Grant Thornton

Tax Legislative Update

Breaking news from Capitol Hill
From Grant Thornton's Washington National Tax Office

Dec. 22, 2017

2017-15A

President signs sweeping tax reform bill into law

The president today signed a sweeping tax reform bill Congress approved earlier this week. The legislation will overhaul individual, business and international taxes, and the enactment in 2017 means the effects must be included in 2017 financial statements.

The bill passed the Senate on a 51-48 vote on Dec. 19 with no Republicans opposing it. Three provisions were removed before the vote after Democrats successfully sustained three points of order under reconciliation rules. The title of the bill was removed, as well as provisions allowing 529 plans to pay for homeschooling expenses and providing that the exception from the excise tax on college endowments for universities with fewer than 500 students is based only on "tuition-paying" students. The changes forced the House to hold a second vote on the amended version, and it passed easily 224-201 on Dec. 20. With that done, President Donald Trump signed the bill in a White House ceremony this morning.

The bill's tax changes are broad and transformational, and will affect all types of businesses in every industry. Major changes include:

- Cutting the corporate rate to 21%
- Cutting the individual rate to 37%
- Providing a 20% deduction against qualifying pass-through income
- Doubling bonus depreciation to 100% for five years and allowing used property to qualify
- Limiting net interest expense deductions to 30% of adjusted taxable income
- Limiting NOL deduction to 80% of taxable income
- Repealing the corporate alternative minimum tax (AMT)
- Shifting toward a territorial tax system in which much certain foreign earnings could be repatriated tax free through a 100% dividends received deduction
- Imposing a one-time tax on unrepatriated earnings to 15.5% on cash and cash equivalents and 8% on other assets
- Creating anti-base-erosion and minimum tax provisions
- Limiting the deduction for mortgage interest to $750,000 of acquisition debt
- Retaining the individual AMT with higher exemptions and higher phase-out thresholds

- Limiting the state and local tax deduction to $10,000
- Doubling the estate gift tax exemptions
- Sunsetting the major individual changes in 2026

It's important to note that for such a sweeping bill, it was assembled relatively quickly and then repeatedly re-written on the fly. The version that the Senate passed literally included handwritten changes in the margins. Conferees continued making last-minute changes to the conference agreement in the moments before it was filed. Many of the new provisions are extremely complex, and the lawmakers focused on encouraging economic growth over simplification.

The 500 pages of legislative language are sure to include not only technical glitches, but also provisions that have unintended or surprising results when implemented. There are many areas that already appear ambiguous and open to interpretation. Enacting technical corrections and fixes for unintended policy results may be difficult. Republicans will only have 51 Senate seats in January, meaning they will need at least nine Democratic votes for any legislation using regular order. Reconciliation rules generally preclude technical corrections that have no revenue impact.

Democrats vehemently oppose the bill and appear unlikely to participate in fixes unless significant concessions are made. Republicans took a similar stance when the Affordable Care Act was enacted, and Democrats were never able to make many of the corrections they sought.

Treasury and the IRS could address many of the issues, but the undertaking is massive. There are more than 100 specific grants of regulatory authority or instructions to provide guidance. It could take years to produce the needed guidance, and their task is complicated by recent funding cuts and a Trump administration executive order requiring two regulations to be repealed for every new one added. Taxpayers may be forced to interpret difficult legislative language in many areas without immediate guidance. The changes certainly create challenges, but also many new planning opportunities.

The following provides more details on the key provisions.

Revenue impact and 'sunrise' and 'sunset' provisions

The Joint Committee on Taxation (JCT) estimates that the legislation will reduce government revenue by $1.456 trillion over the 10-year budget window. This figure is well within the $1.5 trillion allowance provided by the reconciliation instructions, but the reconciliation process also precludes revenue losses outside the budget window. The conference agreement is made revenue-neutral outside the budget window primarily by "sunsetting" all individual changes in 2026 except for two permanent revenue-raisers. These provisions permanently repeal the excise taxes on individuals who fail to obtain health coverage under the ACA (often called the "individual mandate") and permanently slow down inflation adjustments for the tax brackets and other items. There are also a handful of revenue-raising business changes that do not take effect for several years, and these "sunrise" provisions also raise revenue outside the budget window.

> Grant Thornton Insight: The repeal of ACA excise taxes on individuals under the individual mandate is estimated to raise revenue because government scorekeepers believe that without the taxes, less individuals will purchase insurance on the exchanges and claim the corresponding tax credits. The likely reduction in relatively healthy participants in the exchanges is also expected to drive up rates and discourage participation.

Republicans will have opportunities to extend the individual provisions before they expire and delay the unfavorable business changes before they take effect. In the past, many temporary tax benefits were routinely extended for years. On the other hand, some partisan bills passed under reconciliation have proven difficult to retain. The last three reconciliation tax bills passed in a partisan manner show mixed results. Key parts of the 2001 and 2003 tax cuts were ultimately allowed to expire, and Republicans appear to be on the verge of reversing at least one major aspect of the ACA.

> Grant Thornton Insight: The sunset and sunrise provisions and political opposition raise questions about the permanence of the tax bill. Democrats are attacking the legislation aggressively and should be expected to run on promises to amend or reverse certain aspects of it. Proactive repeal may be difficult in the short-term, but the sunset provisions will give them considerable leverage in future negotiations. Nevertheless, certain provisions are likely to be popular among certain industries, and it is often difficult for Congress to agree to repeal or limit popular tax provisions.

Rates

The conference agreement provides a $1.2 trillion rate cut over the next 10 years by reducing rates across the tax brackets. The final version cuts the top rate to 37%, lower than either the 38.5% rate in the Senate bill or the 39.6% rate in the House bill. Many of the bracket thresholds are adjusted, but the tax cut is achieved primarily by preserving the seven tax brackets and cutting the rates themselves:

- 10% retained
- 15% lowered to 12%
- 25% lowered to 22%
- 28% lowered to 24%
- 33% lowered to 32%
- 35% retained
- 39.6% lowered to 37%

The conference agreement does not include a House provision to impose a 6% surtax. The top bracket begins at $600,000 for joint filers and $500,000 for single filers. Both figures are higher than under current law, but the House and Senate bills both originally proposed a $1 million threshold for joint filers. The conference agreement leaves the tax rates on capital gains and dividends unchanged, with the three brackets of zero, 15%, at 20% all applying at the same income levels as under current law. The changes are effective for 2018, and all set to expire in 2026 except one. The conference agreement permanently changes the measure of inflation used to adjust the tax brackets, which will cause shallower adjustments in future years.

> Grant Thornton Insight: The Republican press material suggests the bill creates a new "zero" percent bracket. There is no actual bracket in which taxable income is subject to a zero rate. This merely refers to the new higher standard deduction. To the extent that a standard deduction can be considered a "zero bracket," then it should be noted that there is a "zero bracket" under current law that can be as large or even larger when considering personal exemptions.

Family incentives

The conference agreement increases the standard deductions from $6,350 for singles, $9,350 for heads of households, and $12,700 for joint filers to $12,000, $18,000 and $24,000 respectively. The additional standard

deduction for the elderly and blind is unchanged. Personal exemptions are repealed. The conference agreement increases the child tax credit to $2,000, with $1,400 refundable, and creates a $500 nonrefundable credit for qualifying non-child dependents. It also increases the start of the phaseout threshold to $400,000 in adjusted gross income for joint filers and $200,000 for all other taxpayers. All changes are effective in 2018 and set to expire in 2026.

> Grant Thornton Insight: Several estimates predict the increased standard deduction (combined with limits on itemized deductions) could result in more than 90% of taxpayers taking the standard deduction, up from around 70% according to the most recent IRS figures. With less than one in 10 taxpayers itemizing deductions, the overwhelming majority of taxpayers will no longer have any tax incentive for charitable giving or home ownership, despite the retention of deductions for these activities.

Kiddie tax

The conference agreement repeals the "kiddie tax" that applies parents' tax rates to children's unearned income once income reaches a specific threshold. Instead, for tax years beginning after Dec. 31, 2017, the unearned income of children will be taxed at trust and estate rates.

