimum Tax. Beginning in 2026, the rate for the Base Erosion Minimum Tax would be 12.5 percent (and 13.5 percent for banks and securities dealers).

The "modified taxable income" over which the minimum tax is calculated is the taxable income determined without regard to any deductions with respect to any "base erosion payments" and without regard to a proportion of the NOL carryovers equal to the "base erosion percentage."[9]

A "base erosion payment" is a payment made to a related foreign person that is deductible or includable in the basis of a depreciable or amortizable asset. Payments that are included in cost of goods sold (e.g., purchases of merchandise) would not be considered base erosion payments unless the recipient is a related "surrogate foreign corporation" (or an affiliate thereof) resulting from an inversion transaction. A payment would not be considered a base erosion payment to the extent it is subject to US withholding tax. The Senate Bill also excepts from the definition of "base erosion payments" amounts paid or accrued by a taxpayer for services provided at cost and certain"qualified derivative payments."

This base erosion minimum tax would apply to domestic corporations that (i) are part of a group with average annual gross receipts of at least $500 million in the preceding three-year period (gross receipts of foreign affiliates are only taken into account to the extent they are "effectively connected income") and (ii) have a base erosion percentage of 4 percent or higher for the tax year. Regulated investment companies, real estate investment trusts and S corporations would be exempt from this minimum tax.

Disqualified Expenses Paid in Hybrid Transactions or to Hybrid Entities. The Senate Bill would deny a deduction for any "disqualified related party amount" paid pursuant to a "hybrid transaction" or to a "hybrid entity." A disqualified related party amount is any interest or royalty paid to a foreign related party to the extent that, under the laws of such party's country of residence, there is no corresponding income inclusion or the related party is allowed a deduction for a corresponding amount. A hybrid transaction is any transaction or instrument wherein payments are treated as interest or royalties for US tax purposes but not so under the tax laws of the recipient's country of residence. A hybrid entity is any entity that is treated as fiscally transparent for US tax purposes but not for foreign tax purposes or vice versa. This proposal would be effective for tax years beginning after December 31, 2017.

Modifications to CFC/Subpart F Regime. The Senate Bill incorporates a number of modifications to the Subpart F regime. Notably, the Bill expands the definition of "United States

shareholder" to include US persons that own 10 percent of the vote *or value* of a foreign corporation (the definition under current law focuses exclusively on voting power). The Senate Bill would also modify certain stock attribution rules in the determination of CFC status, which may result in various foreign corporations unexpectedly becoming CFCs. Unlike the Senate Tax Reform Proposals, in which both of these changes were effective for the 2017 tax year, the Bill makes the modification to the attribution rules effective beginning in the 2017 tax year, but the expanded definition of "United States shareholder" effective beginning in the 2018 tax year.

Like the House Bill, the Senate Bill would eliminate the requirement that a corporation be a CFC for 30 uninterrupted days during the year for the Subpart F regime to apply.

Foreign based company oil related income would no longer constitute Subpart F income subject to current US taxation.

The "look-through" exemption 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 Senate Bill no longer treats 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, as in the House Bill, this income would be sourced solely based on the location of the production activity.

Separate Foreign Tax Credit Basket for Foreign Branch Income. Beginning in 2018, the Senate Bill, like the Senate Tax Reform Proposals, allows that foreign source income earned through one or more branches in one or more countries would be allocated to a separate foreign tax credit basket.

Acceleration of Election to Allocate Interest Expense on Worldwide Basis. Section 864(f) of the US Tax Code permits taxpayers to make a one-time election to allocate and apportion interest expense on a worldwide basis. The effective date of Section 864(f) has been continually postponed and is currently set for tax years beginning after December 31, 2020. However, the Senate Bill would accelerate this effective date to tax years beginning after December 31, 2017.

Repeal of Fair Market Value Election for Interest Expense Apportionment. The Senate Bill retains the change in the Senate Tax Reform Proposals that would no longer allow taxpayers to use the fair market value of assets to apportion interest expense between foreign and domestic source income. Instead, in all cases taxpayers would be required to use the adjusted tax bases of assets.

