Ballard Spahr LLP

taxtruths

A PUBLICATION OF THE BALLARD SPAHR TAX GROUP *VOLUME 3, ISSUE 1 – JANUARY 2018*

This publication highlights developments in areas of tax law of interest to our clients.

On December 22, 2017, H.R.1, informally known as the Tax Cuts and Jobs Act (the Act), was signed by President Trump and became law. In this issue of Tax Truths, Ballard Spahr's Tax Group analyzes certain key provisions of the Act.

IN THIS ISSUE

TAXATION OF INDIVIDUALS

The Act makes many significant changes to the taxation of individuals. These changes include changes to tax brackets, increasing the standard deduction, eliminating personal exemptions, and increasing the child credit.

Changes to Tax Rates and Brackets

The Act keeps seven brackets, but changes the marginal rates.

The tables below set forth the current and new rates:

2017 – Married, Filing Jointly

Taxable Income	2017 Rates
$0 to $18,650	10% of taxable income
$18,651 to $75,900	$1,865 plus 15% of the excess over $18,650
$75,901 to $153,100	$10,452.50 plus 25% of the excess over $75,900
$153,101 to $233,350	$29,752.50 plus 28% of the excess over $153,100
$233,351 to $416,700	$52,222.50 plus 33% of the excess over $233,350
$416,701 to $470,700	$112,728 plus 35% of the excess over $416,700
$470,701 and above	$131,628 plus 39.6% of the excess over $470,700

2017 – Single Individual Filers

Taxable Income	2017 Rates
$0 to $9,325	10% of taxable income
$9,236 to $37,950	$932.50 plus 15% of the excess over $9,325
$37,951 to $91,900	$5,226.25 plus 25% of the excess over $37,950
$91,901 to $191,650	$18,713.75 plus 28% of the excess over $91,900
$191,651 to $416,700	$46,643.75 plus 33% of the excess over $191,650
$416,701 to $418,400	$120,910.25 plus 35% of the excess over $416,700
$418,401 and above	$121,505.25 plus 39.6% of the excess over $418,400

New Rates – Married, Filing Jointly

Taxable Income	New Rates
$0 to $19,050	10% of the taxable income
$19,051 to $77,400	$1,905 plus 12% of the excess over $19,050
$77,401 to $165,000	$8,907 plus 22% of the excess over $77,400
$165,001 to $315,000	$28,179 plus 24% of the excess over $165,000
$315,001 to $400,000	$64,179 plus 32% of the excess over $315,000
$400,001 to $600,000	$91,379 plus 35% of the excess over $400,000
$600,001 and above	$161,379 plus 37% of the excess over $600,000

New Rates – Single Individual Filers

Taxable Income	New Rates
$0 to $9,525	10% of taxable income
$9,526 to $38,700	$952.50 plus 12% of the excess over $9,525
$38,701 to $82,500	$4,453.50 plus 22% of the excess over $38,700
$82,501 to $157,500	$14,089.50 plus 24% of the excess over $82,500
$157,501 to $200,000	$32,089.50 plus 32% of the excess over $157,500
$200,001 to $500,000	$45,689.50 plus 35% of the excess over $200,000
$500,001 and above	$150,689.50 plus 37% of the excess over $500,000

The Act leaves capital gain tax rates unchanged and also leaves in place the 3.8% tax on net investment income.

Increased Standard Deduction and Elimination of Personal Exemptions

For 2018 through 2025, the Act increases the standard deduction to $12,000 for single filers, $18,000 for heads of household, and $24,000 for joint filers (compared to $6,500, $9,550, and $13,000, respectively, for 2017) and suspends the deduction for personal exemptions entirely for tax years beginning after December 31, 2017, through the end of 2025.

Significant Changes to Family, Homeowner, and Education Incentives

To assist families with children in the absence of personal exemptions, the Act increases the child tax credit to $2,000, refundable up to $1,400 (indexed for inflation, using a rounding convention to bring the credit down to the next lowest multiple of $100). In addition to the child credit, the Act adds a $500 nonrefundable credit for certain non-child dependents. The Act also modifies the adjusted gross income phase-out for these credits to $400,000 for married taxpayers filing jointly and $200,000 for all other taxpayers. The phase-out thresholds are not indexed for inflation.

Under the Act, the itemized deduction for mortgage interest on debt incurred after December 15, 2017, is limited to interest paid on up to a total of $750,000 of acquisition debt on a principal residence and one other residence selected by the taxpayer. Acquisition debt on a principal residence incurred prior to December 15, 2017—or debt incurred after that date to refinance existing debt—as long as the debt's principal amount does not increase, is grandfathered.

For grandfathered debt, the limitation will remain at $1 million. The Act repeals the deduction for interest on home-equity debt, with no grandfathering. As is true of other changes to individual taxes, the Act provides for these changes to sunset on December 31, 2025. Gain from the sale of a principal residence still can be excluded, without an income cap and subject to the same limitations as existed before the Act.

Effective for tax years beginning after December 31, 2017, the Act also impacts saving and paying for education expenses by broadening the definition of qualified expenses that is applicable to Section 529 plans. The Act allows plans to distribute up to $10,000 per year per student from new or existing accounts for elementary and high school tuition and for certain expenses incurred in connection with a homeschool curricula. All Section 529 accounts established for a student are aggregated in determining whether the annual limit is exceeded. This modification does not include a sunset provision.

Other Changes to Deductions, Exclusions, and Credits

The Act makes additional changes to deductions, exclusions from income, and credits against tax effective for tax years beginning after December 31, 2017, and expiring on December 31, 2025. The Act repeals the above-the-line deduction and the exclusion relating to moving expenses as well as the exclusion for qualified bicycle commuting reimbursements. The Act also provides that alimony would be neither included in the payee's income nor deductible by the payor for alimony payable under divorce decrees or separation agreements executed after 2018.

The Act repeals the income-based limitation on itemized deductions, known as the Pease limitation. The Act also disallows all miscellaneous itemized deductions currently subject to the 2% floor and caps the deduction for personal state and local taxes at $10,000, inclusive of income, property taxes, and sales and use taxes. The Act prohibits a deduction for a prepayment of 2018 or later state and local income taxes. However, the Act permits limited personal deductions for casualty losses incurred in a declared disaster and retains the deduction for medical expenses, decreasing the threshold from 10% to 7.5% of adjusted gross income for 2017 and 2018 for both regular and alternative minimum tax purposes. Additionally, effective after 2018, the Act permanently eliminates the shared-responsibility payment imposed by the Affordable Care Act.

Estate, Gift, and Generation-Skipping Taxes

The Act does not repeal the estate and generation-skipping taxes—instead, it increases the exemption amount for those taxes and the gift tax to $10 million per person (from the current $5.49 million per person exemption) beginning in tax years after 2017, but the increased exemption amount expires on December 31, 2025. The exemption amount is indexed for inflation beginning in 2011 so that the exemption for 2018 is approximately $11.2 million per person. *See our legal alert published January 5, 2018*.

Alternative Minimum Tax

The Act retains the individual alternative minimum tax (AMT), but increases the exemption amount from $84,500 to $109,400 for married taxpayers filing jointly and from $54,300 to $70,300 for single individual taxpayers and increases the income over which the exemption phases out ($0.50 for every dollar over the phase-out amount) to $1 million (indexed for inflation) from $160,900 for married taxpayers filing jointly and to $500,000 from $120,700 (indexed for inflation) for single individual taxpayers. Because the deduction for home-equity mortgage interest will be eliminated and the deduction for foreign, state, and local taxes will be limited to $10,000—and because more people will be eligible to use the AMT exemption—significantly fewer individual taxpayers will pay AMT.

Retirement Plan Changes

Although the contribution limits for 401(k) plans and IRAs remain unchanged, the Act makes a minor change, effective for tax years beginning after December 31, 2017, to IRAs. Under the Code as in effect before the Act, individuals could pay tax and convert a traditional IRA to a Roth IRA but retain the right to undo the conversion.

Under the Act, however, the rule allowing a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA. Thus, recharacterization cannot be used to unwind a Roth conversion.

20% Business Income Deduction

In tax years beginning after December 31, 2017, an individual can deduct 20% of his or her qualified business income earned directly or through a partnership, LLC, or S corporation. This deduction is capped at the greater of (a) 50% of the wages paid by the qualified business that are allocable to the individual or (b) the sum of (1) 25% of the wages paid by the qualified business that are allocable to the individual and (2) 2.5% of the original cost of qualified assets owned by the qualified business.

Qualified Business

A qualified business is a trade or business. Neither the trade or business of being an employee, nor a specified service business (see below) is a qualified business. See below for rules allowing certain individuals engaged in a specified service business to take all or part of the 20% deduction for qualified business income.

Qualified Business Income

Qualified business income is net income from a qualified business that is effectively connected with a U.S. trade or business. Qualified business income does not include passive-type income, such as long- or short-term capital gains and losses, dividend or dividend equivalents, interest income or annuity income (except interest or annuity income allocable to a trade or business), and certain foreign personal holding company income. Qualified business income also does not include reasonable compensation paid to the taxpayer by the qualified business, guaranteed payments paid to the taxpayer by the qualified business, and as to be provided in regulations, payments by a qualified business to a partner or member of an LLC in his capacity other than as a partner or member. Income from a specified service business also is not eligible for the 20% deduction, with certain exceptions described below.

