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Legal Update
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"The Good, the Bad and the Ugly"—Fundamental Tax Reform Is Enacted Into Law

On December 22, 2017, after some degree of uncertainty as to timing, President Donald Trump signed H.R. 1, the "Tax Cuts and Jobs Act" (the "Tax Act"), into law. The Tax Act is an amalgam of the tax bills passed by each chamber of Congress and marks the most sweeping changes to the US tax system in 30 years. It touches virtually every area of the US tax rules, including how corporations and pass-through entities are taxed and overhauls the international tax system and individual taxes. This Legal Update provides an overview of many facets of the Tax Act. We divide our discussion into the impact of the Tax Act on businesses, the international US tax system, financial institutions, compensation, individuals, partnerships, real estate, tax-exempt entities, the insurance industry and life settlements.

With the speed of the legislative process, resulting in a number of gaps created in the statutory language, Treasury and the Internal Revenue Service ("IRS") will be required to issue significant guidance and regulations to fully implement the Tax Act. Mayer Brown will provide updates as Treasury and the IRS fill in these gaps, all of which will be posted on our Tax Reform Roadmap, at https://www.mayerbrown.com/experience/us-tax-reform-roadmap/.

Business

21 Percent Corporate Tax Rate. The Tax Act will impose a flat tax rate of 21 percent for tax years beginning after December 31, 2017, replacing the existing progressive corporate tax rate structure.

Elimination of Corporate AMT. The Tax Act eliminates the current corporate alternative minimum tax ("AMT") for tax years beginning after December 31, 2017. The Tax Act provides rules on how AMT credit carryovers can be utilized post-2017.

Accelerated Tax Income Recognition. The Tax Act 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 original issue discount ("OID") and interest. Income recognized based on special methods of accounting, such as the long-term contracts method, would be exempt. In addition, the Tax Act 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.

Expensing of the Cost of New and Used Property. The Tax Act permits full expensing (that is, 100 percent bonus depreciation) of new and used property placed in service on or after September 27, 2017, and before January 1, 2023 (January 1, 2024 for property with longer production periods and certain aircraft). The Tax Act phases out bonus depreciation by stepping down the deduction by 20 percent per year for property placed in service on or after January 1, 2023 and before January 1, 2027 (January 1, 2028, for property with longer production periods), at which point no bonus depreciation is available.

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 Tax Act increases these amounts to $1 million and $2.5 million, respectively, beginning in 2018 and expands the provision to include certain improvements to nonresidential real property and certain tangible personal property used in connection with furnishing lodging.

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

Revised NOL Rules. The Tax Act limits the use of net operating losses ("NOLs") to 80 percent of taxable income, effective with respect to losses incurred in tax years beginning after December 31, 2017. The Tax Act also eliminates the current carryback rules for NOLs arising in tax years ending after 2017. The new rules do not apply to property and casualty insurance companies. As a result, these companies may continue to carry NOLs back for two years and then forward for twenty years.

New Limits on the Deduction of Interest. The Tax Act 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 tax years beginning after January 1, 2022, the Tax Act reduces taxable income by non-business income, NOLs and business interest income. For taxable years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to depreciation and amortization deductions (i.e., EBITDA rather than EBIT). This change functions as a phase-in of the 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 in the statutory language appears to apply on a company-by-company basis, although the legislative history supports treating a consolidated group as a single taxpayer for purposes of applying the limitation. We anticipate that Treasury will be urged to issue guidance that follows the legislative history. Further, certain exceptions to the limitation are provided, including for electing real estate businesses (which must forgo immediate expensing as a trade-off) and certain regulated utility companies.

With regard to partnerships, the limitation will apply at the partnership level. 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. Similar rules apply to S corporations.

Reduction in the DRD. Current law provides a tax deduction for a portion of the dividends received by a corporation, recognizing that without such a deduction, corporate earnings would be subject to triple or greater taxation. This deduction is referred to as the dividend received deduction ("DRD"). The Tax Act 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 will be reduced from 80 percent to 65 percent. Both provisions will be effective for tax years beginning after December 31, 2017. The 100 percent DRD for dividends from companies owned 80 percent or more by the payee will not be affected.