Itemized deductions

The conference agreement makes important changes to itemized deductions:

- **Charitable deductions** – The AGI limit on cash contributions is increased from 50% to 60% from 2018 through 2025. No deduction is allowed for payments made in exchange for college athletics seating rights, and the substantiation exception for certain contributions reported by any donee organization is repealed.

- **Mortgage interest** – The mortgage interest deduction is limited to $750,000 for any home acquisition debt incurred after Dec. 15, 2017. Taxpayers with a binding written contract in place before Dec. 15 who purchase a home before April 1, 2018, can continue to deduct up to $1 million in acquisition debt. The grandfathering rules also apply to refinancing of existing debt to the extent the amount of debt does not increase. The provision would expire in 2026.

- **Gambling loss** – This deduction is retained but from 2018 through 2025, other expenses incurred as part of wagering are also subject to the limit against wagering gains.

- **Miscellaneous itemized deductions** – All deductions subject to the 2% AGI floor are repealed from 2018 through 2026, including those for tax preparation, unreimbursed employee expenses, and expenses for the production of income such as investment fees and expenses. Miscellaneous itemized deductions not subject to the AGI floor, such as investment interest, are retained.

- **Medical expenses** – The AGI threshold for deducting medical expenses is reduced from 10% to 7.5% in 2018 and 2019.

- **Sales taxes** – The deduction for state and local taxes is limited to $10,000 in combined income and property taxes for 2018 through 2025 (the election to deduct state sales tax in lieu of income tax is still available under the limit). The exception for state and local taxes incurred in a trade or business or for

the production of income is retained. The JCT description indicates this exception only allows for sales and property taxes paid by businesses, but the statutory language is far from clear. It is also unclear whether this exception would apply to state gross receipts taxes that are imposed at the pass-through entity level.

In addition, the "Pease" limitation on itemized deductions is repealed from 2018 to 2025.

> Grant Thornton Insight: The conference agreement includes specific language disallowing 2017 deductions for state taxes attributable to 2018 liability. Although there are opportunities to accelerate deductions before year-end, accounting rules preclude deductions for many prepayments of future liability. The determination may depend on whether taxpayers are on the cash or accrual method and the type of expense.

Above-the-line deductions

The conference agreement repeals the above-the line deductions for moving expenses (unless military) and casualty losses (unless disaster-related). Both of these provisions are effective from 2018 through 2025. In addition, the conference agreement repeals the above-the-line deduction for alimony effective for divorce instruments executed after Dec. 31, 2018. The recipient would no longer be required to include the payment in income. These changes expire in 2026. The deductions for qualified tuition and student loan interest are retained.

Income exclusions

The conference agreement repeals only the exclusions from income for employer reimbursement for bike commuting and moving expenses from 2018 through 2025. The final version does not include prior proposals to repeal or modify exclusions for:

- Gain on the sale of a principal residence
- Employer-provided housing
- Dependent-care assistance
- Employee achievement awards
- Employer-paid adoption expenses
- Employer-provided education benefits

Other benefits

The conference agreement omits many other proposed changes from the House and Senate bills. It does not repeal the credits for plug-in electric vehicles or those for the elderly and permanently disabled, and does not make any changes to the American Opportunity or Lifetime Learning tax credits for education. Most importantly, the conference agreement strikes a provision from the Senate bill that would have required taxpayers to use a first-in, first-out method to determine gain or loss when selling from a pool of identical securities with different bases.

Retirement provisions

The conference agreement repeals a rule allowing a conversion to a Roth IRA to be reconverted to a traditional IRA. It extends the amount of time a taxpayer has to repay a loan from a defined contribution plan or an IRA from 60 days after termination of the plan or employment to the due date of an employee's tax return (including extensions). Both changes are effective after Dec. 31, 2017.

Individual AMT

The conference agreement retains the individual AMT, but beginning in 2018, the exemption amounts are increased 39% and the phaseout thresholds rise to $1 million for joint filers and $500,000 for all other taxpayers. These figures are indexed for inflation before the AMT would revert to current law in 2026. The exemption amount phases out at a rate of 25 cents on the dollar of excess over the threshold amount. Current law continues to apply to the individual AMT rate, so in 2018 the AMT rate is 26% on the first $191,500 of alternative minimum taxable income in excess of the exemption amount and 28% on any additional alternative minimum taxable income.

> Grant Thornton Insight: The bill should change the impact of the AMT significantly. The combination of an increased ability to use exemptions and limits on AMT preference items like the state and local tax deduction should reduce the number of taxpayers who are affected. However, this does not mean that liability will be decreased in all cases, especially with the cut in regular individual tax rates in comparison to AMT rates. Individual taxpayers with business-related AMT adjustments should take the continued AMT exposure of individuals into account in determining whether they wish to convert any pass-through or Schedule C businesses to corporate form.

Transfer taxes

The conference agreement includes the Senate provision doubling the lifetime gift, estate and generations-skipping transfer (GST) tax exemptions beginning in 2018 from $5.6 million (2018 figure after inflation adjustments) to $11.2 million. The exemption would continue to be indexed them for inflation. No repeal of the taxes is included as in the House bill, and the exemptions are scheduled to revert to current law in 2026.

Corporate rates

The conference agreement replaces the current corporate rate schedule with a flat rate of 21%, up from the 20% proposed in both the House and Senate bills. The rate cut is effective for tax years beginning after Dec. 31, 2017. Fiscal year taxpayers use a blended rate calculated under Section 15 based on the ratio of the number of days in their tax year occur before or after the effective date. Professional service corporations do not have a separate rate schedule, and are subject to the general 21% flat rate.

The conference agreement reduces the dividend-received-deduction (DRD) rates. The 70% DRD would be reduced to 50%, while the 80% DRD would be reduced to 65%. The changes are meant to compensate for the reduced corporate tax rate of 21%.

Pass-through business rate

The conference agreement follows the Senate bill's approach for pass-through businesses by providing a deduction for qualifying business income. The deduction is reduced from 23% in the Senate bill to 20% in the final agreement. Because the top individual rate in the Senate bill is also reduced from 38.5% in to 37%, the deduction still provides a top effective rate of 29.5%

The deduction is limited to the greater of either (1.) 50% of the owner's allocable share of W-2 wages paid by the business or (2.) 25% of that W-2 wage share plus 2.5% of the original cost basis of qualified property. The latter option was added in conference committee as a concession to capital-intensive and real estate businesses.

Qualified property is depreciable business property still held by the taxpayer for which the "depreciable period" has not ended. The depreciable period ends at the end of the applicable recovery period, but is no shorter than 10 years.

Wages are assigned to owners in the same proportion that wage expense is allocated. The wage restrictions do not apply to taxpayers with up to $157,000 (single) or $315,000 (joint) in taxable income, down from $250,000 and $500,000 respectively, in the Senate bill. The wage restriction phases in from those thresholds over the next $50,000 (single) or $100,000 (joint) in taxable income.

Qualified business income includes items of income, gain, deduction, and loss, including rental income, from a qualified trade or business conducted in the United States or Puerto Rico. It generally does not include investment items, such as capital gains and losses, dividends, or interest. If the sum of qualified business income attributed to a taxpayer is negative, the negative amount is treated as a qualified business income loss in the following year.

The deduction is not affected by whether the owner is active or passive. However, qualified business income does not include wages of an S corporation owner or guaranteed payments for services by partners. The legislation would rely on the existing reasonable compensation standards for S corporation owners. There is no requirement that partners receive any guaranteed payment for services, but the IRS is authorized to write regulations excluding payments to partners for services. No additional measures are included to distinguish compensation or service income from business income.

Income from certain service businesses would qualify only for taxpayers with up to $157,000 (single) or $315,000 (joint) in taxable income (down from $250,000 and $500,000 respectively, in the Senate bill). Disqualified service businesses are defined as health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services; investing and investment management, trading, or dealing in securities, partnership interests, or commodities; or any trade of business where the principal asset is the reputation or skill of one or more of its employees or owners. Notably, engineers and architects were excluded from this list in the final conference agreement.

The conference agreement makes the deduction available to trusts and estates, which the Senate bill did not allow. Certain publicly traded partnerships and real estate investment trusts can also use the deduction. Although prior versions of the House bill proposed changes to the self-employment tax treatment of pass-throughs, the conference agreement leaves the self-employment tax provisions intact. The conference agreement also clarifies that the deduction is treated as a reduction to taxable income, and not adjusted gross income, and is available regardless of whether a taxpayer itemizes deductions. Like the rest of the individual changes, the deduction would expire in 2026.