Tax (and Withholding) on Disposition of Partnership Interests. The Senate Bill addresses a long-standing controversial issue regarding the treatment of gains from the sale by non-residents of interests in a partnership engaged in a US trade or business. The IRS had ruled that a portion of the gain from the disposition of a partnership interest may be treated as income effectively connected with the conduct of a US trade or business to the extent the gain from a hypothetical sale of the partnership's assets would be treated as such.[10] However, the Tax Court recently rejected this IRS ruling in the *Grecian Magnesite* decision, concluding that gain from the sale or exchange by a foreign person of a partnership interest shall be treated as foreign source income, even when the partnership is engaged in a US trade or business. [11] The Senate Bill would override *Grecian Magnesite* and would treat gain or loss from the sale or exchange of a partnership interest as effectively connected with a US trade or business to the extent the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value.

In addition, the Senate Bill implements a withholding regime for transfers of partnership interests that would result in gain treated as

effectively connected income. Upon the transfer of the partnership interest, the transferee would be required to withhold 10 percent of the amount realized on the sale or exchange unless the transferor certifies its status as not being a non-resident alien individual or foreign corporation.[12]

These changes would apply to transfers of partnership interests made on or after November 27, 2017.

Surrogate Foreign Corporations Not Eligible for Qualified Dividend Rates. The Senate Bill would deny the preferential "qualified dividend income" rate to dividends distributed by a foreign corporation that is treated as a "surrogate foreign corporation" under Section 7874 (i.e., the foreign acquiror in an inversion transaction within the 60 percent–80 percent shareholder continuity range). This rule would apply to dividends paid in tax years beginning after December 31, 2017.

Tax Changes Directed at Financial Institutions

The tax changes identified in the Senate Bill mirror those described in the earlier Senate Tax Reform Proposals.

FDIC Premiums. Beginning in 2018, 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.

Basis Reporting. While cast as a change to the rules relating to basis reporting, the Senate Bill would actually affect investors more than financial institutions. Specifically, beginning in 2018, the Senate Bill requires the use of first-in first-out basis allocation for sold securities except to the extent that the average basis method is allowed (as in the case of stock of a RIC). Since longer-held securities generally have more gain than shorter-held securities, this reporting is likely to cause investors to be considered to sell lower basis securities before higher basis securities.

Changes to Compensation Taxation

The changes identified in the Senate Bill relating to compensation vary significantly from those described in the Senate Tax Reform Proposals.

Deduction Limits for Highly Compensated Employees of Public Companies. The US Tax Code currently limits the amount of compensation that a publicly traded corporation may deduct to $1 million for CEOs and the other four most highly compensated officers ("covered employees") whose compensation must be reported under the federal securities laws, except where the compensation is based on performance. Like the Senate Tax Reform Proposals, the Senate Bill repeals the current law exception for performance-based compensation and commissions. The Senate Bill also revises the definition of covered employee to conform to changes in terminology made in 2006 to the SEC reporting rules for executive compensation; under the Senate Bill, "covered employee" includes a corporation's "principal executive officer" and "principal financial officer" (in the case of "principal financial officer, the effect is to restore a corporation's CFO as a covered employee). Under the Senate Bill, once an individual becomes a covered officer, the individual remains a covered officer for all future years (including with respect to compensation paid to a covered employee's beneficiaries after his or her death). Finally, the Senate Bill would expand the definition of a publicly traded corporation to include issuers that are required to file reports under 15 U.S.C. § 78o(d).

Increase in Excise Tax Rate for Stock Compensation of Insiders in Expatriated Companies. The US Tax Code currently provides an excise tax on stock compensation received by high-level employees in an inverted corporation. Generally, the excise tax equals 15 percent of the

value of the stock compensation. The Senate Bill would increase the excise tax rate to 20 percent.