A taxpayer must compare the income from each of his or her qualified businesses against the cap from that qualified business to determine the 20% deduction. Net losses from qualified businesses are carried forward and offset future income from that qualified business.

The Act provides no guidance on how qualified trades or businesses are grouped or what happens if there are both qualified trades or businesses and businesses that are not qualified trades or businesses within the same entity or conducted by the same individual, or how the qualified business income deduction and qualified business loss carryover interact with existing Code limitations (such as the passive activity loss and at-risk limitations).

Cap

This deduction is capped at the greater of (a) 50% of the wages paid by the qualified business that are allocable to the individual and (b) the sum of (1) 25% of the wages paid by the qualified business that are allocable to the individual or (2) 2.5% of the original cost of qualified assets owned by the qualified business. However, the cap does not apply to taxpayers with $315,000 or less of taxable income on a joint return and $157,000 or less of taxable income on a single return. These thresholds are based on taxable income, *i.e.*, income reduced by items such as 401(k) contributions, deductions for medical insurance, 50% of self-employment taxes, health savings account contributions, and itemized deductions or the standard deductions. There are phase-outs for taxpayers with no more than $415,000 of taxable income on a joint return or $207,500 of taxable income on a single individual return.

For purposes of the wage element of the cap, wages are the sum of W-2 wages, elective deferrals, and deferred compensation. Distributions to partners or members of an LLC and guaranteed payments are not wages. Note that under the Code as in effect before the Act, which remains unchanged, payments to a partner or member of an LLC cannot be wages.

For purposes of the qualified property element of the cap, qualified property is depreciable tangible property that (1) is owned by and available for use in the qualified business at the close of the qualified business' taxable year, (2) was used by the qualified business (*i.e.*, placed in service) at any time during the qualified business' taxable year, and (3) the depreciable period for which has not ended before the close of the qualified business' taxable year. The depreciable period is 10 years for property with a Modified Accelerated Cost Recovery System (MACRS) recovery period of 10 years or less, and the depreciable period for property with a MACRS recovery period of more than 10 years is the property's MACRS recovery period.

Specified Service Business

Income from a specified service business generally is not qualified business income. A specified service business includes (i) a professional service business, such as the business conducted by doctors, dentists, lawyers, accountants, and actuaries, (ii) a business conducted by consultants, (iii) the business of athletes or performers, (iv) individuals performing financial services, brokers, and other businesses if the principal asset is the reputation or skill of one or more of the owners or employees, and (v) the business of investing, investment management, trading, dealing in securities, partnership interests, or commodities. However, happily for architects and engineers, they are NOT engaged in a specified service business.

Phase-Outs

There are two different phase-outs for taxpayers who have between $315,000 and $415,000 of taxable income on a joint return and between $157,500 and $207,500 of taxable income on a single individual return.

<u>Specified Service Business</u>

For taxpayers in a specified service business, the 20% deduction as well as the cap is reduced by a fraction the numerator of which is the amount by which the taxpayer's qualified business income exceeds $315,000 on a joint return ($157,500 on a single individual return) and the denominator of which is $100,000 ($50,000 on a single individual return).

<u>Other Businesses</u>

For taxpayers not engaged in a specified service business who have taxable income between $315,000 and $415,000 on a joint return, or between $157,500 and $207,500 on a single individual return, there is a different phase-out formula. Under this phase-out, the taxpayer's qualified business income is multiplied by a fraction the numerator of which is the excess of 20% of the taxpayer's qualified business income over the cap and the denominator of which is $100,000 in the case of a joint return ($50,000 for a single individual return). Unlike in the case of a specified service business, the cap does not apply.

REIT Dividends, Qualified Cooperative Dividends and Income From a Publicly Traded Partnership

A deduction also is allowed for 20% of REIT dividends, other than capital gain dividends and those treated as qualified dividends eligible for the 20% rate, qualified cooperative dividends, and income from a publicly traded partnership (that is, one not treated as a corporation) as well as any ordinary income recognized on the sale of an interest in such a publicly traded partnership because the partnership has "hot assets." The cap does not apply to these items of income.

Widget Maker LLC

John and Jane each own 50% of Widget Maker LLC, a widget manufacturer. In 2018, Widget Maker LLC has $1.2 million of taxable income allocated to John and Jane. Widget Maker LLC paid $400,000 of wages in 2016 and has depreciable assets, the original cost of which was $2 million, the depreciable period for which has not yet expired.

John's tentative deduction is $120,000, 20% of $600,000. The cap is the greater of (a) $100,000 (50% of the W-2 wages paid by Widget Maker LLC allocable to him) or (b) $50,000 ($25,000 (25% of the W-2 wages paid by Widget Maker LLC allocable to him)) plus $25,000 (2.5% of 50% of the original cost of depreciable assets allocable to him). Thus, John's deduction is $100,000. Jane has the same deduction.

Accounting Firm LLC

John and Jane each own 50% of Accounting Firm LLC, which provides accounting and tax services. Accounting Firm LLC is a specified service business. John is married to Alice and Alice earns $250,000 in wages in 2018. Jane is married to Bob and Bob does not work. Accounting Firm LLC allocates $400,000 each to John and Jane in 2018. John and Alice have $160,000 of deductions (including 401(k) contributions, self-employed medical insurance deduction, 50% of John's self-employment taxes, a HSA contribution, and the standard deduction). Thus, John and Alice have $490,000 of taxable income ($400,000 + $250,000 - $160,000). Because their taxable income exceeds $415,000, John is not entitled to a business income deduction. Jane, on the other hand, is entitled to a business income deduction. Jane and Bob have $110,000 in deductions and $290,000 of taxable income ($400,000 - $110,000). Because Jane's and Bob's taxable income is less than $315,000, no cap applies and Jane can deduct $80,000 on her joint return with Bob.

Real Estate LLC

Real Estate LLC acquired an office building for $55 million of which $5 million was allocated to land. Real Estate LLC financed its purchase of the property with $40 million of debt and $15 million of equity. David is a 20% member of Real Estate LLC and is allocated 20% of Real Estate LLC's depreciation. Real Estate LLC has no employees. David is allocated $125,000 of ordinary income from Real Estate LLC (for example, gain from the sale of dealer property or rental income). David's tentative business income deduction is $25,000—20% of the $125,000 of income allocable to him from Real Estate LLC. David's cap is the greater of (a) -0- wages or (b) -0- wages plus $250,000 (2.5% of the original cost of depreciable property allocated to him). Thus, David can deduct $25,000.

Carried Interests

Managers of investment partnerships and LLCs, such as private equity funds, typically receive a carried interest in such partnerships/LLCs relating to services performed for such partnerships/LLCs. Under the Code as in effect prior to the Act, a manager's share of long-term capital gain relating to its carried interest was eligible to be taxed at long-term capital gain rates. Since 2007, legislation has often been proposed, but never enacted, to tax gain relating to carried interests in certain investment partnerships/LLCs at ordinary income rates.

The Act treats gain allocated to a carried interest as short-term capital gain if the asset that produces the capital gain was not held for at least three years or, apparently, upon a transfer of a carried interest held for less than three years. (See below for "related party" sales). Qualified dividend income that passes through to the owner of a partnership/LLC holding a carried interest is still taxed at a 20% rate.

Pursuant to the Act, a carried interest is an interest in partnerships/LLCs received in consideration for services relating to assets (including real estate) held for investment on behalf of third-party investors. However, a partnership/LLC interest that would be a carried interest covered by these new rules is not a carried interest for this purpose if (1) it is held directly or indirectly by a corporation or (2) to the extent distributions are proportionate to capital interests or the capital interest attributable to a partnership/LLC interest that was subject to tax upon receipt or vesting.

Prior proposals that would have converted income passing through to the holder of a carried interest into ordinary income also would have subjected such income to self-employment tax. However, the Act does not subject amounts of income or gain attributable to a carried interest to self-employment tax. Additionally, such income would remain subject to the 3.8% net investment income tax, if it is passive.

The Act contains an anti-abuse rule governing transfers of a carried interest subject to these rules to related parties. "Related party" has a unique definition in this context. A related party is a family member or a person the taxpayer worked with in the business that issued the carried interest in the current year and any of the prior three years. It is unclear if the Act accelerates gain attributable to the partnership's/LLC's assets that have been held for less than three years when a carried interest is transferred to a related person. The carried interest provisions apply to taxable years beginning after December 31, 2017.

Increased Expensing

The length and applicability of depreciation deductions have been hotly debated since depreciation deductions have been allowed. Critics have bemoaned the complexity and administrative effort it takes to track the various depreciation schedules for assets. Many forms of accelerated depreciation have been introduced into the Code, with immediate expensing being the most accelerated. The Act expands the application of expensing in many ways.

100% Expensing

Under the Code in effect before the Act, taxpayers were entitled to bonus depreciation for "qualified property" through 2019. Bonus depreciation was available for 50% of the cost of qualified property placed in service in 2017 and gradually phased down to 30% in 2019. Generally, qualified property is tangible property with a useful life of 20 years or less under MACRS, certain computer software, water utility property, and qualified improvement property, the original use of which begins with the taxpayer.