> Grant Thornton Insight: The bill increases the compliance burden on partnerships and partners to track allocable shares of W-2 wage payments and unadjusted bases of qualified property, which becomes increasingly complex through tiered partnerships. More importantly, the large disparity in effective rates between C corporations and pass-through businesses could prompt many businesses to re-examine their entity choice. Even with the potential second layer of tax on corporate earnings when distributed, the lower 21% rate could be attractive. Lawmakers appeared to recognize the potential for this development, and specifically provided the relief discussed below for conversions from an S corporation to a C corporation. An actual analysis of entity choice will depend on many factors, such as

the tax rates and participation of individual owners, how earnings are distributed, whether the business benefits from the cash method of accounting, and any plans to exit the business.

Pass-through business provisions

S corporation conversions to C corporations
The conference agreement provides relief from the tax consequence of a conversion from an S corporation to a C corporation. Some methods of accounting available to S corporations are not allowed for certain C corporations. The conference agreement would allow taxpayers to spread any Section 481 adjustments for unfavorable method changes, such as cash to accrual, over six years instead of four. This treatment is available for businesses that were S corporations as of the day before the date of enactment and make the conversion within two years of the date of enactment with no change in owners.

In addition, the conference agreement expands the ability of these former S corporations to make tax-free distributions from the accumulated adjustments account (AAA). Under current law, an S corporation that converts to a C corporation can only make tax-free distributions during the one-year post termination transition period (PTP). The conference agreement provides that after the PTP, a converted C corporation would still be able to treat a portion of distributions as tax-free according to the ratio of AAA to accumulated earnings and profits.

Grant Thornton Insight: This provision could make the toll tax upon conversion less painful, but S corporations with international operations would have to weigh this relief against the loss of the special provision allowing them to indefinitely defer the one-time tax on unrepatriated earnings (discussed in the international section below).

Losses
The conference agreement raises $150 billion with a significant new revenue-raiser that would prevent pass-through owners from using a business loss against other kinds of income. Under current law, taxpayers with passive losses generally only deduct these losses against passive income, but non-passive owners can generally deduct business losses. The proposal would require pass-through owners to aggregate trade or business income and loss, and any net loss in excess of $250,000 (single) or $500,000 (joint) would not be deductible. Any net loss would instead be added to the net operating loss (NOL) carry-forward. It would then be subject to the NOL restrictions described below.

Carried interest
The conference agreement changes the long-term capital gains holding period for certain assets held in partnerships engaging in certain investment and real estate activities. Taxpayers who receive their interest in the partnership for the provision of services related to specified investment activities must use a three-year holding period instead of one year for the long-term capital gain treatment. Gains on assets held for three years or less will be treated a short-term capital gains. This rule applies to gains arising from either the partner's disposition of its partnership interest or the disposition of assets by the partnership. Any long-term capital losses (determined as if a three-year holding period applies) are also taken into account in these calculations.

The three-year holding period must be used regardless of whether the taxpayer made an election under Section 83(b). The rule does not apply to any capital interests in a partnership which provides the taxpayer with a right to share in partnership capital commensurate with the amount of capital contributed or the value of the interest subject to tax under Section 83 upon the receipt or vesting of the interest. Special rules apply to the transfer to a

related party of a partnership interest to which these rules apply. The provision is effective for taxable years beginning after Dec. 31, 2017.

Expansion of mandatory basis adjustments for built-in losses
The conference agreement modifies the definition of a substantial built-in loss in the context of transfers of partnership interests. Under current law, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds its fair market value by more than $250,000. The provision would expand that definition to include situations where a transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition of all the partnership's assets immediately after purchasing a partnership interest. This mandatory step-down could apply even where a partnership had an overall built-in gain in its partnership property.

Charitable contributions and foreign taxes limited by basis rules
The conference agreement suspends a partner's distributive share of charitable contributions and foreign taxes to the extent they exceed the partner's basis in its partnership interest. Currently, the basis limitation rules on partnership losses do not take into account partnership charitable contributions or foreign taxes paid, in contrast to the basis limitation rules for S corporations.

Technical terminations
The conference agreement repeals the current law provision that terminates a partnership if at least 50% of its capital and profits interests are sold or exchanged within 12 months. The Senate bill does not include this provision.

> Grant Thornton Insight: After a technical termination, the partnership is treated as newly formed, even though it continues on in the same legal entity. Any previous accounting-method elections and Section 754 elections would no longer be in effect, and depreciation would generally be restarted over a new recovery period by the newly formed partnership. This common trap can have severe tax consequences. Taxpayers often missed the short-period return filing requirement for the period ending on the date of the technical termination.

Cost recovery provisions

Full expensing
The conference agreement provides 100% bonus depreciation for property placed in service after Sept. 27, 2017, and before Jan. 1, 2023. The bonus depreciation rate then phases down over the following five years:

- 80% in 2023 (100% for long production period property "LPPP")
- 60% in 2024 (80% for LPPP)
- 40% in 2025 (60% for LPPP)
- 20% in 2026 (40% for LPPP)
- 0% in 2027 (20% for LPPP)

The conference agreement also makes used property eligible for bonus depreciation for the first time, but anti-churning rules would apply for related parties. Qualified films and theatrical productions also qualify. Public utilities and businesses with floor plan financing indebtedness are exempt from the interest limitation and so cannot use bonus depreciation. A transition rule applies for property acquired before Sept. 27, 2017, and placed in service after that date. A special rule allows taxpayers to elect to apply 50% bonus deprecation rather than 100% bonus depreciation as an election for the first taxable year ending after Sept. 27, 2017.

The conference agreement increases the Section 179 expensing limit to $1 million for tax years beginning after 2017 and before 2023, with the start of the phaseout increased to $2.5 million. Both limits would be indexed to inflation, and the eligible property is expanded to include qualified improvement property, personal property used predominantly to furnish lodging, and improvements to non-residential roofs, HVAC, fire protection and alarm systems, and security systems placed in service after building is first placed in service.

Real property cost recovery

The conference agreement does not include Senate provisions to shorten the recovery period for residential and non-residential real property to 25 years. It also omits the proposed shorter recovery period for qualified leasehold, restaurant, and retail property, and in fact repeals the current 15-year recovery period. The JCT description of the bill indicates that qualified improvement property would be eligible for a 15-year recovery period, but this does not appear to be in the actual legislative text. In addition, the real property trades or businesses which elect out of the interest limitation would be required to use the alternative depreciation system on real property assets.

R&D expensing

Beginning with costs paid or incurred after Dec. 31, 2021, the conference agreement repeals the ability of taxpayers to expense R&D costs or defer them over a period of 60 or more months. Instead, the costs are required to be capitalized and amortized over five years beginning with the midpoint of the year in which they are incurred. Software development is included as an R&D expenditure, meaning that the costs of in-house software development is recovered over five years. No deduction is allowed for a disposition of any research expenditure during the amortization period. The expenditure continues to be amortized over the remaining period.

> Grant Thornton Insight: If the R&D provision takes effect in 2022 as scheduled, it will create a costly compliance burden for many taxpayers who do not currently identify all of their Section 174 research expenditures. This is largely because the Section 174 definition of research and experimentation is broader than capitalizable research costs for GAAP purposes. For example, many manufacturers make process improvements that they deduct as ordinary and necessary expenses, but that are actually Section 174 research expenditures. Under this provision, manufacturers would be required to perform research studies to determine the amount of Section 174 expenditures that they have not identified for GAAP purposes and capitalize those costs as an intangible research asset. Even taxpayers that claim the research credit often will ignore this type of process research and instead focus on their biggest projects. The inclusion of software development as an R&D expense that must be capitalized and amortized over five years means that in-house software development has a longer recovery period than the three-year recovery period for purchased software.

Farm property

The conference agreement shortens the cost recovery period from seven to five years for certain machinery or equipment. It also repeals the required use of the 150% declining balance method for three-, five-, seven-, and 10-year property.