Tax Changes Proposed for Individuals

Tax Year 2025 Sunset. The Senate Bill sunsets most of the individual provisions after tax year 2025. No sunset was included in the original Senate Tax Reform Proposals, but they have been incorporated to comply with a Senate budget reconciliation rule. The 2025 sunset does not apply to the repeal of the ACA's individual mandate.

Lowering of Top Marginal Rate. The Senate Bill lowers the top marginal rate, beginning in 2018, from 39.6 percent to 38.5 percent. The new top marginal rate would apply to taxable incomes of $500,000 or more for single filers and $1 million for married couples filing joint returns (up from $418,400 and $470,700, respectively). The Senate Bill simplifies the "kiddie tax" by applying the rates for trusts and estates to children's unearned income instead of the parents' marginal rate. This is pared down from the Senate Tax Reform Proposals, which applied all four of the rates for trusts and estates. The Senate Bill increases the standard deduction to $24,000 for married individuals filing jointly, $12,000 for single filers, and $18,000 for heads of household, and the bill eliminates the personal exemption deduction.

AMT. Though the Senate Tax Reform Proposals eliminated the individual AMT, the current Senate Bill retains AMT but temporarily increases both the exempt amount and the phase-out thresholds.

Pass-Through Income. The Senate Bill is similar to the Senate Tax Reform Proposals, but provides a more generous tax cut to individuals with a broader range of incomes. The Senate Bill provides non-corporate taxpayers a 23 percent deduction for "qualified business income," earned from a partnership, S Corporation or sole proprietorship, increased from the 17 percent deduction in the Senate Tax Reform Proposals. For individuals with income of at least $250,000, or $500,000 for joint filers, the deduction is limited to 50 percent of the individual's portion of the business's W-2 wages. That limitation is phased in over the next $50,000 of taxable income ($100,000 for joint filers). Qualified business income does not include specified services income, which includes, among others, health, law, engineering, architecture, accounting and financial services. But a taxpayer with income less than $250,000, or $500,000 for joint filers—up from $75,000 and $150,000 respectively—may still take this deduction without regard to whether that income is services income; the restriction on services income is phased in similarly to the 50 percent W-2 wage limitation.

Limitation on Pass-Through Loss. Under current law, to the extent deductions attributable to passive activities exceed income from those activities, they may not be deducted against other sources of income. The Senate Bill adds a limitation for non-passive losses. Beginning in 2018, the Senate Bill would allow up to $250,000 ($500,000 for joint return) of net and aggregate pass-through losses to offset other income, such as investment income and wages. Disallowed pass-through losses are carried forward as net operating loss. In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner or shareholder take its allocable share of the partnership's or S corporation's items of income, gain, deduction, or loss into account.

Limitation of State and Local Tax Deduction. Unlike the Senate Tax Reform Proposals, which eliminated nearly all state and local tax deductions, the Senate Bill allows a deduction for state and local real property tax to $10,000 (married filing separately $5,000). The bill denies other state or local taxes, except to the extent such taxes are incurred in connection with the conduct of a trade or business or a for-profit activity.

Suspension of Miscellaneous Itemized Deductions. Like the Senate Tax Reform Proposals, the Senate Bill denies deductions for all miscellaneous itemized deductions, beginning in

2018. The suspension denies deductions for investment management fees, including fees charged by hedge funds, and denies deductions for transactions entered into for profit, including losses from swap (notional principal contract) transactions and from foreign exchange transactions that taxpayers had not elected to treat as capital transactions.

Gift and Estate Tax Exclusion. The Senate Bill temporarily increases the unified credit from $5 million to $10 million for tax years starting in 2018 until 2026.

Partnerships

Expansion of Built-in Loss Rules. The built-in loss rules force a mandatory basis step-down when a partnership interest changes hands and the partnership has a net built-in loss of more than $250,000. These rules (essentially a mandatory Section 754 election) prevent two taxpayers from claiming the same economic loss as a tax loss. Beginning December 31, 2017, the Senate Bill (same as the Senate Tax Reform Proposals) would test the existence of a built-in loss at the partner and partnership level, so even if the partnership did not have a built-in loss, if there was a built-in loss in a partner's partnership interest (assuming all the partnership assets are sold for cash equal to their fair market value immediately after transfer), the mandatory basis step-down would occur.