The Act allows for 100% expensing for qualified property (both new and used provided it is the taxpayer's first use of the property) and phases out between 2023 and 2026 (the phase-out occurs between 2024 and 2027 for property with longer production periods). Certain public utility property and property used in a business that has floor-plan financing (e.g., auto dealerships) is not eligible for expensing. Although real property with a MACRS life of 20 years or more is not eligible for 100% expensing, qualified improvements are intended to be eligible for expensing, subject to the taxpayer's election concerning the deduction of interest expenses related to a real estate trade or business.

A real estate trade or business is permitted to elect to deduct 100% of its interest expense (as opposed to limiting such deduction to 30% of its income as adjusted (see below)), and any real estate business that so elects is not entitled to expense eligible real estate. Instead, an electing real estate business is required to depreciate its residential and non-residential real estate (including qualified improvement property) using the alternative depreciation system (ADS) lives. The ADS life is 30 years for residential real estate, 40 years for non-residential property, and 20 years for qualified improvement property. Qualified improvement property is any improvement to the interior of nonresidential real property if such improvement is placed in service after the date the building is placed in service. The MACRS recovery period for qualified improvements is intended to be 15 years. (However, it appears that as a result of a drafting glitch, qualified improvement property never was assigned a 15-year MACRS recovery period. Thus, notwithstanding

Congress' intention to allow expensing of qualified improvement property, there is uncertainty as to whether such expensing will be allowed for real estate trades or businesses that elect to forgo their full interest deduction.)

This provision applies to property acquired and placed in service after September 27, 2017, and the change in ADS lives for real estate applies for property placed in services after December 31, 2017.

Expansion of Section 179

Section 179 was introduced in an effort to encourage small businesses to purchase new equipment by allowing for an immediate expensing of certain property that otherwise would be subject to depreciation deductions over its useful life. Under the prior Section 179, taxpayers could immediately expense up to $500,000 of the cost of any Section 179 property placed in service each taxable year. This amount was reduced by the amount by which the total cost of such property placed in service during the tax year exceeds $2 million. It was further reduced if the taxpayer's taxable income reached certain thresholds. Similar to the definition of qualified property eligible for bonus depreciation, Section 179 property includes tangible personal property with a recovery period of 20 years or less under MACRS, certain computer software, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

The Act increases the amount eligible for immediate expensing from $500,000 to $1 million and the threshold from $2 million to $2.5 million, both amounts as indexed for inflation. The Act also expands the definition of Section 179 property to include certain depreciable tangible personal property (property used to furnish lodging) and expands the definition of qualified real property to include improvements made to non-residential real property, including improvements for roofs, heating, ventilation, air conditioning, fire protection, and alarm and security systems. This provision applies to property placed in service in tax years beginning after December 31, 2017.

Small Business Considerations

Small businesses have been a hot-button policy issue for both political parties, and it is no surprise that the Act provides for provisions to specifically benefit small businesses. In addition to the changes to Section 179, the Act, among other things, expands the application of certain simplified accounting methods and exempts small businesses from the limitations on interest deductibility.

Expanded Use of Cash Method Accounting

Small businesses generally prefer to use the cash method of accounting rather than the accrual method because it is simple and easy to understand. Although many businesses would prefer to use the cash method, there are situations in which the accrual method is required. Under the Code as in effect before the Act, a business organized as a sole proprietorship, partnership or LLC (without a corporate partner or member), and S corporations could use the cash method of accounting. A C corporation or partnership with a C corporation partner could use the cash method of accounting if its average gross receipts did not exceed $5 million (including prior years for any predecessor). The Act increases this threshold to $25 million (indexed for inflation) beginning after 2017.

For a business where the production, purchase, or sale of merchandise is a material income-producing factor, the use of an inventory method such as LIFO and FIFO is required. Under the Code as in effect before the Act, a business required to use an inventory method also was required to use the accrual method of accounting unless it had average gross receipts of $1 million or less or is within an exempt industry with average gross receipts of $10 million or less. The Act increases the $1 million gross receipts threshold to $25 million, regardless of industry designation for tax years beginning after 2017. Affiliated entities are aggregated for purposes of the $25 million threshold.

Uniform Capitalization (UNICAP) Rules Restrictions

Under the UNICAP rules, certain direct and indirect costs for real or tangible personal property produced by a business or acquired by a business for resale are required to be included in inventory or capitalized into the basis of such property. The Code as in effect before the Act allowed for an exemption from the UNICAP rules for businesses with $10 million or less in average annual gross receipts with respect to personal property acquired for resale, but not for real and personal property manufactured by the business. The Act increases the threshold to $25 million and would apply to real and personal property acquired or manufactured by the business for tax years beginning after 2017.

Long-Term Contracts

For long-term contracts (contracts that cover a period beyond a single taxable year), taxable income is generally recognized and expenses are deducted based on the percentage of the contract that is completed each taxable year (commonly known as the percentage-of-completion method). Under the percentage-of-completion method, income generally is recognized under the contract based on the percentage of actual costs incurred under the contract for the year compared to the estimated total contract costs. Certain businesses with average annual gross receipts of $10 million or less in the preceding three years were not required to use the percentage-of-completion method of accounting (and could use the completed contract method) for contracts expected to be completed within a two-year period. The Act increases the gross receipts threshold to $25 million for tax years beginning after 2017.

Exemption From Limitation on Interest Deductibility

The Act limits the deductibility of interest for a business to 30% of the business' adjusted business taxable income (roughly, EBITDA before 2022 and EBIT thereafter). Since many small businesses rely on debt to finance their operations and growth, the Act exempts businesses with average gross receipts of $25 million or less beginning after 2017. This limitation is determined at the partnership/LLC level and affiliated entities are aggregated for purposes of the $25 million gross receipt limit. The Act also exempts electing real property trades or business from the interest expense deduction limitation but also includes a depreciation trade-off. See above.

Individual's Excess Business Losses

For tax years beginning in 2018 and before 2026, a non-corporate taxpayer will be able to use excess business losses (which become net operating losses) only to offset 80% of business income and gain in future years. Excess business losses are the taxpayer's aggregate deductions from the taxpayer's trades or businesses over the sum of (a) the taxpayer's gross income and gain from such trades or businesses and (b) $500,000 on a joint return and $250,000 on a single individual return, each indexed for inflation. This provision is applied at the partner, LLC member, or S corporation shareholder level and each item of income, gain, deduction and loss of the partnership, LLC, or S corporation is taken into account.

Like-Kind Exchanges

Under the Code as in effect prior to the Act, although real estate may be the most common type of property exchanged, like-kind tangible personal property and certain intangible property also could be exchanged if such property is used in a trade or business or held for investment. To be like-kind, tangible personal property must be of the same general class, such as automobiles.

The Act limits property eligible for a like-kind exchange to real estate and prohibits exchanges of personal property, both tangible and intangible. This change applies to exchanges completed after December 31, 2017. But if property is disposed of (or received) in a deferred like-kind exchange before the end of 2017, the exchange will qualify for tax deferral (if otherwise qualified) if it is completed after the end of 2017.

Capital Contributions, Grants, and Other Non-Member Capital Contributions

Under the Code as in effect prior to the Act, a capital contribution of money or property to a corporation from either a shareholder or from a non-shareholder was tax-free to the corporation. The Act generally continues to provide that a contribution to capital does not include any contribution in aid of construction or any other contribution made by a customer or potential customer and adds that it does it include any contribution by a governmental entity of civic group unless it is a shareholder (and it removes the special rules for water and sewerage disposal utilities). The conference committee affirms that the other provisions of Section 118, that allow capital contributions to the capital of a corporation to generally be excluded from income, applies only to corporations. As a result, grants to corporations generally will be taxable to the recipient corporation.

This provision is effective for contributions made, and transactions entered into, after December 22, 2017, but it does not apply to any contribution made after December 22, 2017, by a governmental entity pursuant to a master development plan that was approved prior to such date by a governmental entity.

Partnership Termination

Under the Code as in effect before the Act, a partnership or LLC was terminated for tax purposes (and a new partnership was deemed to be created) if there is a sale or exchange of 50% or more of the total interest in the partnership or LLC capital and profits in a 12-month period. The primary significance of this provision was that the new partnership or LLC was treated as if it had newly acquired its tangible property from a third party. The "new" partnership/LLC had the same tax basis for the property as the basis the terminating partnership or LLC had for that property. But this basis had to be depreciated over the full recovery period applicable to the class of property to which the property belongs.

Other consequences arose from such a termination, including a "bunching" of income from more than one tax year in certain cases when the partnership or LLC is using a different tax year than a partner or member, although this is rare for an individual taxpayer. Also, partnership-level elections generally ceased to apply following such a termination.

The Act repeals the rule that the sale or exchange of 50% or more of a partnership or LLC causes a technical termination of a partnership or LLC. This will eliminate the mostly negative consequences that can arise by reason of a termination when there is a sale or exchange of 50% or more of a partnership or LLC. The change is effective for partnership taxable years beginning after December 31, 2017.

Certain Self-Created Intellectual Property No Longer Will Be Capital Assets

Effective for dispositions after December 31, 2017, a self-created patent, invention model, or design, secret formula or process no longer will be a capital asset. As a result, gain or loss from a sale or exchange of such an asset will not be capital gain or loss; the gain or loss will be ordinary income or loss. This change also applies to the intellectual property listed above that was contributed to a partnership, LLC, or corporation in a non-recognition transaction.