In addition, farming businesses that elect out of the interest limitation must use the alternative depreciation system (ADS) for any property with a recovery period of 10 years or more. The changes are generally effective for property placed in service after Dec. 31, 2017, in taxable years ending after such date.

Depreciation limit for luxury automobiles
The conference agreement increases the Section 280F limitations to:

- $10,000 in year one
- $16,000 in year two
- $9,600 in year three
- $5,760 in each succeeding taxable year

The conference agreement also removes computer or peripheral equipment from the definition of listed property. The changes are effective for property placed in service after Dec. 31, 2017, in taxable years ending after such date.

Key business provisions

Interest deduction limitation
The conference agreement limits the deduction for net business interest in excess in interest income to 30% of adjusted taxable income for tax years beginning after Dec. 31, 2017. Adjusted taxable income is defined as taxable income computed without interest expense, interest income, NOL deductions, the 20% deduction for certain qualified business income under Section 199A. For tax years beginning before Jan. 1, 2022, adjusted taxable income also excludes depreciation, amortization, and depletion. So for the first four years, the calculation is more equivalent to earnings before interest, taxes, depreciation and amortization (EBITDA), and then becomes more equivalent to "EBIT." Any disallowed interest expense is carried forward indefinitely. Investment interest income and expense are not affected by the provision.

The limit does not apply to regulated public utilities and businesses with average annual gross receipts of $25 million or less for the three prior taxable years. Certain real property and farming trades or businesses can make an irrevocable election to forgo bonus depreciation and be exempt from the limit. The definitions of real property trade or business in broad and includes property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage. In addition, interest related to debt used to finance motor vehicles that are held for sale or lease is exempt.

There are special rules that apply the limit for partnerships. First, the limit applies at the entity level to determine the deduction of business interest with respect to the partnership's non-separately stated interest expense. If there is excess adjusted taxable income for the partnership, a partner can increase its own adjusted taxable income by its share of such excess in determining such partner's business interest deduction. If business interest is disallowed at the partnership level in a taxable year, such disallowed interest is allocated to the partners and may only be deducted by a partner against excess adjusted taxable income allocated to the partner from such partnership in a succeeding year. Similar rules apply to an S corporation and its shareholders.

> Grant Thornton Insight: The limit on interest deductions was largely conceived as a trade-off for the full expensing provision. Lawmakers specifically barred most businesses that are exempt from the interest limitation from using bonus depreciation. But the potential impact of the interest limitation for most companies will not depend heavily on how much property they expense, but simply how much leverage they use. This may or may not correspond with how much property they place in service that is eligible for bonus depreciation. The reach of the interest limitation is also likely to depend on many external

factors, and could affect more businesses in future years if interest rates rise or an economic slowdown suppresses earnings.

Corporate AMT and NOLs

The conference agreement repeals the corporate AMT effective for tax years beginning after Dec. 31, 2017. Taxpayers with unused AMT credits can claim 50% of the credits after liability is reduced to zero as refundable in each of the years 2018, 2019 and 2020, with all remaining credits claimed as refundable in 2021.

However, the repeal of the corporate AMT is undermined by new limits on NOLs. Under current law, the most common corporate AMT trigger is the limit on the NOL deductions to 90% of taxable income. Although the AMT is repealed, an even harsher new NOL limit is imposed outside of the AMT. Under the conference agreement, NOL deductions can only offset up to 80% of taxable income. The bill also repeals NOL carry-backs but allows indefinite carry-forwards. Carry-forwards are not indexed for inflation as proposed in the House bill. Property and casualty insurance companies retain the current two-year carry-back and 20-year carry-forward provisions, and certain farming losses retain a two-year carry-back. The 80% limit applies to NOLs arising from tax years beginning after Dec. 31, 2017, and the new carry-forward period applies to NOLs arising in tax years ending after Dec. 31, 2017.

Grant Thornton Insight: The repeal of the AMT, coupled with the effective date of the NOL limit, provides a favorable result for NOLs generated in tax years beginning before Dec. 31, 2017. These NOLs appear to escape both the 90% AMT limitation under prior law and the new 80% limitation under the conference agreement.

Revenue recognition

The conference agreement includes a major revision to the rules for revenue recognition. Under the provision, accrual taxpayers would be required to recognize income no later than the tax year in which it is taken into account in a taxpayer's "applicable financial statements" (or other financial statements as designated by Treasury). Taxpayers who do not have applicable financial statements (generally defined as audited financial statements) are exempt. There is also a special exception for mortgage-servicing rights. The provision does not apply to income subject to a special method of accounting not included under Section 451 (such as installment sales under Section 453 and long-term contracts under Section 460). Taxpayers will be allowed to follow the allocation of contract price between performance obligations on their applicable financial statements.

The provision also codifies the one-year deferral of advance payments (and the definition of advance payments) currently allowed in Revenue Procedure 2004-34. Taxpayers will continue to have the option to recognize eligible advance payments in the year of receipt or to recognize them only to the extent they are recognized in the year of receipt for book, with the remaining portion in next taxable year. Revenues from rents are not allowed to be deferred. The provision allows taxpayers to separately elect whether to apply this method to each category of advance payments. Treasury is given authority to determine how and when the election is made, but once made, it is a method of accounting that must be used for all subsequent years. The deferral does not apply to advance payments received in the year in which taxpayer ceases to exist. The JCT explanation states that this provision is intended to override any deferral method provided by Treas. Reg. Sec. 1.451-5 for advance payments received for goods, which would include the two-year deferral for inventoriable goods.

Grant Thornton Insight: These provisions will reduce burden for taxpayers by adhering more closely to book, but will come at the cost of accelerating revenue for federal income tax purposes. Taxpayers with large deferred tax liabilities for unbilled receivables will find their tax deferral disappear over the section 481(a) spread period. Similarly, taxpayers who have been relying on Treas. Reg. Sec. 1.451-5 to defer advance payments from gift cards and sales of goods for more than one year will be limited to the one-year deferral in the new provision.

Contributions to capital

The conference agreement reduces the scope of the proposed change to contributions of capital in the House bill. The conference agreement requires contributions of capital to be included in gross income if made as a "contribution to construction" or by "a customer or potential customer," of from "governmental entities" and "civic groups" (other than contributions "made by a shareholder as such"). The latter set of contributions to capital by governmental agencies and civic groups represents a marked change from decades of prior law. Corporations that receive incentives to locate operations in certain states and cities will have to include the contributions in income. The provision applies to contributions after the date of enactment, but with an exception for contributions if made pursuant to a "master development plan" that was approved by the governmental entity prior to the date of enactment.

Grant Thornton Insight: This provision could face a constitutional challenge. In *Edwards v. Cuba Railroad Co.* (268 U.S. 628), the Supreme Court held that inducements received from a governmental entity did not constitute income pursuant to the Sixteenth Amendment.

Accounting methods

The conference agreement increases the $5 million gross receipts eligibility threshold to a $25 million threshold for the following favorable accounting methods:

- Cash method under Section 448 for corporations and partnerships with corporate partners (also taxpayers who meet the new gross receipts test are eligible even if they failed to meet the gross receipts test in a prior year)
- Cash method under Section 447 method of accounting for certain corporations engaged in farming
- Exceptions from the Section 263A uniform capitalization rules for both resellers and manufacturers
- Special rules in Section 460 for long-term construction contracts (does not include long-term manufacturing contracts)

Taxpayers meeting the new Section 448 gross receipts test would no longer be required to account for inventory under Section 471. This means most businesses with gross receipts of less than $25 million could use the cash method of accounting even if they have inventories. Additionally, the agreement provides a special provision that excludes the aging period for beer, wine and distilled spirits from the production period for purposes of UNICAP (Section 263A) interest capitalization rules.

Grant Thornton Insight: Small manufacturers that are required to use the percentage-of-completion method under Section 460 for their long-term manufacturing contracts do not see any relief under these provisions. They must continue to use percentage-of-completion. This is already a trap for the unwary, as many manufacturers of unique items do not realize that their contracts are subject to the percentage-of-completion method under Section 460. The percentage-of-completion method requires

taxpayers to recognize revenue as costs are incurred, not when cash is received, and generally relies on the rules of Section 263A for allocating costs among the contracts.