Cash Method Accounting Expansion. Current law restricts the use of the cash method of accounting for C corporations and partnerships with C corporation partners. The Tax Act expands the ability to use the cash method of accounting to businesses with average annual gross receipts of no more than $25 million 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 will continue to be able to use the cash method.) In addition, the Tax Act will expand the ability of C corporations engaged in farming to use the cash method. The Tax Act also simplifies inventory accounting and provides exemptions from the uniform capitalization rules, for businesses eligible to use the cash method. These changes will be effective beginning in 2018.

Fringe Benefits. The Tax Act 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 Tax Act will continue to allow a 50 percent deduction for food and beverage expenses related to a trade or business beginning in 2018. The rules eliminating deductions for employer-provided meals are applicable to amounts incurred or paid beginning in 2026.

International Tax

Transition to a Territorial System—The Participation Exemption. The Tax Act includes a 100 percent deduction or "participation exemption," beginning in 2018, for foreign source dividends that a domestic C corporation (other than a regulated investment company ("RIC") or a real estate investment trust ("REIT")) receives from a non-US subsidiary in which it owns 10 percent or more of the stock vote or value. No direct or indirect foreign tax credits or deduction for foreign taxes will 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). In addition, the DRD will 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 ("PFICs") will not benefit from the participation exemption. The participation exemption will also apply to gain from the sale of stock of foreign subsidiaries to the extent such gain is characterized as a dividend under Internal Revenue Code ("Code") Section 1248.

Dividends that qualify for the participation exemption will 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. The new rules do not change the fact that US corporations will still be subject to US tax on any foreign income earned through a branch or disregarded entity. The Tax Act does not include the provision in the House and Senate Bills that would have repealed the Code Section 956 "deemed dividend" rules for US corporations that are shareholders of a controlled foreign corporation ("CFC"), including through a domestic partnership.

Deemed Repatriation Tax or "Toll Charge." The Tax Act imposes a one-time tax on the non-previously taxed post-1986 earnings of foreign subsidiaries. The tax will 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 in which at least one domestic corporation owns 10 percent or more of the voting power (each, a "specified foreign corporation"). The non-previously taxed post-1986 earnings of specified foreign corporations are measured either as of November 2, 2017, or as of December 31, 2017, whichever is greater, and the specified foreign corporation's US shareholders will include their pro rata share of such earnings in the last tax year that begins before January 1, 2018. By application of a deduction against the amount included in a US shareholder's income, this one-time tax will be imposed at an effective 15.5 percent rate for foreign earnings attributable to cash and other liquid assets and at an effective 8 percent rate for the remainder of the earnings (that is, earnings that are treated as reinvested in illiquid assets). The US shareholder's "aggregate cash position" is the greater of the aggregate of the US shareholder's pro rata share of (i) the cash position of all specified foreign corporations (of such US shareholder) as of the last day of the taxable year to which these mandatory inclusion rules apply or (ii) the average of the annual cash position for the 2 taxable years of each specified foreign corporation ending before November 2, 2017. US shareholders will be permitted otherwise allowable foreign tax credits for the attributable portion of the foreign subsidiaries' foreign tax pools, reduced to account for the deductions that effectively reduce the rates at which the deemed repatriation tax is imposed (and no deduction is permitted for any foreign tax for which a foreign tax credit is denied). US shareholders may offset the earnings of their foreign subsidiaries with their pro rata share of the post-1986 accumulated deficits of other foreign subsidiaries as of the measurement date. Taxpayers may elect to pay this deemed repatriation tax in up to eight annual installments, which taxpayers can backload so that they are required to settle only 40 percent of the tax liability (in equal 8 percent installments) over the first five years. If the US shareholder is an S corporation, its shareholders may elect to defer paying the deemed repatriation tax until the occurrence of certain triggering events. Finally, a recapture provision requires a US shareholder that becomes an "expatriated entity" in an inversion transaction in the succeeding ten years to pay an additional amount of repatriation tax, for the first taxable year it becomes an expatriated entity, equal to 35 percent of the deduction permitted under this provision (with no foreign tax credits allowed against such additional tax).