CORPORATE TAX AND OTHER BUSINESS PROVISIONS

Reduction in Corporate Tax Rate

Under previous law, the following rates applied to a corporation's taxable income:

Taxable Income	Tax Rate
$0-$50,000	15%
$50,001-$75,000	25%
$75,001-$10,000,000	34%
Over $10,000,000	35%

The 15% and 25% rates were phased out for corporations with taxable income between $100,000 and $335,000. As a result, a corporation with taxable income between $335,000 and $10 million effectively was subject to a flat tax rate of 34%. Similarly, the 34% rate was gradually phased out for corporations with taxable income between $15 million and $18.3 million, such that a corporation with taxable income of $18.3 million or more effectively is subject to a flat rate of 35%.

Personal service corporations could not use rates below 35%. A personal service corporation is a corporation in which the principal activity is the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. Such services are substantially performed by the employee-owners.

The Act provides that a flat rate of 21% applies to the taxable income of corporations. This rate also applies to the taxable income of personal service corporations.

The 21% flat corporate rate is effective for tax years beginning after December 31, 2017.

Below are some initial observations regarding the corporate rate tax cut.

Unlike many of the individual tax changes, and the tax cut on pass-through income, this rate reduction is enacted as a permanent cut.

For years, the conventional wisdom has been that in order to avoid high double-taxation, an entity should be formed as a limited liability company or other pass-through entity. Is this a game changer? Maybe. At a minimum, the low rate certainly means that a pass-through entity is no longer a no-brainer. With the corporate tax rate being so much lower than the highest tax rate applicable to individual income, even with double taxation, the effective tax rate on corporate income is slightly lower than the highest rate on an individual's ordinary income. Compare 37% with 36.8% (21% + (79%*20%)). Further, the effective corporate tax rate may be lower than 21% given that some expenses, such as state and local taxes, would be deductible by the corporation but not by an individual. (See discussion below.) However, factors that should be considered in the full evaluation of corporation versus pass-through entity include the following:

- Is this a situation where the lower tax on certain pass-through income could apply?
- Will the 3.8% net investment income tax apply to any dividends received by an individual shareholder? If so, the effective tax rate with double taxation will be higher.
- What are the applicable state tax rates on the corporate and individual income? If a high state tax rate is applicable, the effective tax rate with double taxation may be considerably higher. As an aside, we note that, as we have written about before, these tax changes raise important questions as to state taxation: Will states continue to follow federal tax treatment as to computation of income? Will they increase rates? Will they become more aggressive in pursuing revenues?

- Is there risk that the distribution from the corporation to a shareholder would be taxed as something other than a dividend—perhaps compensation? If so, since compensation would be subject to a 37% rate (higher if employment taxes are considered) rather than the 20% that qualified dividends are subject to, the effective tax rate could be much higher than 37%.

- Will the income of the business need to be withdrawn by the owners of the business in the near term? Where there is no need to take the cash out, a corporation may make sense. The longer earnings can stay in a corporation, the greater the resulting value of the deferral will be.

- If the entity is a corporation, is it possible that the stock of the corporation could qualify as qualified small business stock under Section 1202 of the Code? If so, there may be a 0% tax rate on the gain from the sale of the stock. Is it possible that no earnings need to be withdrawn until the death of the shareholders—in which case the stock would pass with a stepped up tax basis to the shareholder?

- Taxpayers and their advisers will have to start considering the accumulated earnings tax, and the personal holding company tax—both taxes designed to ensure a corporation does not retain too much cash beyond the reasonable needs of the business.

Since a tax deduction or loss when the tax rate is 35% yields a greater savings than a deduction or loss when the tax rate is 21%, the cut in the corporate rate also means that corporations will place less value going forward on such deductions or losses.

The rate differential between the corporate rate and the individual rate likely will cause many taxpayers to implement creative tax planning strategies—especially where taxpayers can afford for the corporation to be a vehicle that serves to save earnings—thus at a minimum providing deferral of the second level of tax. The bottom line is that the corporate rate is low enough that in many cases, there is less of a disincentive to try creative tax-planning strategies. If one sets aside legal and other transactional costs, it may be that even if the strategy fails, an individual would be paying tax roughly equal to the tax that would have been payable if she or he had not tried the strategy at all.

Finally, one has to consider the possibility that another Congress may increase the corporate tax rate. If the 21% tax rate is increased in the not-too-distant future, that would leave businesses housed in C corporations in somewhat of a bind. As you likely know, while it is usually tax-free to convert from an LLC or other entity taxed as a partnership to a corporation, it can be prohibitively expensive to convert from a C corporation to an entity taxed as a partnership or LLC.

Corporate AMT

Effective for tax years beginning after December 31, 2017, the Act repeals the corporate AMT.

The Act continues to allow the prior year minimum tax credit to offset a corporate taxpayer's regular tax liability for any tax year. For tax years beginning after 2017 and before 2022, the prior year minimum tax credit would be refundable in an amount equal to 50% (100% for tax years beginning in 2021) of the excess of the credit for the tax year over the amount of the credit allowable for the year against regular tax liability.

Dividends Received Deduction

Corporations that receive dividends from domestic corporations in which they own stock are still entitled to a dividends received deduction. However, the percentage of the deduction has been reduced.

Generally, under previous law, the amount of the deduction was equal to 70% of the dividend received. In the case of any dividend received from "20% owned" (or more) corporation, the deduction was equal to 80% of the dividends received. The term "20% owned corporation" means any corporation if 20% or more of the stock of such corporation (by vote and value) is owned by the taxpayer. For this purpose, certain preferred stock is not taken into account.

In the case of a dividend received from a corporation that is a member of the same affiliated group, a corporation is generally allowed a deduction equal to 100% of the dividend received.

The Act reduces the 80% dividends received deduction to 65% and the 70% dividends received deduction to 50%. This provision is effective for tax years beginning after December 31, 2017.

Changes to Rules Governing Taxable Year of Inclusion of Income

The Act makes a number of changes relating to the timing of when an accrual basis taxpayer is required to include certain income in gross income.

By way of background, income generally is includible in the gross income of an accrual-method taxpayer when the "all events" test is met—that is, when all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy.

New Section 451(b) expands the "All Events" Test

- The Act adds new Section 451(b) to the Code, which will provide that the "all events" test is treated as met no later than when the item is taken into account as revenue by the taxpayer in a "financial statement" (with a specified meaning). Thus, where Section 451(b) applies, the taxpayer will be required to recognize taxable income in an earlier year than under previous law.
  - Section 451(b) provides a list of financial statements that qualify. If a taxpayer has no financial statement on the list, Section 451(b) does not apply to it. The term "applicable financial statement" means:

    A. a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is:

       i. a 10-K (or successor form), or annual statement to shareholders, required to be filed by the taxpayer with the U.S. Securities and Exchange Commission (SEC),

       ii. an audited financial statement of the taxpayer which is used for

           I. credit purposes,

           II. reporting to shareholders, partners, or other proprietors, or to beneficiaries, or

           III. any other substantial nontax purposes,

       iii. filed by the taxpayer with any other federal agency for purposes other than federal tax purposes.

    B. a financial statement that is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government that is equivalent to the SEC and which has reporting standards not less stringent than the standards required by such Commissioner, or

    C. a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Treasury Secretary.

  - Section 451(b) applies to income on debt instruments that are subject to the original issue discount (OID) rules, and, thus, may require interest income to be reported earlier than would other be required under the OID rules. Future regulations hopefully will illustrate the interaction of Section 451(b) and the OID rules.

- The new rules under Section 451(b) will not apply to income realized but not recognized under non-recognition rules such as Sections 351 and 721.
- If the financial results of a taxpayer that is a member of a group of entities are reported on the applicable financial statement, then the statement will be treated as the applicable financial statement of the taxpayer.
- Excluded from the scope of Section 451(b) are items of gross income earned in connection with a mortgage servicing contract.

- New Section 451(c) codifies exception to the "all events" test for certain advance payments. Section 451(c) codifies an exception to the application of the all events test relating to certain advance payments received by accrual-method taxpayers for goods, services, and other specified items provided by the IRS under Revenue Procedure 2004-34.
  - General rule. Under new Section 451(c), an accrual-method taxpayer can elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes. This provision is intended to override any deferral method provided by Treasury Regulations Section 1.451-5 for advance payments received for goods. Thus, the deferral is only for one year.
  - "Advance payments" are those for goods, services, or such other items as may be identified by the Treasury Secretary, and they are payments, a portion of which is included in revenue by the taxpayer for a subsequent year in one of the financial statements listed in A(i) or (ii) above as described in the Section 451(b). The following payments are specifically excluded: rent, insurance premiums, payments with respect to financial instruments, payments with respect to warranty or guarantee contracts under which a third party is the primary obligor, payments subject to section 871(a), 881, 1441, or 1442, payments in property to which section 83 applies, and any other payment identified by the Treasury Secretary.
  - Election. The election is effective for the relevant taxable year and all subsequent taxable years, unless the taxpayer receives the Treasury Secretary's consent to revoke the election. If a taxpayer does not make an election under the new Section 451(c), an advance payment must be taken into account under the general rules in Section 451(b).
- Coordination with Section 481. Any change that is required by the rules described above will be treated as initiated by the taxpayer and as made with the consent of the Secretary of the Treasury. The period for taking into account any Section 481 adjustments with respect to income from a debt instrument with OID is six years.