Expansion of Basis Limitation Rules. A partner may not claim losses from a partnership to the extent that the losses exceed the partner's basis in his partnership interest. Charitable contributions and foreign taxes are not within the category of items that are treated as losses. Beginning December 31, 2017, same as the Senate Tax Reform Proposals, the Senate Tax Bill would expand the items that cannot be claimed by a partner in excess of his basis to include charitable contributions and foreign taxes.

3-Year Holding Period for Carried Interest. The Senate Tax Bill contains the same 3-year holding rules for carried interest as those proposed in the House Tax Bill. Beginning December 31, 2017, a partner generally must hold an "applicable partnership interest" for at least three years to qualify for the long-term capital gain treatment. An applicable partnership interest is an interest held in connection with the 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. An applicable partnership interest does not include any interest held by a corporation, or any capital interest allowing the partner to share in partnership capital commensurate with the amount of capital contributed (determined upon receipt of such partnership interest).

Treatment of Revoking S Corporations. The Senate Bill adopted the beneficial treatment provided in the House Tax Bill for a S corporation that converts into a C corporation after the enactment of the bill. Beginning with the year of a change of accounting method, an "eligible terminated S corporation" may take into account any section 481(a) adjustment attributable to the change ratably for six years. Also, cash distributions by an eligible terminated S corporation would be treated as coming out of the corporation's accumulated adjustments account or earnings and profits, in the same ratio as the amount of the accumulated adjusted account bears to the earning and profits. The bill defines an eligible terminated S corporation as any C corporation that (i) is an S corporation before the enactment of the bill, (ii) revokes its S corporation election within two years after the enactment of the bill, and (iii) is owned by the same persons in the same proportions when the bill is enacted and when the S corporation election is revoked.

Tax Changes Directed at Real Estate

Several changes announced in the Senate Tax Reform Proposals related to real estate have been retained, with minor modifications, in the final version of the Senate Bill.

Reduction in Depreciable Life. The Senate Bill would shorten the depreciable life for both residential and non-residential real property to 25 years (from 27.5 and 39 years, respectively) for property placed in service in 2018. The Senate Bill would also end distinctions among various types of improvements and provide for a 10-year recovery period for qualified improvement property. In addition, qualified improvement property would be eligible for small business expensing (Section 179 expensing). The changes would be effective for property placed in service after December 31, 2017.

LKEs. The Senate Bill would limit the ability of taxpayers to engage in Like-Kind Exchanges (LKEs) to only non-inventory real estate for exchanges occurring after 2017. This change could adversely impact the high-end art market as many of the participants in such market have used LKEs. The Senate Bill also makes clear that US real property and foreign real property are not like-kind for purposes of the provision.

Reduction in Tax Rate for REIT Dividends. The Senate Bill provides a deduction of 23 percent —increased from the original 17.4 percent in the Senate Tax Reform Proposals—of the amount of ordinary dividends (i.e., not capital gain dividends or qualified dividend income) received from a real estate investment trust (REIT), beginning in 2018.

Principal Residence Gain Exclusion. The Senate Bill would increase the length of time that a taxpayer must have resided at his or her principal residence before the taxpayer can take advantage of the $500,000 gain exclusion from two of the last five years to five of the last eight years. The change applies to sales or exchanges from 2018 through 2025.

HELOCs. The only change to the home mortgage interest deduction rules in the Senate Bill is to repeal the deduction for interest paid on home equity lines of credit (HELOCs) beginning in 2018, regardless of when amounts on the HELOC had been drawn. The repeal would remain in effect until 2026.

Tax Changes Directed at Tax-Exempt Organizations

Excise Tax for Compensation Payments More Than $1 Million. Like the Senate Tax Reform Proposals, the Senate Bill includes a provision that would impose a 20 percent excise tax on compensation paid in excess of $1 million to any "covered employee" in 2018 or after. A covered employee is one of the five highest paid employees for the year or anyone who was a covered employee for any tax year beginning after December 31, 2016. In addition, the excise tax would apply to employees of taxable entities if such entity controls, or is controlled by, the tax-exempt entity. (No excise tax is imposed if the taxable entity is limited in the deductibility of the payment under the $1 million rule discussed above.) The excise tax also applies to excess parachute payments.