The "GILTI" Regime for CFC's Intangible Income. The Tax Act provides that a US shareholder of any CFC will currently include in income (and be subject to US tax on) its "global intangible low-taxed income" or "GILTI." This regime will mainly affect US multinationals earning significant income from intellectual property in low-tax jurisdictions. The amount of a US shareholder's GILTI in a given taxable year is equal to the excess, if any, of (i) the US shareholder's "net CFC tested income" over (ii) a "net deemed tangible income return" (i.e., 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. For these purposes, a US shareholder's net CFC tested income is equal to the excess, if any, of (i) the aggregate of its pro rata share of its CFCs' "tested income" (i.e., gross income without regard for certain items, including but not limited to, items of Subpart F income and "effectively connected income") over (ii) the aggregate of its pro rata share of deductions properly allocable to tested income. Thus, CFCs that primarily own intangible assets or highly depreciated tangible property will not have much of a routine return that could serve to reduce a US shareholder's GILTI inclusion. The Tax Act permits domestic corporations (other than a RIC or REIT) to annually deduct 50 percent of their GILTI amount (plus the corresponding Code Section 78 gross-up amount) for 2018 through 2025 and 37.5 percent of their GILTI amount (and corresponding Code Section 78 gross-up amount) beginning in 2026. This will result in GILTI being taxed at a 10.5 percent effective rate for 2018 through 2025 and a 13.125 percent effective rate beginning in 2026. Non-corporate US shareholders (including S corporations) will not benefit from a deduction of their GILTI amount. In addition, inclusions of GILTI by domestic corporate shareholders will carry foreign tax credits equal to 80 percent of the product of (i) the domestic corporation's "inclusion percentage" multiplied by (i) the otherwise allowable amount. For these purposes, "inclusion percentage" refers to the ratio of (i) the domestic corporation's GILTI amount, divided by (ii) the domestic corporation's pro rata share of its CFCs' tested income. The Tax Act creates a separate foreign tax credit basket for GILTI, with no carry-forward or carry-back for excess credits. The GILTI regime applies for tax years beginning after December 31, 2017.

The Deduction for Foreign-Derived Intangible Income. The Tax Act provides domestic corporations (other than a RIC or REIT) with 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 will be taxed at a 13.125 percent effective rate for 2018 through 2025 and a 16.406 percent effective rate beginning in 2026. Foreign-derived intangible income is income derived directly by a domestic corporation that, through a complex set of rules, is treated as intangible income from the sale, license, lease, exchange or other disposition of property for foreign use and the provision of services to foreign persons or with respect to foreign property. This provision is intended to encourage retention of intangibles in the United States through taxation at particularly favorable corporate income tax rates.

Elimination of Special Rule for IP Repatriation. The Tax Act does not include the provision in the Senate Bill that would have deferred the tax cost of repatriating into the United States intangible property held by a CFC.

Outbound Transfers of Intangible Property. The Tax Act expands when outbound transfers of intangibles to foreign corporations will be taxable. In this regard, the Tax Act generally puts into law the approach recently adopted by the 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 Code Section 367(d). Importantly, the Tax Act also picks up transfers of domestic, as well as foreign, goodwill.

Repeal of Active Trade or Business Exception for Outbound Transfers of Property. The Tax Act 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).

Elimination of Limit on Deduction of Interest Expense for Excess Domestic Indebtedness. The Tax Act does not include the provisions in the House and Senate Bills that, beginning in 2018, would have disallowed interest expense deductions for US corporations that are overleveraged compared to their worldwide affiliated group.

The "Base Erosion Minimum Tax" (the "BEAT" tax). The Tax Act introduces 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 will equal the excess of (i) 10 percent (5 percent for taxable years beginning in calendar year 2018) 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. Taxpayers that are members of an affiliated group that includes a bank or a registered securities dealer will be subject to an 11 percent rate (6 percent for 2018) when calculating their Base Erosion Minimum Tax. Beginning in 2026, the rate for the Base Erosion