The new rules under Section 451 are effective for taxable years beginning after December 31, 2017, except that, for debt instruments with OID, the effective date is delayed until the first taxable year beginning after December 31, 2018.

Modification of Net Operating Loss (NOL) Deduction

Under the Code in effect before the Act, NOLs could be carried back by corporations for two years and carried forward for 20 years and claimed as a deduction in such tax years. However, for AMT purposes, the NOL deduction was limited to 90% of the alternative minimum taxable income.

The Act modifies the NOL deduction by:

- Limiting the deduction that may be claimed with respect to NOLs to 80% of taxable income;
- Eliminating the carryback of NOLs, except for losses incurred in the trade or business of farming; and
- Replacing the 20-year carryforward period with an indefinite carryforward period.

The modified NOL rules do not apply to a property and casualty insurance company.

The provision allowing indefinite carryforwards and modifying carrybacks applies to net operating losses arising in taxable years ending after December 31, 2017. The provisions limiting the NOL deduction to 80% of taxable income applies to losses arising in taxable years beginning after December 31, 2017.

Limitation on the Deductibility of Business Interest

Under the Code as in effect before the Act, taxpayers engaged in a trade or business generally were allowed a deduction for interest expense when paid or accrued. The deductibility of interest expense is a key assumption underlying the use of debt financing.

Provisions of the Code in effect before the Act provided numerous limitations on the deductibility of interest expense, including the so-called earnings stripping rules of Section 163(j) relating to interest paid or accrued by a corporation to certain related parties exempt from U.S. tax (such as foreign affiliates).

The Act replaces the earnings stripping rules with a broad rule that generally limits deductions for business interest to 30% of "adjusted taxable income" for the taxable year, plus any business interest income and floor plan financing interest for such year. Any interest that is disallowed as a deduction under new Section 163(j) may be carried forward to future taxable years.

For tax years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is calculated similarly to EBITDA, and for tax years beginning on and after January 1, 2022, adjusted taxable income would be calculated similar to EBIT (*i.e.*, without adding back deductions for depreciation, amortization, or depletion).

With respect to partnerships and S corporations, the 30% limitation is applied at the partnership or S corporation level and deductions for interest allowed under these rules are included in the partners' or shareholders' non-separately stated taxable income or loss. However, to prevent double-counting of income at the owner level, an owner of a partnership or an S corporation ignores the owner's share of the entity's tax items for purposes of applying the 30% limitation to the owner. An owner is permitted to increase the owner's adjusted taxable income by the owner's share of the excess taxable income of the partnership or S corporation (*i.e.*, the owner's share of additional interest expense the partnership or S corporation could have deducted under this 30% rule).

Special rules apply to the carryforward of disallowed interest deductions ("excess business interest") to partnerships. Excess business interest is required to be allocated to each partner in the same manner as non-separately stated taxable income or loss of the partnership. A partner is permitted to deduct its share of such excess business interest only when the partnership has excess taxable income. In addition, each partner is required to reduce its basis for the partner's partnership interest by the partner's share of excess business interest, even if the carryforward is not deductible in such year. Upon a taxable disposition of the partner's partnership interest, the partner is permitted to increase its basis for the partnership interest immediately before the disposition for any excess business interest that reduced the partner's basis for the partnership interest that was not deducted by the partner.

Taxpayers that meet the average annual gross receipts test of $25 million or less during the three preceding years) are exempt from these rules. For purposes of determining whether the gross receipts test is satisfied, the gross receipts of related taxpayers are aggregated. Other taxpayers that would be exempt from these rules include: taxpayers engaged in the business of performing services as an employee, certain utilities, taxpayers engaged in a real property trade or business for purposes of Section 469 that elect to be excluded from these rules and taxpayers engaged in the business of farming that elect to be excluded from these rules. A taxpayer engaged in a real property trade or business that elects to be excluded from these rules is required to use the alternative depreciation system to depreciate real property used in a trade or business. A taxpayer that is engaged in the business of farming that elects to be excluded from these rules is required to use the alternative depreciation system to depreciate any property with a recovery period of 10 years or more.

These limitations on the deductibility of business interest apply to tax years beginning after December 31, 2017.

TAX CREDITS

Modification of the RTC and Retention of Business Credits

The New Markets Tax Credit (NMTC) and the Rehabilitation Tax Credit (RTC), including historic tax credits, have attracted significant private investment to low-income communities and historic buildings.

The Act retains the NMTC, the employer-provided child-care credit, the work opportunity tax credit, the credit for expenditures to provide access to disabled individuals and all business credits. The Act repeals the 10% RTC and retains the 20% RTC applicable to historic structures, and permits the RTC to be claimed ratably over a five-year period beginning in the tax year when the structure is placed in service. This change is effective for qualified rehabilitation expenditures (QREs) incurred after December 31, 2017; however, in the case of QREs incurred with respect to any building owned or leased by the taxpayer during the entire period after December 31, 2017, with respect to which the 24-month rehabilitation period (or the 60-month period for phased rehabilitations) begins not later than 180 days after enactment, the new rules will only apply to QREs incurred after the end of that 24-month (or 60-month) period. Finally, with respect to the credit for clinical testing expenses for certain drugs for rare diseases of conditions, the Act reduces the credit rate from 50% to 25%.

Retention of R&D Tax Credit and LIHTC

The Act retains the R&D Credit and the low income housing tax credit (LIHTC) in their current form and the tax exemption for private activity bonds.

Energy Credits

The Act retains the ITC and PTC in their current form.

BEAT – Base Erosion Anti-Abuse Tax

The Act includes a Base Erosion and Anti-abuse Tax (BEAT)—which is discussed below under International Tax Provisions—applicable to corporate taxpayers. The BEAT is aimed at stopping some corporations from storing money off shore in order to reduce their tax liability beyond 10% of their taxable income. However, certain tax credits became entangled in this provision. To calculate the BEAT, corporate taxpayers are required to perform two calculations: (1) 10% of taxable income modified to include certain base erosion payments and (2) the regular tax liability minus tax credits (allowing 80% of the LIHTC, PTC and ITC). If the amount in (1) is larger than the amount in (2), then the taxpayer would owe tax equal to the excess. The Act incorporates a late-added amendment effective through 2025 pursuant to which the effect of the BEAT is reduced by only 80% of the LIHTC, PTC, and ITC (as indicated above).

EXEMPT ORGANIZATIONS

Creation of Basket System for Separately Taxing UBTI of Each Trade or Business Operated

The Act requires those exempt organizations that carry on more than one unrelated trade or business (directly or through a pass-through entity) to calculate unrelated business taxable income (UBTI) for each trade or business separately, so that deductions from each unrelated trade or business are available to offset income from only that unrelated trade or business and do not offset income from other unrelated trades or businesses.

Excise Tax Imposed on Net Investment Income of Private Colleges and Universities

The Act imposes a 1.4% excise tax on net investment income of certain private colleges and universities that are public charities. Under the Code as in effect before the Act, an excise tax on net investment tax applied only to private foundations. The new excise tax applies to private colleges and universities that had (1) at least 500 students during the preceding tax year, (2) more than 50% of the students of which are located in the United States, and (3) that had non-charitable use assets valued at the close of the preceding tax year of at least $500,000 per full-time student. For purposes of the rule, the number of students is based on the daily average number of full-time students attending the institution (with part-time students taken into account on a full-time student equivalent basis). State colleges and universities are not subject to the excise tax on net investment income. The assets and net investment income of certain related organizations are treated as the assets of private colleges or universities for purposes of this tax.

Excise Tax on Excess Tax-Exempt Organization Executive Compensation

The Act imposes a 21% excise tax on exempt organizations that pay compensation in excess of $1 million or certain severance payments to any of its five highest-paid employees (including former employees) for the tax year. Compensation for this purpose includes cash and the cash value of all remuneration (including benefits) paid in any form other than cash, except for payments to a tax-qualified retirement plan and amounts excludable from the employee's gross income. For purposes of the excise tax, compensation is treated as paid when the rights to the compensation are no longer subject to a substantial risk of forfeiture. Thus, the tax can apply to the value of compensation that is vested (and any increases in such value or vested compensation) even if such vested compensation has not yet been received. The tax does not apply to compensation paid to a licensed medical professional (including a veterinarian) for the provision of medical or veterinarian services.

Denial of Charitable Deduction for Amounts Paid in Exchange for College Athletic Event Seating Rights

Under the Code as in effect prior to the Act, purchases of seating rights at college athletic events were allowed as charitable deductions for up to 80% of the amount paid. The Act prohibits any charitable deduction for amounts paid to colleges in exchange for the right to purchase tickets or seating at an athletic event.

Repeal of Exception to Substantiation Rules for Charitable Contributions

Under the Code as in effect prior to the Act, no charitable deduction was allowed for any contribution of $250 or more unless the donor receives a contemporaneous written acknowledgement of the contribution from the donee charity. However, this requirement was waived if the donee reported the contribution in its return in accordance with Treasury Regulations (which have been proposed but not adopted). The Act eliminates the availability of this exception to the substantiation requirement.