Excise Tax on Income of Large Private Educational Institutions. Like the Senate Tax Reform Proposals, the Senate Bill would impose a 1.4 percent excise tax on the investment income earned by large private colleges and universities and related organizations beginning in 2018. Under the Senate Bill, the excise tax would apply only if the value of the endowment is at least equal to $500,000 per student.

Elimination of Proposed Expansion of Unrelated Business Income Taxes (UBIT) Rules. Senate Bill eliminated the provision from the Senate Tax Reform Proposals that would have treated royalty income from the licensing of a tax-exempt organization's name or logo as unrelated business taxable income beginning in 2018.

Segregation of Unrelated Businesses. Like the Senate Tax Reform Proposals, the Senate Bill would require tax-exempt organizations subject to the UBIT to silo each trade or business beginning in 2018, with the result that losses from one trade or business could not be used to shelter income from another trade or business. However, the Senate Bill provides that this requirement will not apply to preexisting NOLs (i.e., from tax years

beginning prior to 2018) from a trade or business that are carried over to future years.

Increase in Charitable Contribution Limit. Like the Senate Tax Reform Proposals, the Senate 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.

Professional Sports Teams. The Senate Bill eliminated the provision from the Senate Tax Reform Proposals that would have stripped the National Football League of its tax exemption beginning in 2018.

No Change to Excess Benefit Transactions Sanctions. "Intermediate sanctions" is an excise tax penalty regime applicable to tax-exempt Code Section 501(c)(3) charitable organizations (other than private foundations). The intermediate sanctions penalties apply to "excess benefit transactions"—compensation and property transactions between a covered exempt organization and a "disqualified person" in which the amount paid or the economic benefit provided to the disqualified person is determined to be excessive.

If an excess benefit transaction is found to have occurred, a tax of 25 percent of the excess benefit (e.g., the excess amount of compensation paid to a disqualified person) is imposed on the disqualified person. An additional tax of 200 percent is imposed on the disqualified person's excess benefit if the violation is not corrected. The Senate Tax Reform Proposals would have substantially toughened the intermediate sanctions regime. However, the Senate Bill eliminated provisions addressing this issue. As a result, the existing intermediate sanctions regime will continue to apply.

Insurance Provisions

Modification of the PFIC Exception for Insurers. 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 Senate Bill would replace the predominantly engaged test with a requirement that the company's "applicable insurance liabilities" exceed 25 percent of the company's total assets as reported on financial statements. If the non-US company fails the 25 percent test, the exception may still apply if the insurer meets at least the 10 percent threshold and failed the 25 percent test "due solely to run-off-related or rating-related circumstances."

Increase in the DAC Capitalization Rates. Under current law, insurance companies with premiums from "specified insurance contracts" (primarily life and annuity contracts) are required to capitalize a certain percentage of their otherwise deductible ordinary and necessary business expenses and spread those deductions over 10 years. The Senate Bill would increase those capitalization percentages from 1.75 percent to 2.1 percent for annuities, from 2.05 percent to 2.46 percent for group life contracts and from 7.7 percent to 9.24 percent for all other specified insurance contracts. The Senate Bill would extend the amortization period from 120 months to 180 months. These changes are less drastic than those in the earlier Senate Tax Reform Proposals, which would have extended the amortization period to 600 months and increased the capitalization percentages to 3.17 percent for annuities, 3.72 percent for group life contracts, and 13.97 percent for all other specified insurance contracts.

Net Operating Losses of Life Insurance Companies. Under current law, the net operating loss deduction under section 172 is generally disallowed to life insurance companies. In lieu of the net operating loss deduction, however, life insurance companies are allowed an "operations loss deduction," the computation of which parallels the computation of the net operating loss deduction. The Senate Bill repeals the special "operations loss deduction" provisions, and permits life insurance companies to take section 172 net operating loss deductions.