Deductions for government fines and penalties

The conference agreement expands the denial of deductions for fines and penalties paid to or at the direction of a government entity. Under the provision, any amounts related to restitution, remediation or required compliance with any law would not be deductible unless they were identified in the court order or settlement agreement as such. The proposal requires government agencies to report to the IRS and the taxpayer the amount of each settlement agreement or order where the amount is at least $600. The reporting must separately identify any amounts that are for restitution, remediation of property or correction of noncompliance.

Grant Thornton Insight: This provision could capture ordinary compliance costs and create a large burden for taxpayers and local governments. There are many instances when local government officials perform routine inspections and tell taxpayers they must perform certain actions or purchase or install additional equipment or building components to ensure compliance with local, state or federal law. It appears based on the statutory language that the official must provide a document that states the amount constitutes an "amount paid to come into compliance with the law" or the taxpayer will not be allowed a deduction. This information reporting requirement will also be very burdensome on local governments.

Deductions for sexual harassment or abuse settlements

The conference agreement denies a deduction for any settlement, payout or attorney fees related to sexual harassment or sexual abuse if payments are subject to a nondisclosure agreement. This is effective for amounts paid or incurred after the date of enactment.

Key deductions and businesses benefits repealed

The conference agreement repeals or limits many other business credits, deductions and incentives.

Provision	Conference agreement
Section 199	• Repeals for tax years beginning in 2018
Rehabilitation tax credit	• Repeals the 10% credit for pre-1936 buildings for amounts paid or incurred after Dec. 31, 2017, with some transition relief • Retains the 20% credit for certified historic structures
Orphan drug credit	• Reduces the credit rate from 50% to 25% for tax years beginning after Dec. 31, 2017
Advanced refunding bonds	• Provides that interest on advanced refunding bonds issued after 2017 is not tax-exempt
Tax credit bonds	• Bars new issues after 2017 (existing holders and issuers would continue receiving tax credits and payments)
Like-kind exchanges	• Limits like-kind exchanges to real property for tax years beginning after Dec. 31, 2017, meaning deferral no longer available for personal or intangible property
SSBIC rollover deferral	• Repeals the ability to defer gain on the sale of public securities by rolling over proceeds into a specialized small business investment corporation (SSBIC) effective for sales after Dec. 31, 2017
FDIC premium deduction	• Phases out deduction based on assets from $10 billion to $50 billion effective for tax years beginning after 2017
Deduction for meals provided for the convenience of the employer	• Deduction reduced to 50% in 2018 and then eliminated altogether in 2026
50% deduction for entertainment expense	• Repeals the present-law exception to the deduction disallowance for entertainment, amusement or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50% limit) • Effective for payments after Dec. 31, 2017

Deduction for local lobbying	• Repeals the deduction for local government lobbying expenses, including to Indian Tribal Governments • Effective after the date of enactment
Capital gains treatment for self-created intellectual property	• Repeals capital gain treatment for self-created intellectual property including a patent, invention, model or design (whether or not patented), secret formula, or process • However, does not repeal the special treatment under Section 1235
Deduction for certain employee transportation fringes	• Disallows a deduction for expenses associated with providing any qualified transportation fringe to employees of the taxpayer ($225 in 2017 for parking and mass transit and $20 for bike commuting) for amounts paid after Dec. 31, 2017 • Exception allowed if necessary for ensuring the safety of an employee
Deduction for employee achievement awards	• Repeals the deduction for employee achievement awards in the form of cash, cash equivalents, gift coupons, gift certificates, vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, or other similar items • Effective for payments after Dec. 31, 2017

The conference agreement does not repeal many other deductions or credits that either the House or Senate bills proposed to repeal. Key provisions that are retained by the conference agreement include:

- Deduction for litigation costs that attorneys advance to clients in contingent-fee cases
- Work-opportunity tax credit
- New-markets tax credit
- Enhanced-oil-recovery credit
- Credit for producing oil from marginal wells
- Private-activity bonds

In addition, the conference agreement does not include any changes to Section 45 and Section 48 credits, as originally proposed in the House bill.

Insurance provisions

The conference agreement raises an estimated $40 billion from provisions changes affecting insurance companies. The key provisions would:

- Repeal the three-year carry-back and 15-year carry-forward for NOLs from life insurance companies and subject them to the new NOL rules for all businesses (no carry-backs, indefinite carry-forwards)
- Repeal a provision that allows life insurance companies to deduct 60% of their first $3 million of income (subject to a phase-out as income approaches $15 million)
- Provide that income or loss resulting from a change in method of computing life insurance company reserves is taken into account consistent with IRS procedures, generally ratable over a four-year period, instead of over a 10-year period
- Require current taxation of "policyholders surplus accounts," certain legacy amounts of untaxed and undistributed income that a small number of taxpayers retained from an insurance taxation regime repealed in 1984
- Replace the limit on certain deductions of property and casualty insurance companies of 15% of certain categories of tax exempt income with an "applicable rate" computed as 5.25% divided by the highest Section 11(b) rate (which computes to a 25% applicable rate under the conference agreement)
- Repeal an election that allows insurance companies that made certain estimated tax payments to claim a deduction equal to the difference between discounted reserves and undiscounted reserves

- Replace a complex formula life insurance companies use to calculate income from decreases in reserves with a simple rule whereby the amount of the life insurance reserves for any contract (other than certain variable contracts) is the greater of (1.) the net surrender value of the contract (if any), or (2.) 92.81% of the amount determined using the tax-reserve method otherwise applicable to the contract as of the date the reserve is determined (variable contracts follow a method similar to the above)
- Modify the formula life insurance companies use allocate tax-exempt income between the life insurance company and the policyholders by providing that the company's share is 70% and the policyholder's share is 30%
- Change the recovery period for expenses associated with earning a stream of premium income for 10 to 15 years and adjust the calculation of the expenses that are spread by increasing the percentages of net premiums received from 1.75% to 2.09% for annuity contracts, 2.05% to 2.45% for group life insurance contracts, and 7.7%to 9.2% for other specified insurance contracts
- Impose reporting requirements when the purchase of an existing life insurance contract in a reportable policy sale and on the payer in the case of the payment of reportable death benefits, create rules for determining the basis of a life insurance or annuity contract, and modify the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale
- Change the discount rate rules for unpaid loss reserve deductions to require property and casualty insurance companies to use Treasury's corporate bond yield curve to determine the discount subject to certain computational modifications, and extend for 14 more years the special rule under current law that extends loss payment pattern periods for long-tail lines of business.

Compensation and benefits

Compensation deductions

The conference agreement expands the limit on a public company's ability to deduct compensation under Section 162(m). The exceptions for commissions and performance-based compensation would be removed for tax years starting in 2018 or later, meaning no compensation in excess of $1 million for covered employees would be deductible regardless of its character. The bill expands the definition of a covered employee to include the CFO, and the $1 million deduction limitation applies to a covered employee's compensation in all future years, including after termination of employment or death. The bill also expands the definition of a public corporation to include foreign corporations publicly traded through American depositary receipts (ADRs) and certain large private corporations and S corporations. The changes do not apply to compensation paid under a written binding contract that was in effect on Nov. 2, 2017, if the contract is not materially modified. Once a contract is renewed, compensation paid under the contract becomes subject to these changes.

> Grant Thornton Insight: This is a significant expansion of the limits on compensation deductions. Not only does it remove the exception for incentive compensation, but it expands the number of employees and officers affected. Many companies will have more than five covered employees when compensation continues after covered employees change their roles or leave the company.

Credit for leave

The conference agreement creates a new temporary tax credit for qualifying employers that make payments to qualifying employees for family and medical leave in 2018 and 2019. The credit rate begins at 12.5% of payments as long as the program's payment rate is 50% of the employee's normal wages. The credit rate is increased by 0.25% for each percentage point by which the payment exceeds 50% of normal wages, capped at 25% when payments reach 100% of normal wages. To qualify, employers must provide all qualifying full-time employees at least two weeks of annual paid family and medical leave and provide part-time employees an

amount of leave on a pro rata basis. Qualifying employees must have at least one year of service and wages cannot exceed $72,000 (indexed for inflation).