UBTI Increased by Amount of Certain Fringe Benefits for Which Deduction Is Disallowed

The Act increases UBTI by amounts paid or incurred by an exempt organization for certain transportation (parking) fringe benefits that are not tax deductible by the recipients of such fringe benefits.

Provisions Not Included in the Act

The House and/or Senate bills contained several provisions that would have affected exempt organizations but those provisions are not contained in the Act.

Clarification of Application of UBIT

Government sponsored entities will not be subject to UBIT.

Limitation on Exclusion of Certain Research Income from UBIT

Under the Code as in effect before the Act, organizations that carry on fundamental research, the results of which are freely available to the general public, may exclude all of the organization's research income from unrelated business income tax (UBIT). The Act does not change this.

Simplification of Investment Income Tax Rate

Under the Code as in effect before the Act, excise tax on net investment income applicable to private foundations is 2%, but it may be reduced to 1% under certain circumstances. The Act does not change this.

Limitation on Private Operating Foundation Status for Certain Art Museums

The Act does not impact the ability of organizations that operate art museums as a substantial activity to qualify as a private operating foundation.

Expansion of Business Interests That Would No Longer Constitute Excess Business Holdings

Under the Code as in effect before the Act, private foundations generally may not own more than a 20% voting interest in a for-profit business. The Act does not change this.

Exempt Organizations Allowed to Make Certain Political Statements

Under the Code as in effect before the Act, organizations exempt under Code Section 501(c)(3) are prohibited from participating in, or intervening in, any political campaign on behalf of or in opposition to any candidate for public office. The Act does not change this.

New Excise Tax on Exempt Organizations Involved in Excess Benefit Transactions

Under the Code as in effect before the Act, if an exempt organization provides certain economic benefits to a disqualified person (a DQP), the DQP and the organization's management are subject to excise taxes on the amount of any "excess benefit." The Act does not change this.

Repeal of Tax Exemption for Professional Sports Leagues

Under the Code as in effect before the Act, professional sports leagues may qualify for tax-exempt status under Section 501(a). The Act does not change this.

INTERNATIONAL TAX PROVISIONS

Establishment of a Participation System of Taxation

The United States taxes its citizens,[1] resident alien individuals, and business entities that are organized in the United States on their worldwide income. Although other countries impose taxes on worldwide income based on the concept of "residence," they generally determine the residence of entities from factors such as situs, management, and control of the businesses.

The United States taxes non-resident alien individuals and business entities organized in foreign jurisdictions only on their U.S. source income and generally only on a gross basis. Because business entities organized in non-U.S. jurisdictions do not pay tax on their non-U.S. source income while business entities organized in the United States do, the current U.S. system of taxation has encouraged U.S.-controlled businesses to conduct their foreign operations through non-U.S. entities. In that way, U.S. taxation of offshore earnings generally has been deferred indefinitely.

Because all non-U.S. entities are classified as "corporations" for U.S. tax purposes in default of elections to be treated as pass-through entities, the opportunities to employ this deferral strategy have few limitations. Specifically, since 1962, some types of offshore income (primarily passive forms of investment income) have not been eligible for deferral by U.S.-controlled foreign corporations (CFC) under the subpart F provisions of the Code. In situations where subpart F is applicable, 10% U.S. shareholders of a CFC have been required to include in their taxable income certain types of income earned by the foreign corporation, regardless of whether such amounts have yet been remitted as dividends. Since 1986, similar anti-deferral provisions have existed for certain non-U.S.-controlled foreign corporations (so-called "passive foreign investment companies" or PFICs).

The Act does not abandon the fundamental principles of the U.S. system—worldwide taxation based on citizenship, residence, and entity place of organization. However, the Act supplements these principles with a "participation exemption system" for foreign income earned by domestic corporations, similar to that employed by other countries with worldwide systems of corporate taxation. Briefly, the Act allows a 100% deduction for the "foreign-source portion" of dividends received by a 10%[2] U.S. corporate shareholder from a CFC or from a non-CFC with active business operations (that is, excluding any PFIC that is not a CFC). Both direct and indirect ownership of the foreign corporation through a foreign partnership are taken into account when determining whether the 10% ownership threshold is satisfied by the domestic corporation.

The term "dividend" is broadly defined for purposes of the new dividends received deduction to include generally all amounts received as "dividends" under the Code. Specifically, amounts of recognized long-term capital gain from the sale of stock of foreign corporations that are recharacterized as dividends by reason of Section 1248 or Section 964(e) are treated as dividends eligible for the 100% deduction. However, although both the House and Senate Bills would similarly have eliminated from domestic corporate income subpart F inclusions for repatriated investment in U.S. property, the Act leaves the current Section 956 provisions in place. Thus, a tax distinction is drawn that depends on the form that is used to repatriate investment. Cash that is repatriated and invested in the U.S. by a domestic corporation will receive the deduction, while cash that is used by a CFC of a domestic corporation to invest in U.S. property will be fully taxable to the domestic corporate shareholders as if it had been repatriated.

Also notably, the new participation exemption system does not extend to foreign businesses operated by branches of U.S. entities. As under the Code as in effect prior to the Act, foreign branches as nominal U.S. tax residents were subject to current U.S. taxation on the income that they earn and obtain relief from double taxation only through the allowance of

1 Currently, the United States and Eritrea are the only two countries in the world that tax citizens on their worldwide income.

2 Because of a concurrent change to subpart F, 10% ownership of a CFC will now be determined by vote or value of the shares a domestic corporation holds of a foreign corporation.

foreign tax credits. However, under the Act, certain foreign branches will obtain tax relief from the new foreign-derived intangible income (FDII) deduction that is discussed below.

The "foreign-source portion" of dividends received is determined by the ratio of the foreign corporation's "undistributed foreign earnings" to all of its undistributed earnings. "Undistributed foreign earnings" is defined as all of the foreign corporation's undistributed earnings other than (1) its post-1986 earnings attributable to income that is effectively connected to the conduct of a trade or business in the United States and (2) its post-1986 earnings attributable to dividends received from domestic corporations. However, 10% corporate shareholders will generally be allowed dividends received deductions ranging from 50% to 100% under the Act for dividends paid by foreign corporations from these two excluded sources (Section 245 of the Code). Likewise, although the new dividends received deduction does not apply to distributions made by a CFC out of previously taxed subpart F income, such distributions already are currently excluded from the income of a domestic corporation (Section 959 of the Code).

The Act contains a special holding period rule to limit the use of dividend capture strategies, analogous to the one that applied to the dividends received deduction allowable under the Code as in effect before the Act (Section 246 of the Code). Specifically, the requisite holding period will be at least 366 days during the 731-day period beginning on the date that is 365 days before the ex-dividend date. In addition, the foreign corporation must maintain its status as a CFC or as a non-CFC that is not a PFIC and the dividend recipient must maintain its status as a 10% corporate shareholder throughout the requisite holding period. Anti-abuse provisions are included to prevent diminution of the payee's risk during the required holding period.

Under the Act, the portion of the stock-generating dividends eligible for the new 100% dividends received deduction will not be taken into account in allocating and apportioning deductible expense between foreign and U.S. source income.

The Act disallows dividends received deduction for any "hybrid dividend," which is defined to mean a dividend for which the foreign corporation received a deduction or other tax benefit. Furthermore, where any CFC with a domestic corporate 10% shareholder receives a hybrid dividend from another CFC with respect to which the same domestic corporation also is a 10% shareholder, the dividend is treated as subpart F income and is included in the domestic corporation's subpart F income, regardless of whether it is remitted to the United States.[3]

A toll charge that is exacted by the Act for use of the new participation system is the loss of credits for foreign taxes associated with the dividends received by the domestic corporation. These lost credits include both direct credits for withholding taxes paid to the source country of the dividend and indirect credits for corporate income taxes previously paid to foreign countries on the remitted earnings. In addition, dividends receiving the new 100% deduction are not treated as foreign-source income in calculating the foreign tax credit limitation applicable to the foreign tax credits that remain allowable to the domestic corporation from other sources. The Act also will create a separate foreign tax credit limitation basket for foreign branch income in determining the credits that remain allowable.

Under the Act, the new dividends received deduction and related provisions apply to distributions made after December 31, 2017. The new foreign tax credit limitations is effective for taxable years beginning after December 31, 2017.

Anti-Artificial Loss Provision – Expanded Basis Reduction

Under the Code as in effect before the Act (Section 1059 of the Code), the basis of stock held by corporate shareholders was reduced by the portion of any extraordinary dividend received for which the shareholder has received a dividends received deduction. The Act requires a similar basis reduction by any amount for which a dividends received deduction was allowed by a domestic corporation under the new participation exemption system. Unlike Section 1059, the new basis reduction is required regardless of whether the foreign-source dividend is an extraordinary dividend and applies only to

3 It should be noted that an actual dividend that is paid by a non-CFC to a CFC is to be treated similarly to subpart F income under the Code.

the extent that a loss would otherwise be recognized. However, the new provision can apply in conjunction with Section 1059 in situations where a dividends received deduction is allowable under the Code as in effect before the Act for the U.S. portion of a dividend paid by a foreign corporation (Section 245). In that circumstance, the basis reduction under Section 1059 is made first, prior to any adjustment under the Act's provision.