Repeal of Small Life Insurance Company Deduction. Under current law, life insurance companies with less than $500 million in assets are permitted a deduction equal to 60 percent of their first $3 million in taxable income, with a phase-out up to $15 million in taxable income. The Senate Bill repeals this deduction.

Adjustment for Change in Computing Reserves. Current law provides that any income or loss resulting from a change in method for computing an insurance company's reserves be taken into account over a 10-year period. The Senate Bill would eliminate this special provision, and provide that income or loss resulting from a change in method be taken into account according to general section 481 IRS procedures, which is generally over a four-year period.

Repeal of Special Rule for Distributions to Shareholders from Pre-1984 Policyholders Surplus Accounts. Current law imposes corporate income tax on distributions to shareholders made from policyholders surplus accounts. The Senate Bill repeals this provision, and provides for phased inclusion of income for any existing pre-1984 policyholders' surplus accounts over eight years.

Modification of Proration Rules for Property and Casualty Insurance Companies. Under current law, property and casualty insurance companies must reduce the amount they deduct for losses incurred by 15 percent of (i) the insurer's tax-exempt interest income, (ii) the deductible portion of dividends received (with special rules for dividends from affiliates), and (iii) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns. The Senate Bill modifies this percentage to 5.25 percent divided by the top corporate tax rate. For a top corporate tax rate of 20 percent, the reduction percentage would be 26.25 percent.

Repeal of Special Estimated Tax Payments. Current law allows insurance companies to elect to deduct certain amounts of unpaid losses. If the election is made, taxpayers must establish a special loss discount account for the deductions made and must make special estimated tax payments equal to the tax benefit of the additional deduction. The Senate Bill repeals this provision.

Life Settlement Provisions

The provisions in the Senate's Bill related to the life settlement industry are the same as those provided for in the Senate's Proposed Bill and the Senate's Tax Reform Proposals.

Reportable Policy Sales. Purchasers of interests in life settlements in 2018 or after who do not have a familial or business relationship to the insured must report a sale of a life insurance policy to the seller, the insurer and the IRS. (It appears that the reporting would be made on IRS Form 1099.)

Insurer Basis Reporting. As stated in the Senate Tax Reform Proposals, the Senate Bill requires each insurer under a life insurance contract, following receipt of a reportable policy sale notice, to report the seller's basis in the life insurance contract to the IRS and the seller. Reporting is also required upon the transfer of a life settlement to a non-US person.

Death Benefit Reporting. If an insurer has received a notice of a reportable policy sale, when death benefits are paid on the life insurance policy, the insurer would be required to report to the payee and the IRS (i) the gross amount of the death benefits, (ii) the TIN (taxpayer identification number) of the payee and (iii) the insurer's estimate of the holder's basis in the life insurance contract.

Reversal of IRS Position in Revenue Ruling 2009-13. In Revenue Ruling 2009-13, the IRS ruled that an insured's basis in an insurance policy is reduced by the cost of insurance, that is, the portion of the premiums allocable to insurance coverage. The Senate Bill reverses this position and allows insureds to count such charges in their basis in the insurance policy retroactively to August 25, 2009 (the date of issuance of Rev. Rul. 2009-13).

Modification of Transfer for Value Rules. The statutory exceptions to the transfer for value rules allow certain transferees to exclude the death benefits from income. The Senate Bill makes these exceptions inapplicable to reportable policy sales beginning in 2018.

For more information about this topic, please contact any of the following lawyers.