Creation of qualified equity grants

The conference agreement creates a new election to allow employees of certain private companies to elect to defer the recognition from stock options and restricted stock units (RSUs). The election is allowed for grants of nonstatutory stock options or incentive stock options, as well as grants under an employee stock purchase plan. For the RSUs or options to qualify, the private company must offer them to at least 80% of full-time employees (taking into account all employees in a controlled group). Employees may receive varying amounts of options or RSUs, but all of them must receive the same type of award (either options or RSUs), and must receive more than a de minimis amount.

If the awards qualify, employees may make an election within 30 days of vesting to defer recognition of income. If the election is made, income recognition is generally deferred until either when the stock becomes transferable to another party (including to the employer), or the employer has an initial public offering, whichever occurs first. However, if neither of these occurs within five years after vesting, the employee must recognize the income on the date that is five years after vesting. The compensation income for the employee is equal to the stock value at the time the stock is transferred and is vested, less any amount paid for the stock by the employee. Any further increase in value is capital gain. This special tax treatment is not available if the employee has the right immediately upon vesting to either sell the stock to the employer or settle the award in cash.

The election is not allowed for excluded employees, defined as the CEO, CFO, or any individual that has owned more than 1% of the business or been among the four highest-paid employees over the last 10 years. If an employee who made the election later becomes an excluded employee, the income must be recognized.

The employer receives a deduction at the same time the employee recognizes income, and the deduction amount equals the employee's income. These provisions apply to stock attributable to options exercised, or RSUs settled after Dec. 31, 2017.

International

Establishment of participation exemption system

The conference agreement replaces the current system of taxing U.S. corporations on foreign earnings of their foreign subsidiaries when the earnings are repatriated with a partial territorial system. The system provides a 100% dividends-received deduction (DRD) to domestic corporations for foreign-source dividends received from 10%-or-more owned foreign corporations. Domestic corporations must hold the foreign stock for 365 days to be eligible for the DRD. The conference agreement also allows a DRD on certain deemed income inclusions resulting from the disposition of lower-tier controlled foreign corporations (CFCs).

The DRD is not allowed for "hybrid dividends." A hybrid dividend is an amount received from a CFC if the dividend gives rise to a local country deduction or other tax benefit. The provision also subjects hybrid dividends received by a CFC from another CFC to Subpart F resulting in income inclusion for U.S. shareholders of that CFC.

No foreign tax credit or deduction is allowed for foreign taxes on any portion of the dividend for which the DRD is allowed. However, "deemed-paid" foreign tax credits under Sections 902 and 960 would continue to be allowed for Subpart F income inclusions.

Solely for purposes of determining loss on disposition of foreign subsidiary stock of a 10% or more U.S. corporate owner, the adjusted tax basis in such shares is reduced by the amount of the DRD, but not below zero. These provisions would be effective for distributions made after 2017.

Domestic corporations that transfer substantially all the assets of a foreign branch to a 10%-or-more owned foreign subsidiary will include in gross income any net branch losses (reduced for any gain recognized under Section 367) that were deducted by the domestic corporation in previous years.

The above provision regarding dividend distributions or transfers of branch assets are effective for tax years after Dec. 31, 2017.

Notably, the conference agreement does not repeal Section 956. So investments in U.S. property would continue to be subject to tax as they are under current law. This departs from both the House and Senate bills, which contained a repeal of these rules for domestic corporations.

> Grant Thornton Insight: Although the move to a territorial system is favorable on its face, the actual benefits will be limited substantially by its narrow application and the minimum tax provisions discussed below. For example, the territorial system does not exclude Subpart F earnings, earnings subject to the global intangible low-taxed income (GILTI) minimum tax or earnings from of a foreign branch. The determination of these inclusions will be important to understanding the actual benefit, if any, of the territorial system.

One-time tax

The conference agreement subjects unrepatriated foreign earnings to a one-time transition tax. The report generally follows the Senate bill, but does contain a number of changes reconciling certain differences between the House and Senate bills. The conference agreement also increases the rates for the one-time tax to 15.5% for cash and cash equivalents and 8% for other assets.

The one-time tax is applicable to U.S. shareholders in "specified foreign corporations." Specified foreign corporations are defined to include all CFCs and all other foreign corporations (which are not passive foreign investment corporations) with at least one U.S. corporation as a U.S. shareholder.

The one-time tax is imposed by using the Subpart F rules to require applicable U.S. shareholders to include their pro rata share of post-1986 earnings and profits (E&P) in income to the extent such E&P has not been previously subject to U.S. tax. E&P includes only earnings that accrued while the foreign corporation was a specified foreign corporation. The E&P measurement-date is either Nov. 2, 2017, or Dec. 31, 2017, whenever the amount is greater. The inclusion in income would be for the foreign subsidiary's last taxable year beginning before 2018, and is determined without regard to any dividends paid during the taxable year.

E&P is calculated on a net basis, taking into account the U.S. shareholder's proportional share of any accumulated E&P as well as any E&P deficits of each 10%-owned foreign subsidiary. Deficits are measured as of

Nov. 2, 2017 and are allowed to offset positive E&P of members within the same U.S.-affiliated group. Hovering deficits can also be absorbed by current year E&P.

E&P is classified as either earnings that are deemed held in the form of cash and cash equivalents, or as non-cash earnings. The bill defines cash and cash equivalents to include: net accounts receivable, actively traded property, commercial paper, certificates of deposit, foreign currency, and obligations with a term of less than one year.

The reduced tax rate applicable to foreign E&P is achieved by allowing a DRD which would result in tax being imposed at the lower rate of 15.5% or 8%. For example, a $100 E&P repatriation which is all attributable to cash or cash equivalents would be offset with a 55.7% deduction so that $44.30 would be subject to tax at 35%, resulting in tax of $15.50.

Aggregate cash and cash equivalents is defined to be the greater of the U.S. shareholder's pro rata share of the aggregate cash positions on:

- The last tax year beginning before 2018, or
- The average of the cash position determined as of the close of the last two taxable years of each specified foreign corporation ending before Nov. 2, 2017.

Foreign tax credits can offset the one-time tax, but would be subject to a "haircut" based on the difference between the 8% and 15.5% rates and the normal 35% rate (or other applicable statutory rate). Existing foreign tax credit carryforwards would also be available to offset the one-time tax.

Special rules allow S corporations to defer the one-time tax indefinitely until certain triggering events occur (e.g., liquidation of the S corporation).

An election is available to allow U.S. shareholders to spread the payment of the one-time transition tax liability over eight years. Under the election, 8% of the installment payments would be due in each of the first five years, 15% in the sixth year, 20% in the seventh year, and the remaining 25% due in the eighth year. An election is also available to forgo the use of NOLs to offset the one-time tax inclusion.

The conference agreement provides broad regulatory authority to the Treasury secretary to issue guidance to prevent the avoidance of the one-time tax. The grant of authority specifically references reductions in E&P through changes in entity classification, and changes in accounting methods.

Minimum tax and incentives for intangible income

The conference agreement imposes a minimum tax on certain foreign income deemed to be in excess of a routine return. The provision is designed to discourage income shifting by subjecting certain foreign intangible income (as well as other income) to current U.S. tax.

Both the House and Senate bills included minimum tax provisions. Although there were similarities between the two bills, they contained key differences. The conference agreement generally follows the Senate bill with certain modifications.

The conference agreement provides that, effective for tax years beginning after 2017, U.S. shareholders of CFCs are subject to current U.S. tax on its "global intangible low-taxed income" (GILTI). In general, GILTI is defined as the excess of a U.S. shareholder's aggregated net "tested income" from CFCs over a routine return on certain qualified tangible assets. This aggregated approach allows loss entities to offset other entities with tested income within the group, but not below zero.

In general, "tested income" is the excess (if any) of the gross income of the corporation over its allocable deductions. The conference agreement provides that certain types of gross income are excluded from being classified as "tested income" including:

- Income taxed as effectively connected with a U.S. trade or business,
- Subpart F income
- Income excluded from foreign-base company income or insurance income by reason of the high-tax exception
- Any dividend received from a related person
- Certain foreign oil and gas extraction income, over deductions (including taxes) properly allocable to such gross income

The conference agreement does not exclude several other categories of gross income that were excluded under the House bill, including active finance income, insurance income, and dealer income.