The basis reduction is effective for distributions made after December 31, 2017.

Expanded Recapture of Foreign Branch Losses

Under the Code as in effect before the Act, a domestic corporation that conducts its foreign operations directly through a foreign branch recaptures those losses if it transferred substantially all of the branch assets to a foreign corporation in a transaction that otherwise would qualify for non-recognition of gain or loss (Section 367(a)(3)(C) of the Code). The Act broadens the existing recapture provision to include all such transfers to a CFC with respect to which the transferor would be a 10% shareholder after the foreign branch asset transfer was made, regardless of whether the transfer would otherwise qualify for non-recognition.

In addition, the recapture income generated under the expanded provision is treated as U.S.-source income.

The expanded foreign branch recapture provision is effective for transfers made after December 31, 2017.

Repeal of Active Trade or Business Exception

Outbound acquisitions of the assets of U.S. trades or businesses through the liquidation of 80% subsidiaries, Section 351 transactions (e.g., incorporations), or through Type A (merger) or Type C (asset transfer) reorganizations have relied upon an "active trade or business" exception to Section 367 in achieving tax-free treatment.

The Act will repeal the active trade or business exception and will assure that a toll charge is generally imposed on most outbound transfers of business assets from the United States. The new provision applies to transfers after December 31, 2017.

Modification of Deemed Paid Foreign Tax Credit

As noted above, repeal of the indirect deemed paid credit attached to dividends paid by a CFC to a domestic corporation is part of the toll charge that will be paid for enactment of the Act. However, the complementary deemed paid credit allowed under the Code as in effect before the Act for subpart F income inclusions is retained to the extent it can be traced to foreign taxes imposed on a tax base that includes the subpart F income inclusion item. Likewise, the pre-Act gross-up provision (Code Section 78) that adds back the deemed paid foreign taxes to the amount of the subpart F inclusion is retained, while the complementary gross-up provision required for actual CFC dividends that carry deemed paid credits is repealed.

These provisions are effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of domestic corporate shareholders in which, or with which, such foreign corporate taxable years end.

Change in Sourcing Rule for Inventory

Under the Code as in effect before the Act, gain from the sale of inventory produced within the United States and sold outside the United States or from the sale of inventory produced without the United States and sold within the United States could be allocated and apportioned between U.S.-source and foreign-source income using one of three methods elected by the taxpayer. The Act will source income from the sale of inventory solely according to the place of the inventory's production and without regard to the place of title passage.

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

Expansion of Subpart F for 2017 Taxable Years – One-Time Repatriation

The primary toll charge for the transition to the participation exemption regime is the imposition of one-time repatriation taxes on the 10% U.S. shareholders of "specified foreign corporations." Specified foreign corporations include CFCs and other foreign corporations in which one or more domestic corporations is a 10% shareholder (taking into account actual and constructive ownership). 10% shareholders of PFICs that are not CFCs are not subject to this toll charge because their anti-deferral system remains in place. However, all U.S. persons that hold stock representing 10% or more of the voting power[4] of the specified foreign corporation are subject to this toll charge, not merely domestic corporations that will receive the benefit of the new dividends received deduction under the participation exemption system.

Each 10% shareholder of a specified foreign corporation is required to include in its subpart F income for its last taxable year beginning before January 1, 2018 its pro rata share of the greater of its accumulated post-1986 earnings and profits determined as of November 2, 2017,[5] and its accumulated post-1986 earnings and profits determined as of December 31, 2017. Earnings and profits effectively connected to the conduct of a trade or business within the United States or attributable to previously taxed subpart F income are excluded from the repatriation inclusion because they already have been subject to U.S. tax. Only earnings and profits accumulated in post-1986 taxable years in which the corporation was a specified foreign corporation are taken into account. However, the amount of such post-1986 accumulated earnings and profits to be taken into account by any 10% shareholder will not be limited to earnings and profits accumulated in taxable years in which such person was a 10% shareholder of the specified foreign corporation.

Dividends paid in the measurement taxable year will not be allowed to reduce accumulated earnings and profits unless they have been paid to another specified foreign corporation.

Accumulated earnings and profits are reduced by accumulated deficits existing in specified foreign corporations owned by the same 10% shareholder as of the November 2, 2017, and December 31, 2017, determination dates. The earnings and profits deficits are allocated among the profitable corporations based upon their relative contributions to the total deferred foreign income of the shareholder. Intragroup netting of deficits that remain unused after the application of the general earnings reduction rule with the remaining earnings of specified foreign corporations within the same affiliated group also is permitted. The IRS is authorized to issue U.S. Department of the Treasury regulations to limit reduction of the amount of accumulated earnings and profits through the use of retroactive check-the-box elections and other repatriation tax-avoidance strategies.

Once the amount of accumulated post-1986 deferred foreign income inclusion is determined for a domestic corporate shareholder, a notional 15.5% tax is imposed on the portion of the subpart F income inclusion that represents the "aggregate cash position" of the shareholder with respect to each specified foreign corporation, and a notional tax of 8% is imposed on the remainder of the income inclusion.[6] The deductions[7] allowed to any 10% domestic corporate shareholder to achieve its applicable notional repatriation tax rates will be recaptured and taxed at a 35% rate if the domestic shareholder becomes an expatriated entity (other than one that is still treated as a domestic corporation) within 10 years of the date of enactment. Other deductions, including the net operating loss carryover deduction, may be allowable after the special inclusion deductions are taken. The Act permits 10% shareholders to elect to forego the use of the net operating loss deduction for the repatriation taxable year.

---

4 As indicated in footnote 2, the Act prospectively changes the definitional test of 10% shareholder status to one of vote or value of shares held. However, this change takes effect after the repatriation taxable year, so the (solely) voting power test of the Code as in effect before the Act applies for purposes of the repatriation tax.

5 November 2, 2017, was the date of introduction of the proposed tax legislation in the House.

6 Technically, the Act accomplishes this result in a highly complex manner by allowing the 10% shareholder to deduct amounts sufficient to produce the specified percentages of tax on the amount of each inclusion (as determined before the deduction). The highest rate of corporate income tax for the repatriation taxable year is assumed in sizing the deduction, even in the case of non-corporate 10% shareholders. As explained in the text, however, further deductions may be taken before the ultimate shareholder tax liability is determined for the repatriation taxable year.

7 That is, the deductions referenced in footnote 6 that achieve the repatriation tax rate.

The aggregate cash position represents the greater of the shareholder's indirect, prorated ownership of cash and cash equivalents of the specified foreign corporations on (1) the last day of the taxable year of the specified foreign corporation beginning before January 1, 2018, and (2) the average of such amounts as of the close of the specified foreign corporation's last two taxable years ended before November 2, 2017. The Act takes into account the cash position of non-corporate foreign entities that would be specified foreign corporations if classified as corporations in determining the appropriate amount of repatriation tax. Reductions to the shareholder's aggregate cash position are made to eliminate double-counting. The excess of the subpart F income inclusion over the aggregate cash position presumably represents the illiquid assets held by each specified foreign corporation, although the amount is defined only as a residual category.

The deemed paid foreign tax credits that otherwise would be allowable for the subpart F inclusion under Code Section 960 are reduced under the Act by 55.7% to the extent they are attributable to the aggregate cash position portion and by 77.1% to the extent attributable to the remainder of the inclusion.

Under the Act, a 10% shareholder may elect to pay the net tax liability resulting from the deemed repatriation inclusion over eight years in non-interest bearing installments.[8] A failure to pay an installment timely, a corporate liquidation or bankruptcy, a sale of substantially all the corporate assets, a cessation of business, or the occurrence of any similar event will accelerate the remaining payments due.

A special rule applies for shareholders of S corporations that have subpart F income inclusions by reason of the repatriation provision. An S corporation shareholder may elect, on or prior to the due date of the shareholder's return for the taxable year that reports the S corporation's subpart F repatriated income inclusion, to defer his or her portion of the net tax liability resulting from the repatriation until a triggering event occurs. If a shareholder makes the tax-deferral election, the S corporation will become jointly and severally liable for its eventual payment. Triggering events include (1) a loss of S corporation status; (2) a corporate liquidation, bankruptcy, sale of substantially all the corporate assets, or a similar event and, (3) a complete or partial transfer[9] of the S corporation shares unless the transferee agrees to assume the transferor's deferred net tax liability. In the case of a type (1) or type (3) triggering event (but not—except with the consent of the IRS—an event falling within type (2)), the shareholder may elect to pay the triggered liability in eight installments (in percentages corresponding to those prescribed under the general installment payment election) beginning with the due date of the tax return.

The Act provides disparate treatment for the regulated corporations that are governed by subchapter M of the Code. REITs that are 10% shareholders will exclude the repatriated amount from gross income in determining whether they satisfy the REIT qualification tests. REITs may also elect spread their repatriated income inclusions over eight years in the same percentages that apply to the election to defer tax[10] in order to facilitate satisfaction of the annual income distribution requirement that is applicable to REITs. No similar provision permits mutual funds (RICs) that are 10% shareholders to exclude the repatriated amount from gross income for purposes of their similar statutory qualification tests or to elect to spread the repatriation inclusions for purposes of their distribution requirements.