Minimum Tax will be 12.5 percent (and 13.5 percent for members of affiliated groups that include a bank or a registered securities dealer). The "modified taxable income" over which the minimum tax is calculated is the taxpayer's taxable income determined without regard to (i) any deductions with respect to any "base erosion payments" or (ii) a portion of the taxpayer's NOL carryovers. A "base erosion payment" is any amount paid or accrued to a related foreign person if such amount 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) will not be considered base erosion payments unless the recipient is a related "surrogate foreign corporation" resulting from a post-November 9, 2017, inversion transaction (or a foreign affiliate thereof). A payment would not be considered a base erosion payment to the extent it is subject to US withholding tax. The Tax Act also excepts from the definition of "base erosion payments" amounts paid or accrued by a taxpayer for (i) certain "qualified derivative payments" and (ii) services that are provided at cost and that meet the eligibility requirements for use of the Code Section 482 services cost method (determined "without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure.") This base erosion minimum tax would apply to corporations (other than a RIC, REIT or S corporation) that (i) have average annual gross receipts of at least $500 million over 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 3 percent or higher (2 percent or higher in the case of taxpayers that are members of an affiliated group that includes a bank or a registered securities dealer) for the tax year.

Disqualified Expenses Paid in Hybrid Transactions or to Hybrid Entities. The Tax Act denies deductions for any "disqualified related party amount" paid or accrued pursuant to a "hybrid transaction" or by, or to, a "hybrid entity." A disqualified related party amount is any interest or royalty paid or accrued to a foreign related party (other than amounts included in the gross income of a US shareholder under Code Section 951(a)) to the extent that, under the laws of such party's country of residence, the related party either has no corresponding income inclusion or is allowed a deduction for a corresponding amount. A hybrid transaction is any transaction, series of transactions, agreement or instrument wherein one or more 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 provision will be effective for tax years beginning after December 31, 2017.

Modifications to CFC/Subpart F Regime. The Tax Act modifies certain provisions of the Subpart F regime. Notably, the Tax Act 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 Tax Act also modifies certain stock attribution rules in the determination of CFC status, which may result in various foreign corporations unexpectedly becoming CFCs. The Tax Act 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. The Tax Act eliminates the requirement that a corporation be a CFC for 30 uninterrupted days during the year for the Subpart F regime to apply. In addition, foreign based company oil related income no longer constitutes Subpart F income subject to current US taxation. The Tax Act does not include the Senate Bill provision that would have made permanent the "look-through" exemption for dividends, interest, rents and royalties received from related CFCs (this look-through exemption is currently scheduled to expire after 2019).

Sourcing of Inventory Sales. The Tax Act eliminates the "title passage rule" for sourcing income from inventory sales by instead sourcing inventory sales income based solely on the location of production activity. The Tax Act thus 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 (i.e., title passing) abroad (or vice versa).

Deemed Paid Foreign Tax Credits. The Tax Act repeals Code Section 902, which deemed domestic corporations to have paid a portion of the foreign income tax paid by the foreign corporation from which the domestic corporation receives (or is deemed to receive) a dividend. The Tax Act modifies Code Section 960 to permit a deemed paid credit for a domestic corporation's Code Section 951(a) inclusions based on properly attributable current-year foreign taxes rather than on a multi-year pooling system.

Separate Foreign Tax Credit Basket for Foreign Branch Income. Beginning in 2018, the Tax Act establishes a new foreign tax credit limitation basket for business profits of a United States person that are attributable to one or more qualified business units (i.e., branches) in one or more foreign countries.

Acceleration of Election to Allocate Interest Expense on Worldwide Basis. The Tax Act does not include the Senate Bill provisions that would have accelerated the effective date of Code Section 864(f), which permits taxpayers to make a one-time election to allocate and apportion interest expense on a worldwide basis, to tax years beginning after December 31, 2017 (thus retaining the current effective date of tax years beginning after December 31, 2020).

Repeal of Fair Market Value Election for Interest Expense Apportionment. The Tax Act no longer permits taxpayers to apportion their interest expense based on the fair market value of their assets. Instead, taxpayers will be required to apportion their interest expense based on the adjusted tax bases of their assets.

Tax and Withholding on Disposition of Partnership Interests. The Tax Act addresses a long-standing controversial issue regarding the treatment of gains from the sale by foreign persons of interests in a partnership engaged in a US trade or business. The IRS had ruled in Rev. Rul. 91-32, 1991-1 CB 107, that a non-US person would be taxable on the gain from the disposition of an interest in a partnership that is engaged in the conduct of a US trade or business. However, the Tax Court recently rejected this IRS ruling in the *Grecian Magnesite Mining v. Comm'r*, 149 TC No 3 (July 13, 2017), decision. The Tax Act overrides *Grecian Magnesite* and treats 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. These changes will apply to transfers of partnership interests made on or after November 27, 2017.