Jason S. Bazar
+1 212 506 2323
jbazar@mayerbrown.com

George W. Craven
+1 312 701 7231
gcraven@mayerbrown.com

Erin Gladney
+1 212 506 2639
egladney@mayerbrown.com

Brian W. Kittle
+1 212 506 2187
bkittle@mayerbrown.com

Mark H. Leeds
+1 212 506 2499
mleeds@mayerbrown.com

William G. McGarrity
+1 312 701 8928
wmcgarrity@mayerbrown.com

Warren S. Payne
+1 202 263 3831
wpayne@mayerbrown.com

James C. Williams
+1 312 701 8139
jcwilliams@mayerbrown.com

Lucas Giardelli
+1 212 506 2238
lgiardelli@mayerbrown.com

Endnotes

[1] For the Mayer Brown coverage of the House Bill, see https://www.mayerbrown.com/files/Publication/bfb55fb5-6a94-4537-8c25-6312c4e4a427/Presentation/PublicationAttachment/996904bd-8206-4ab4-95d6-bb67a5aa3933/A-Sisyphean-Task-The-House-of-Representatives-Passes-Tax-Reform-Legislation.pdf

[2] See https://www.mayerbrown.com/files/Publication/18684547-c293-4e45-815a-456f08235043/Presentation/PublicationAttachment/6891031c-de63-4ef2-99c3-5897985b8f58/Mailing-171113-CHI-Tax-CS-BF-Insurance-Energy-Lit-Update.pdf

[3] Code § 179.

[4] Code § 243.

[5] Code § 446.

[6] This is longer than the 181-day holding period in the Ways & Means Bill.

[7] After the latest amendments, the House Bill currently contemplates rates of 14 percent for earnings held in cash and liquid assets and 7 percent for the remainder.

[8] *See* T.D. 9803 (Dec. 16, 2016).

[9] The "base erosion percentage" for a tax year results from dividing the amount of the taxpayer's base erosion deductions by the aggregate number of its allowable deductions (without taking into account any NOL carryovers).

[10] Rev. Rul. 91-32, 1991-1 C.B. 107.

[11] *Grecian Magnesite Mining v. Comm'r*, 149 T.C. No. 3 (July 13, 2017).

[12] As a backstop, to the extent the transferee fails to withhold the correct amount, the partnership would have a withholding obligation in future distributions to the transferee.

Mayer Brown is a global legal services organization advising clients across the Americas, Asia, Europe and the Middle East. Our presence in the world's leading markets enables us to offer clients access to local market knowledge combined with global reach.

We are noted for our commitment to client service and our ability to assist clients with their most complex and demanding legal and business challenges worldwide. We serve many of the world's largest companies, including a significant proportion of the Fortune 100, FTSE 100, CAC 40, DAX, Hang Seng and Nikkei index companies and more than half of the world's largest banks. We provide legal services in areas such as banking and finance; corporate and securities; litigation and dispute resolution; antitrust and competition; US Supreme Court and appellate matters; employment and benefits; environmental; financial services regulatory and enforcement; government and global trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

Please visit www.mayerbrown.com for comprehensive contact information for all Mayer Brown offices.

Any tax advice expressed above by Mayer Brown LLP was not intended or written to be used, and cannot be used, by any taxpayer to avoid U.S. federal tax penalties. If such advice was written or used to support the promotion or marketing of the matter addressed above, then each offeree should seek advice from an independent tax advisor.

Mayer Brown comprises legal practices that are separate entities (the "Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP and Mayer Brown Europe-Brussels LLP, both limited liability partnerships established in Illinois USA; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales (authorized and regulated by the Solicitors Regulation Authority and registered in England and Wales number OC 303359); Mayer Brown, a SELAS established in France; Mayer Brown Mexico, S.C., a sociedad civil formed under the laws of the State of Durango, Mexico; Mayer Brown JSM, a Hong Kong partnership and its associated legal practices in Asia; and Tauil & Chequer Advogados, a Brazilian law partnership with which Mayer Brown is associated. Mayer Brown Consulting (Singapore) Pte. Ltd and its subsidiary, which are affiliated with Mayer Brown, provide customs and trade advisory and consultancy services, not legal services.

"Mayer Brown" and the Mayer Brown logo are the trademarks of the Mayer Brown Practices in their respective jurisdictions.

This publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek legal advice before taking any action with respect to the matters discussed herein.

© 2017 The Mayer Brown Practices. All rights reserved.