The Act extends the statute of limitations on assessment to six years from the filing of the tax return for the taxable year in which the repatriation income was to be reported.

The repatriation tax is effective for the last taxable year of a foreign corporation that begins before January 1, 2018, and for the taxable years of 10% shareholders with which—or within which—such taxable year ends.

8 Specifically, the installments are 8% for each of the first five years, 15% for the sixth year, 20% for the seventh year, and 25% for the eighth year.

9 In the case of a partial transfer, deferral will end only with respect to the portion of the tax liability allocable to the shares transferred.

10 See footnote 8.

Certain Other Modifications of Subpart F Rules

The Act modifies certain other rules relating to the subpart F provisions:

- The Act repeals Section 955 of the Code. As a result, a U.S. shareholder in a CFC that invested its previously excluded subpart F income in qualified foreign base company shipping operations is no longer required to include in income a pro rata share of the previously excluded subpart F income when the CFC decreases such investments. This provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

- The Act eliminates foreign base company oil-related income as a category of subpart F income under Section 954. This provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

- The Act eliminates the 30-day rule in Section 951(a)(1). Under previous law, a foreign corporation was required to otherwise be a CFC for an uninterrupted period of 30 days or more before it was classified as a CFC for federal income tax purposes. This provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

- The Act amends the ownership attribution rules of Section 958(b) so that certain stock of a foreign corporation owned by a foreign person is attributed to a related U.S. person for purposes of determining whether the related U.S. person is a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. In other words, the provision provides “downward attribution” from a foreign person to a related U.S. person in circumstances in which previous law did not so provide. The pro rata share of a CFC’s subpart income that a U.S. shareholder is required to include in gross income, however, continues to be determined based on direct or indirect ownership of the CFC without application of the new downward attribution rule. The conference report states that the conferees intend to render ineffective certain transactions that are used as a means of avoiding the subpart F provisions. One such transaction that is provided as an example involves effectuating “de-control” of a foreign subsidiary, by taking advantage of the section 958(b)(4) rule that effectively turns off the constructive stock ownership rules of 318(a)(3) when to do otherwise would result in a U.S. person being treated as owning stock owned by a foreign person. Such a transaction, it is stated, converts former CFCs to non-CFCs despite continuous ownership by U.S. shareholders. The provision is effective for the last taxable year of foreign corporations beginning before January 1, 2018 and each subsequent year of such foreign corporations and for the taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

Current Year Inclusion of Global Intangible Low-Taxed Income

The Act requires 10% shareholders of CFCs to include in income currently “global intangible low-taxed income” (GILTI) with respect to such CFCs in a manner similar to Subpart F income. However, as discussed below, the Act provides for a deduction for U.S. C corporations for 50% of GILTI inclusions (37.5% for tax years beginning after December 31, 2025) that reduces the effective rate of tax with respect to such GILTI inclusions.

GILTI means the 10% shareholder’s share of certain “net CFC tested income” in excess of 10% of the aggregate tax basis of depreciable tangible property held by a CFC. Tested income for purposes of these rules generally is defined as gross income, excluding effectively connected income, subpart F income, active financing and insurance income excluded from subpart F, certain related party payments, and certain other items, less deductions properly allocable to such income.

GILTI included in income generally is to be treated in the same manner as subpart F income for purposes of other provisions of the Code, including Sections 959, 960, 961, 962, and 1248. However, deemed paid foreign tax credits relating to GILTI are limited to 80% of the foreign taxes paid or accrued. In addition, foreign taxes relating to GILTI are treated as a separate "basket" under Section 904 that is only creditable against other GILTI inclusions. Moreover, foreign tax credits relating to GILTI are not allowed to be carried back or carried forward under Section 904(c).

The provisions relating to GILTI apply to taxable years beginning after December 31, 2017.

Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income

The Act allows U.S. C corporations to claim a deduction equal to 37.5% of "foreign derived intangible income" plus 50% of the GILTI amount included in income, but not to exceed taxable income. For taxable years beginning after December 31, 2025, the deduction for foreign derived intangible income and GILTI is 21.875% and 37.5% respectively. Shareholders of S corporations are not permitted to claim this deduction.

Foreign derived intangible income is essentially certain deductible eligible income in excess of 10% of the corporation's "qualified business asset investment" that relates to property sold to any person who is not a U.S. person or services provided to any person, or with respect to property, not located within the United States. Qualified business asset investment generally is the adjusted tax basis of certain specified tangible property used in a trade or business as determined under the alternative depreciation system under Section 168(g) of the Code.

As a result of this deduction, taking into account the new 21% corporate tax rate, the effective rate of tax on foreign derived intangible income is 13.125% and the effective U.S. tax rate on GILTI is 10.5% for tax years beginning after December 31, 2017, and before January 1, 2016. Taking into account foreign tax credits for foreign taxes paid with respect to GILTI (80% under the Act), no residual U.S. tax generally is owed with respect to such income if the foreign tax rate was 13.125% or greater. Similarly, for tax years beginning after December 31, 2025, the effective rate of tax on foreign derived intangible income is 16.406% and the effective U.S. tax rate on GILTI would be 13.125%.

Moreover, taking into account foreign tax credits for foreign taxes paid with respect to GILTI (80% under the Act), no residual U.S. tax generally is owed if the foreign tax rate with respect to GILTI was 16.406% or greater.

This deduction applies to taxable years beginning after December 31, 2017.

Limitation on Deductions of Interest by Members of an International Financial Reporting Group or Worldwide Affiliated Group

The Act does not include the provisions of the Senate and House bills that would have limited deductions for interest expense for members of an international financial reporting group or worldwide affiliated group.

Tax on Base Erosion Payments

The Act requires certain applicable taxpayers to pay a tax equal to the base erosion minimum tax amount (BEMTA) for the taxable year.

Essentially, BEMTA is the excess of 10% (5% for tax years beginning in calendar year 2018 and 12.5% for tax years beginning after December 31, 2025) of the taxpayer's taxable income, modified to exclude certain base erosion payments, over the taxpayer's regular tax liability reduced by certain credits (for tax years beginning after December 31, 2025, reduced by all credits). A base erosion payment generally is an amount paid or accrued to a foreign person that is a related party for which a deduction is allowed, including amounts paid or accrued to acquire depreciable property. Relatedness for purposes of these rules is tested based on a 25% ownership threshold, applying the constructive ownership rules under Section 318 of the Code with certain modifications. A base erosion payment also includes any payment that constitutes a reduction in gross receipts that is paid or accrued to a surrogate foreign corporation under Section 7874(a)(2) that is a related party to the taxpayer or a foreign person that is a member of the same expanded affiliated group as the surrogate foreign corporation.

A base erosion payment for which gross basis tax is imposed, and about which tax has been deducted and withheld under Sections 1441 or 1442, generally is not taken into account in computing modified taxable income.

Under the Act, an applicable taxpayer is a corporation (other than a RIC, REIT, or S corporation), with average annual gross receipts of at least $500 million for the three-year period ending with the preceding taxable year and which has a base erosion percentage of 3% or higher for the taxable year (2% in the case of a banks and dealers in securities). The base erosion percentage generally is the percentage determined by dividing deductions for base erosion payments for the taxable year by the aggregate amount of deductions allowable for such taxable year (excluding certain deductions, such as the NOL deduction and the deduction for foreign-derived intangible income and GILTI inclusions). For banks and dealers in securities, the base erosion minimum tax is 11% (6% for tax years beginning in calendar year 2018), increasing to 13.5% for taxable years beginning after December 31, 2025.

The tax on base erosion payments with respect to applicable taxpayers applies to amounts paid or incurred after December 31, 2017.

WRITTEN AND EDITED BY:

Saba Ashraf
Partner, Philadelphia
215.864.8858
ashrafs@ballardspahr.com

Elizabeth A. Beerman
Associate, Minneapolis
612.371.3909
beermane@ballardspahr.com

Jeffrey R. Davine
Senior Counsel, Denver
303.299.7312
davine@ballardspahr.com

Thomas G. Havener
Attorney, Washington, D.C.
202.661.2274
havenert@ballardspahr.com

Joanna Jiang
Associate, Washington, D.C.
202.661.7644
jiangj@ballardspahr.com

Christopher A. Jones
Attorney, Philadelphia
215.864.8424
jonesc@ballardspahr.com

Wendi L. Kotzen
Partner, Philadelphia
215.864.8305
kotzenw@ballardspahr.com

Shawn L. McIntire
Of Counsel, Denver
303.299.7321
mcintires@ballardspahr.com

Kendis Key Muscheid
Partner, Phoenix
602.798.5410
muscheidk@ballardspahr.com

Ann Novacheck
Of Counsel, Minneapolis
612.371.3917
novachecka@ballardspahr.com

Mark D. Salsbury
Partner, Minneapolis
612.371.3959
salsburym@lindquist.com

Wayne R. Strasbaugh
Special Counsel, Philadelphia
215.864.8328
strasbaugh@ballardspahr.com

Adam S. Wallwork
Associate, Washington, D.C.
202.661.7668
wallworka@ballardspahr.com

Alicia M. Went
Associate, Philadelphia
215.864.8154
wenta@ballardspahr.com