In addition, the Tax Act 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 will 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 nonresident alien individual or foreign corporation. (As a backstop, to the extent the transferee fails to withhold the correct amount, the partnership would have a withholding obligation on future distributions to the transferee.) The changes related to withholding would apply to transfers of partnership interests made on or after December 31, 2017 (versus November 27, 2017 as proposed in the Senate Bill).

Surrogate Foreign Corporations Not Eligible for Qualified Dividend Rates. The Tax Act denies the preferential "qualified dividend income" rate to dividends distributed by a foreign corporation that is first treated as a "surrogate foreign corporation" under Code Section 7874 (i.e., the foreign acquiror in an inversion transaction within the 60 percent–80 percent shareholder continuity range) after the effective date for this provision (date of enactment).

Financial Institutions

FDIC Premiums. Beginning in 2018, banks with consolidated assets in excess of $50 billion will not be entitled to deduct FDIC deposit insurance premiums. Banks with assets in excess of $10 billion, but less than $50 billion, will be required to scale back their deductions for FDIC premiums. Financial institutions with consolidated assets of less than $10 billion will remain entitled to deduct FDIC premiums in whole.

Compensation

Elimination of Performance-Based Compensation Exception to $1,000,000 Deduction Limitation for Publicly Traded Companies. The Tax Act eliminates the exception for commissions and performance-based compensation subject to the $1,000,000 deduction limit for a public company's "covered employees." The Tax Act also revises the definition of covered employee to include 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). The lesser reporting requirements for smaller reporting companies is eliminated.

After December 31, 2016, an individual who becomes a covered officer remains a covered officer for the entire year and all future years (including with respect to compensation paid to a covered employee's beneficiaries after his or her death). The Tax Act expands coverage of Code Section 162(m) to include foreign companies with publicly-traded ADRs and potentially certain additional privately held corporations that are not publicly traded but that have public debt.

The amendments to Code Section 162(m) are generally effective beginning after December 31, 2017. A transition rule applies to compensation provided pursuant to a written binding contract in effect on November 2, 2017 that was not materially modified after that date. The application of the transition rule is unclear in many situations.

Qualified Equity Stock. Certain non-executive employees of private companies ("qualified employees") who have been awarded stock options and restricted stock units ("RSUs") may elect to defer income on these awards for up to five years from the exercise date of options and the vesting date of RSUs. Among the provision's requirements is that at least 80 percent of the private company's qualified employees must be granted either options or RSUs.

The amendments are generally effective for options or RSUs settled after December 31, 2017.

Increase in Excise Tax Rate for Stock Compensation of Insiders in Expatriated Corporations. The Tax Act increases the excise tax for stock compensation of insiders in expatriated corporations (Code Section 4985) from 15 percent to 20 percent. This applies to corporations first becoming expatriated after December 22, 2017 (the Tax Act's date of enactment).

Individuals

As a general matter, many of the provisions impacting individuals will sunset after 2025, at which point they would revert to their pre-2018 form. An important exception to this sunset is the requirement that provisions are now indexed to chained CPI. This change is permanent.

Updated Tax Rates and Brackets for Ordinary Income. Under the Tax Act, individuals will be subject to new tax rates on their income starting in 2018. The Tax Act maintains the current seven-rate structure, but updates the rates as follows: 10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent and 37 percent. The Tax Act retains the 4 filing statuses available to taxpayers, but modifies the amounts of income at which point the brackets apply. The new top rate of 37 percent will apply to taxable income of over $500,000 for single filers and $600,000 for married couples filing joint returns. The Tax Act maintains the current system of taxing capital gains and qualified dividends, as well as the current 3.8 percent net investment income tax.

Modifications of Specific Itemized Deductions. As described in more detail below, the Tax Act repeals or modifies many itemized deductions that are heavily relied upon under current law. These modifications will generally sunset after 2025.