The reduction allowed against tested income for routine return when computing the GILTI amount is the product of 10% multiplied by the CFCs' average aggregate adjusted tax bases in depreciable tangible property adjusted downward for certain interest expense. The average of the aggregate adjusted tax bases is determined as of the close of each quarter of the taxable year. The conference agreement clarifies that if a CFC holds an interest in a partnership, the CFC takes into account its distributive share of the aggregate of the partnership's adjusted bases in tangible property.

The GILTI amount would be includable in a U.S. shareholder's income in a similar fashion to Subpart F income. Foreign taxes would be available as a credit but would be limited to 80% of the amount that would otherwise be creditable. The corresponding gross-up under Section 78, however, is calculated based on 100% of the taxes paid. The report also creates a separate foreign tax credit basket for GILTI, with no carry-forward or carry-back available for excess credits.

The conference agreement provides domestic corporations a 50% deduction of its GILTI amount (37.5% for tax years beginning after 2025). This would result in a domestic corporation having an effective tax rate on GILTI of 10.5% (13.125% for tax years beginning after 2025). The conference agreement also includes incentives to domestic corporations to offset a portion of certain foreign-derived intangible income earned by the domestic corporation. Providing an incentive to hold intangibles in the United States the report allows for a deduction equal to 37.5% (21.875% for tax years beginning after 2025) of a domestic corporate taxpayer's foreign-derived intangible income. Both deductions are subject to a taxable income limitation.

Foreign-derived intangible income is broadly defined to include income received from the sale of property for foreign use or services rendered to persons outside of the United States (with certain exceptions for transactions with related parties). The sale of property for foreign use also includes income from leasing, licensing, as well as income from other dispositions. Net foreign-derived intangible income is the excess of foreign-derived intangible

income over a routine return on the domestic corporation's qualified tangible assets (similar to the computation described above for GILTI).

> Grant Thornton Insight: The new regime reduces the benefit of the territorial system. Effectively, the territorial system would only be available for a "routine return" on tangible assets because all other earnings would generally be included as GILTI (although a deduction may be available, and the inclusion may be shielded by foreign tax credits). However, because there are no carry-forwards or carry-backs to smooth out timing differences between United States and foreign tax law, domestic corporations may incur U.S. incremental tax resulting in double taxation on GILTI amounts.
>
> It is unclear why pass-through entities were excluded from the deductions available to reduce GILTI and foreign-derived intangible income. As individuals are not eligible for indirect foreign tax credits, and would also be subject to tax on 100% on the GILTI inclusion, an evaluation should be performed to determine whether it would be more beneficial to hold foreign operations in corporate solution as opposed to in a pass-through entity (or directly by an individual).

Base Erosion Anti-Abuse Tax

The conference agreement includes a measure targeting base erosion concerns by effectively imposing a tax based on deductible payments to related foreign parties. The provision follows the Senate bill with only limited modifications. Referred to as the "Base Erosion Anti-Abuse Tax" (BEAT), the measure imposes a minimum tax on certain domestic corporations' "modified taxable income." The tax is phased in at a rate of 5% for tax years beginning in 2018, 10% for tax years beginning in 2019 through 2025, and 12.5% for tax years beginning after Dec. 31, 2025. These rates are increased by 1% for certain banks and securities dealers.

The BEAT amount is the excess of 5% (or the applicable rate as described above) of the taxpayer's modified taxable income over its regular tax liability reduced for certain general business credits. The credits reducing the regular tax liability exclude the R&D credit and up to 80% (limited to the BEAT amount) of the following other general business credits: the low-income housing credit, the renewable electricity production credit, and the investment credit -- but only to the extent properly allocable to the energy credit. For taxable years beginning after Dec. 31, 2025, the regular tax liability is reduced by the aggregate amount of all general business credits (i.e., no adjustments are made).

Modified taxable income is regular taxable income computed without regard to certain deductible payments made to foreign-related parties, referred to as base erosion payments. It is also computed without regard to certain NOLs attributable to base erosion payments. Although base erosion payments are broadly defined, there are certain exceptions for payments subject to U.S. withholding tax, payments for services which are charged with no mark-up under the so-called "services cost method," and certain qualified derivative payments made in the ordinary course. The exclusion for amounts subject to U.S. withholding tax is reduced to the extent an applicable treaty or statutory reduction applies to the withholdable payment. Importantly, with certain exceptions for inverted corporations, the cost of goods sold would not be considered a base erosion payment for purposes of the BEAT.

For purposes of the BEAT, the term "foreign-related party" is broadly defined using the current rules under the Section 6038A. The definition includes any 25% foreign shareholder or any person related to the domestic corporation or to a 25% foreign shareholder. Constructive ownership rules under Section 318, with some modifications, apply when determining relatedness.

The BEAT applies to domestic corporations other than S Corporations, REITs and RICs that are part of a group with $500 million or more in annual gross receipts over a three-year period and have a ratio of base erosion deductions compared to total deductions of 3% or higher (2% or higher for certain banks and securities dealers) for the taxable year, down from 4% in the Senate bill.

The House bill contained a dramatically different approach targeting base erosion concerns. The House imposed an excise tax on certain gross amounts paid or incurred by a domestic corporation to a related foreign corporation. It also contained an election allowing the foreign payee to treat the payments as income effectively connected with the conduct of a U.S. trade or business in lieu of the U.S. corporation paying the gross basis excise tax. The House's excise tax was largely criticized, and was cited by certain foreign ministers as potentially being incompliant with World Trade Organization (WTO) rules, as well as certain bilateral tax treaty provisions. As opposed to reconciling the differences between the starkly different approaches, the conferees opted for the Senate approach, and did not retain any aspects of the excise tax in the final report.

> Grant Thornton Insight: The BEAT provision is particular troubling for inbound companies with large deductible payments to foreign-related parties. However, the fact that the cost of goods sold are generally not included in the definition of base erosion payments will provide some relief to certain taxpayers. The BEAT provision circumvents some of the WTO issues associated with the House excise tax. However, the provision essentially taxes payments for which the United States has previously agreed to cede taxing jurisdiction to other countries. Consequently, the provision still may face scrutiny by jurisdictions with which we have made certain treaty or trade commitments.

Amounts paid or accrued in hybrid transactions

The conference agreement creates new Section 267A to deny a deduction for interest and royalties paid to related parties in connection with a hybrid transaction, including amounts paid by, or to, a hybrid entity. Interest or royalties could not be deducted under the provision to the extent there is no corresponding income inclusion to the related party under the tax law of the country of which the related party is resident or otherwise subject to tax, or to the extent such related party is provided a deduction in the local country. For purposes of these provisions, the term "related party" is defined by reference to Section 954(d)(3) modified to apply to a payer in this case.

A hybrid transaction is any transaction, series of transactions, agreement, or instrument where payments are treated as interest or royalties for federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of the recipient. A hybrid entity is any entity which is either: (1.) treated as fiscally transparent for U.S. income tax purposes but not treated that way under the tax law of the foreign country where the entity is resident for tax purposes or is subject to tax, or (2.) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is a tax resident or is subject to tax but not so treated for federal income tax purposes.

The conference agreement provides authority to the Treasury secretary to issue a number of regulations. Such regulations may expand the application of these rules in a number of circumstances. The provisions would be effective for tax years beginning on or after Dec. 31, 2017.

> Grant Thornton Insight: The adoption of rules regarding hybrid payments and entities is consistent with certain recommendations made by the Organisation for Economic Co-operation and Development

(OECD) to combat base erosion and profit shifting. These provisions are likely to be significant for U.S.-based multinationals. Taxpayers should begin assessing the impact of these provisions immediately in order to mitigate the effect on their taxable income starting in 2018.

Limitation on interest deductions by corporate members of a worldwide group

The conference agreement did not adopt provisions in both the House and Senate bills aimed at limiting the deductibility of interest for domestic corporations that are members of a worldwide group. The proposals sought to limit interest deductions for certain domestic corporations by focusing the amount of debt held by U.S. corporations as compared to the group debt, but are not included in the final version.