Modifications of Deductibility of Mortgage Interest and Home Equity Interest. Prior to 2018, qualified residence interest, i.e., interest paid or accrued on acquisition indebtedness and home equity indebtedness, is allowed as an itemized deduction subject to certain limitations. The Tax Act limits the deduction on mortgage interest by limiting the amount of debt that is treated as acquisition indebtedness to $750,000 (from the current level of $1 million). Acquisition indebtedness incurred prior to December 15, 2017 is grandfathered and not subject to this limitation. The Tax Act also eliminates the deduction for interest on home equity indebtedness.

Limitation of State and Local Tax Deduction. The Tax Act places a cap of $10,000 on the itemized deductions for state and local income taxes, property taxes and sales taxes. This limitation is not applicable for property taxes incurred in relation to a trade or business. Foreign real property taxes not incurred in a trade or business would not be deductible. The Tax Act specifically prohibits an itemized deduction in 2017 for a prepayment of 2018 state or local income taxes.

Other Noteworthy Limitations on Deductions. The Tax Act eliminates miscellaneous itemized deductions that are subject to the 2 percent floor.

Increased Standard Deduction. Along with the elimination of many itemized deductions, as well as the temporary repeal of deductions for personal exemptions, the Tax Act temporarily increases the standard deduction to $24,000 for joint filers and $12,000 for individual filers. This deduction would be annually adjusted for inflation. The increase in the standard deduction coupled with the limitation of many itemized deductions will likely represent a shift away from itemizing deductions and simplifying the tax return process.

Increased Child Tax Credit. The Tax Act temporarily increases the child tax credit to $2,000 per qualifying child, $1,400 of which would be refundable. This $2,000 tax credit represents an increase of $1,000 compared to the current credit per qualifying child. The Tax Act also temporarily provides for a $500 nonrefundable credit for other qualifying dependents.

Modifications to Individual AMT. The Tax Act retains the individual AMT but increases the exempt amount and phase out thresholds. The AMT exemption amount will be increased to $109,400 (from $86,200 under current law) and the phase-out threshold will be increased to $1,000,000 (from $164,100 under current law) for married taxpayers filing jointly. For single taxpayers, the exemption amount will be increased to $70,300 (from $55,400 under current law) and the phase-out threshold will be increased to $500,000 (from $123,100 under current law).

Pass-Through Income. The Tax Act modifies certain provisions to limit the deduction available to individuals earning pass-through income. The Tax Act provides non-corporate taxpayers with a 20 percent deduction for "qualified business income," earned from a partnership, S Corporation or sole proprietorship. Qualified business income is limited to domestic qualified items of income, gain and loss with respect to a qualified business. A qualified business is any trade or business other than a specified service trade or business or performing services as an employee. Specified service trade or businesses that will not be eligible for the deduction include health, law, accounting, brokerage services, investment management and financial services. The Tax Act provides exception for engineering and architecture.

For individuals with income of at least $157,500, or $315,000 for joint filers, the deduction is limited to either (i) 50 percent of the individual's allocable share of the business's W-2 wages or (ii) 25 percent of such W-2 wages plus 2.5 percent of the unadjusted basis of "qualified property." For this purpose, "qualified property" generally means tangible property used in the business that produces business income and is depreciable for that year. A taxpayer with income of less than $157,500, or $315,000 for joint filers, may still take this deduction without regard to whether the income is specified services income; the restriction on services income is phased in similarly to the W-2 wage (and capital element) limitation. The Tax Act clarifies that the 20 percent deduction reduces taxable income and is available to both non-itemizers and itemizers.

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 Tax Act adds a limitation for non-passive losses. Beginning in 2018, the Tax Act would only allow up to $250,000 ($500,000 for a 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 a net operating loss. In the case of a partnership or S corporation, the provision applies at the partner or shareholder level.

The Affordable Care Act Individual Mandate Repealed. The Tax Act sets at zero the amount of the excise tax imposed on individuals who do not obtain minimum health insurance coverage. This provision is effective starting in 2019 and does not sunset after 2025.

Gift and Estate Tax Exclusion. The Tax Act doubles the estate and gift tax exemption from $5 million under current law to $10 million for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026.

"Kiddie Tax." The Tax Act modifies how the net unearned income of a child is taxed, generally applying the rates applicable to trusts and estates, rather than subjecting the income to the higher of the parents' or the child's rates, as is done under current law.

Partnerships

Expansion of Built-in Loss Rules. Under current law, a mandatory basis step-down is required when a partnership interest changes hands and the partnership has a net built-in loss of more than $250,000. This rule (essentially a mandatory Code Section 754 election) prevents two taxpayers from claiming the same economic loss as a tax loss. Beginning with transfers of partnership interests after December 31, 2017, the Tax Act will test the existence of a built-in loss at both the partner and the partnership level, so that 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 will occur.

Expansion of Basis Limitation Rules. Under current law, 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. For taxable years beginning after December 31, 2017, the Tax Act modifies the basis limitation on partner losses to provide that the limitation takes into account a partner's distributive share of partnership charitable contributions and foreign taxes.

3-Year Holding Period for Carried Interest. The Tax Act contains a 3-year holding period rule for carried interest pursuant to which a partner generally must hold an "applicable partnership interest" for more than three years to qualify for long-term capital gain treatment. It appears that this 3-year holding period is required for both (i) sales of assets held directly or indirectly by the applicable partnership and (ii) sales of interests in the applicable partnership itself. The types of partnership interests affected are those that are 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). Amounts failing the 3-year test would be characterized as short-term capital gain, rather than as ordinary income. The 3-year holding rule applies notwithstanding the rules of Code Section 83 and any elections made under Code Section 83(b). The provision applies for taxable years beginning after December 31, 2017. Thus, existing carried interest structures are subject to the new holding period requirement.

Treatment of Revoking S Corporations. The Tax Act provides for beneficial treatment of a S corporation that converts into a C corporation after its enactment. Beginning with the year of a change of accounting method, an "eligible terminated S corporation" may take into account any Code 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 Tax Act defines an eligible terminated S corporation as any C corporation that (i) is a S corporation before the Tax Act's enactment, (ii) revokes its S corporation election within two years after its enactment and (iii) is owned by the same persons in the same proportions when the Tax Act was enacted and when the S corporation election is revoked.

Repeal of Technical Termination of Partnerships. The Tax Act repeals the Code Section 708(b)(1)(B) rule on technical terminations of partnerships. Code Section 708(b)(1)(A) continues to apply so that a partnership is terminated if the partners no longer carry on any business, financial operation or venture of the partnership.

Real Estate

Modifications in Depreciable Life. The Tax Act ends distinctions among various types of improvements and provides for a 15-year recovery period (increased from the 10-year period in the Senate Bill) for qualified improvement property (20 years for ADS). Qualified improvement property would be eligible for small business expensing (Code Section 179 expensing). For residential rental property, the ADS recovery period would be shortened from 40 years to 30 years. The Tax Act would require a real property trade or business that elects out of the interest deduction limitation to use ADS to depreciate building property. The changes would be effective for property placed in service after December 31, 2017. The Tax Act did not adopt the 25 year depreciable life for both residential rental and non-residential real property (from 27.5 and 39 years, respectively) as proposed in the Senate Bill.

Like-Kind Exchanges. The Tax Act limits the ability of taxpayers to engage in like-kind exchanges to only non-inventory real estate for exchanges occurring after 2017. The Tax Act also makes clear that real property located in the United States and foreign real property are not like-kind for purposes of the provision.

Reduction in Tax Rate for REIT Dividends. The Tax Act provides a deduction of 20 percent (reduced from the 23 percent in the Senate Bill) of the amount of ordinary dividends (i.e., not capital gain dividends or qualified dividend income) received from a REIT, beginning in 2018. Importantly, the deduction will apply without regard to the wage and capital limitations generally applicable to the deduction for qualified business income.

Tax-Exempt Organizations

Excise Tax for Compensation Payments More Than $1 Million. The Tax Act provides for a 21 percent excise tax on compensation paid in excess of $1 million to any "covered employee" by a tax exempt organization 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. An exception is provided for compensation and excess parachute payments made to licensed medical professionals (including veterinarians) for the performance of medical or veterinary services.

Excise Tax on Income of Large Private Educational Institutions. The Tax Act imposes a 1.4 percent excise tax on the investment income earned by large private colleges and universities and related organizations beginning in 2018. The excise tax applies only if the value of the endowment is at least equal to $500,000 per student and more than 50 percent of tuition paying students are located in the United States.

Elimination of Proposed Expansion of Unrelated Business Income Taxes ("UBIT") Rules. The Tax Act does not include 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. Tax-exempt organizations subject to the UBIT are required 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. This does 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.

Such NOLs may be used to reduce UBIT from any unrelated business. In addition, the provision generally does not prevent an organization from using a deduction from one taxable year to offset income from the same unrelated trade or business activity in another taxable year.

Increase in Charitable Contribution Limit. The Tax Act increases 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.

Repeal of Deduction for Amounts Paid for College Athletic Seating Rights. Beginning in 2018, a charitable deduction for a portion of the payment made for the benefit of an institution of higher education in exchange for the right to purchase tickets for seating at an athletic event in such institution's stadium is no longer permitted.

Unrelated Business Taxable Income Increased by Amount of Certain Fringe Benefit Expenses for Which Deduction Is Disallowed. UBIT is increased by an amount an organization pays or incurs for certain transportation fringe benefits (such as transit passes, subsidized parking, shuttle service to or from work), parking facilities used in connection with subsidized parking, or any on-premises athletic facilities, if such amount is generally disallowed as an entertainment, amusement or recreation related expense. This provision does not apply if such amounts are incurred in connection with an unrelated trade or business carried on by the organization.

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 Bill would have substantially toughened the intermediate sanctions regime. However, like the Senate Bill, the Tax Act does not include provisions addressing this issue. As a result, the existing intermediate sanctions regime will continue to apply.

Insurance

Modification of Rules for the Discounting of Reserves for Property and Casualty Insurance Companies. Under current law, property and casualty insurance companies are required to discount their loss reserves in determining their tax deduction for reserves. The discounting is at an interest rate based on the federal government's borrowing cost. The Treasury analyzes industry payment patterns and determines whether a line of business is a "short-tail" line of business or a "long-tail" line of business. "Short-tail" reserves must be discounted over four years, and "long-tail" reserves must be discounted over 10 or 15 years, although insurance companies may elect to use their own historical loss payment patterns for discounting rather than industry-wide patterns. The Tax Act changes the discounting rate to a presumably higher rate based on the corporate bond market, changes the longest discounting period for "long-tail" lines of business from 15 years to 14 years and eliminates the insurance company's right to elect to discount based on its own historical loss payment record.

Modification of Computation of Life Insurance Tax Reserves. The Tax Act substantially rewrites the method for calculating life insurance tax reserves in a way that is projected to raise $15.2 billion in additional tax revenue from the life insurance industry over the next ten years. The biggest change is the deduction based on statutory reserves of life insurance companies is limited to 92.81 percent of the amount of the statutory reserve.

Base Erosion Avoidance Tax Applies to Reinsurance Premiums Paid to an Affiliated Foreign Reinsurer. The Base Erosion Avoidance Tax discussed above was modified in the last step of the legislative process to apply to "any premium or other consideration paid or accrued… for any reinsurance payments." Some commentators (and at least one US Senator) have taken the position that the amount of premiums subject to this tax is to be determined net of ceding commissions and losses and other items paid from the reinsurer to the ceding company, but this result is unclear.

Modification of the PFIC Exception for Insurers. Existing law provides an exception to the passive income treatment for purposes of the PFIC rules for income from the active conduct of an insurance business, provided that the company is predominantly engaged in the insurance business. The Tax Act replaces 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 ten years. The Tax Act increase those capitalization percentages from 1.75 percent to 2.09 percent for annuities, from 2.05 percent to 2.45 percent for group life contracts and from 7.7 percent to 9.2 percent for all other specified insurance contracts. The Tax Act extends the amortization period from 120 months to 180 months. These changes are less drastic than those proposed 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.

NOLs of Life Insurance Companies. Under current law, the NOL deduction under Code 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 Tax Act repeals the special "operations loss deduction" provisions and permits life insurance companies to take Code 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 Tax Act 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 Tax Act eliminates this special provision and provides 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 Tax Act 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 Tax Act 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.

Life Settlements

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. The Tax Act 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 Tax Act 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 Tax Act makes these exceptions inapplicable to reportable policy sales beginning in 2018.

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