Treatment of gain or loss by foreign person disposing of certain partnership interests

The conference agreement effectively reverses a recent Tax Court ruling against the IRS in *Grecian Magnesite Mining, Industrial & Shipping Co., SA vs. IRS* (149 T.C. No. 3) by codifying Rev. Rul. 91-32. Under this provision, Sections 864(c) and 1446 are modified effective for transfers of partnership interests on or after Nov. 27, 2017, to make clear that gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The provisions also require the transferee of a partnership interest to withhold 10% of the amount realized on the sale or exchange unless the transferor certifies that it is neither a nonresident alien nor a foreign corporation. In the event the transferee fails to withhold, the partnership generally must withhold from distributions to the transferee partner.

Limitations on income shifting through intangible transfers

The conference agreement revises the statutory definition of intangible property under Section 936(h)(3)(B) to make clear that workforce in place, goodwill (both foreign and domestic) and going concern value are included. These changes were made in light of numerous controversial issues that have arisen in the context of outbound transfers of certain intangible property under Section 367(d), and transfer pricing under Section 482. Both Sections 367 and 482 make reference to Section 936(h)(3)(B) when defining intangible property. The provisions would be effective for transfers in taxable years beginning after Dec. 31, 2017.

The conference agreement also confirms the authority of the Treasury secretary to require certain valuation methodologies specifically relating to use of aggregate basis valuation and the application of realistic alternative principles.

Grant Thornton Insight: The result of these provisions is likely to expand capability for the IRS to impose taxation on outbound transfers of intangibles and intercompany pricing of related transactions.

Modification of stock attribution rules for determining CFC status

The conference agreement amends the ownership rules of Section 958(b)(4) 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 person would be considered a U.S. shareholder and whether, in turn, a foreign corporation is a CFC. The provision would be retroactively effective beginning with the last taxable year of foreign corporations beginning before Jan. 1, 2018, and all subsequent years of such foreign corporations, and for taxable years of U.S. shareholders in which, or with which, such taxable years of foreign corporations end.

Grant Thornton Insight: The effective date of this provision is noteworthy. For calendar year taxpayers, this provision would be effective for the 2017 tax year. The retroactive nature of this provision warrants

immediate attention from taxpayers to determine whether additional reporting or substantive tax impacts would result from this change.

Modification of the definition of U.S. shareholder
The conference agreement expands the definition of "U.S. shareholder" to include any U.S. person who owns 10% or more of the total value of shares of all classes of stock of a foreign corporation. Under current law, the definition of a U.S. shareholder is limited to a U.S. person who own 10% or more of the total combined voting power of all classes of stock entitled to vote. This provision will likely result in more U.S. persons being considered U.S. shareholders and potentially subject to the Subpart F rules, and will also cause more foreign corporations to be considered CFCs. The provision would be effective for taxable years of foreign corporations beginning after Dec. 31, 2017, and for the taxable years of U.S. shareholders ending with or within such taxable years.

Elimination of the 30-day control requirement for Subpart F
Under current law, a foreign corporation must be controlled for an uninterrupted period of 30 days before Subpart F inclusions are effective. The provisions of the conference agreement eliminate the requirement that a corporation must be controlled for 30 days. The provision would be effective for taxable years of foreign corporations beginning after Dec. 31, 2017, and for the taxable years of U.S. shareholders ending with or within such taxable years.

Look-through rule for related foreign corporations
The conference agreement does not make permanent the look-through rules scheduled to expire under for tax years beginning after Jan. 1, 2020. Under this temporary provision, dividends, interest, royalties and rents received or accrued from a CFC that is considered a related person are not considered Subpart F income to the extent such amounts are attributable to income of the related person which is neither Subpart F income nor income which is effectively connected with a U.S. trade or business. Both the House and Senate bills would have made this treatment permanent, but the provision was excluded from the final bill.

The conference agreement also repeals the treatment of foreign-base company oil-related income as Subpart F, and repeals certain Subpart F provisions associated with foreign-base company shipping income.

The conference agreement did not include a previously proposed amendment to the de minimis exception of present law, which would have indexed for inflation the $1 million de minimis amount for foreign-base company income. Therefore, the de minimis amount will not be indexed for inflation under the final bill.

Other miscellaneous international provisions
The conference agreement provides numerous other provisions impacting the taxation of foreign income and foreign persons, including the following:

- Modifying Section 863(b) rules to provide income from the sale or exchange of inventory property so that it is sourced solely on the basis of production activities with respect to the property. Under current law, the sourcing rules generally provided that the sourcing of income is split between place of production and place of sale.
- The agreement provides a separate foreign tax credit limitation basket for foreign branch income.
- It restricts the application of the qualified dividend rules for dividends received from any corporation which becomes a surrogate foreign corporation not treated as a domestic corporation after Dec. 31, 2017.

- It restricts the exception for certain insurance companies under the Passive Foreign Investment Company rules.
- The agreement prohibits members of a U.S.-affiliated group from allocating interest expense under Section 864 on the basis of fair market value of assets and therefore requiring members to allocate interest expense based the adjusted tax basis of assets.

The above provisions would generally be effective for taxable years beginning after Dec. 31, 2017, unless otherwise noted.

The conference agreement also eliminates provisions that would have allowed, for a period of three years, certain intangible property held by controlled foreign corporations to be transferred to a U.S. shareholders in a tax-efficient manner. The provision would have applied to intangible property as described in Section 936(h)(3)(B) and computer software as described in Section 197(e)(3)(B).

Increased international information return penalties
The conference agreement adopts a proposal contained in both the Senate and House bills that increases the penalties for failing to timely file Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business* from $10,000 per form to $25,000 per form.

> Grant Thornton Insight: The IRS has instituted procedures for businesses with delinquent international information returns, which, under certain circumstances, could allow an eligible business to late-file the Form 5472 without penalty by demonstrating reasonable cause. However, the penalty imposed under Section 6038A(d) is often automatically assessed by the IRS when Form 5472 is attached to a late-filed income tax return. These penalties are difficult to abate, and domestic businesses with significant foreign ownership could see substantially increased penalty liabilities and associated costs in attempting to mitigate the effects of late-filed returns with delinquent Forms 5472.

Tax-exempt organizations

The conference agreement makes several potentially significant changes to the way tax-exempt organizations are taxed, and could have an impact on many colleges, universities, foundations, charities and hospitals.

Excise taxes on foundations and colleges and universities
The conference agreement does not amend the net investment incomes of private foundations as proposed in the House bill, but imposes an excise tax on the net investment income of private colleges and universities for the first time. The provision would apply to private colleges and universities (not a public, state college or university) that have at least 500 students during the preceding year (with more than 50% of those students being located in the United States) and have an aggregate fair market value of assets (other than those assets used to carry out the exempt purpose of the institution) of at least $500,000 per student.

Compensation
The conference agreement generally adopts the Senate's proposal to impose a 21% excise tax (equal to the corporate tax rate) on the wages over $1 million paid by a tax-exempt organization to its highest-paid employees beginning in 2018. The tax applies to any covered employee, defined as one of the five highest-paid employees in any year beginning in 2017 or later. A separate 21% excise tax applies to parachute payments made to covered employees, with certain exceptions. Parachute payments are payments that are contingent upon the

employee's termination of employment. Notably, the final version carves out an exception for certain compensation paid to doctors, nurses or veterinarians.

Unrelated business income tax (UBIT) and excess business holding provisions

The conference agreement adopts, with some modifications, a Senate proposal that would require a tax-exempt entity with more than one unrelated trade or business to separately compute taxable income with respect to each trade or business and without regard for the specific deduction allowable under Section 512(b)(12). The separately computed taxable income is then aggregated to an amount not less than zero, taking into account the specific deduction. Net operating losses are only allowed with respect to the trade or business from which the loss arose.

The conference agreement also adopts the House's proposal to require tax-exempt organizations to increase UBIT by the amount of certain fringe benefits provided to employees. These fringe benefits are limited to qualified transportation, any parking facility used in connection with qualified parking or any on-premises athletic facility for which the expenses are not otherwise deductible under Section 274 because they are entertainment expenses.

Outlook

The remarkable speed at which this legislation has moved through Congress leaves little time for businesses to plan ahead for an effective date that begins in 2018. Nonetheless, businesses should strongly consider what year-end planning may be possible, including potentially deferring income and accelerating deductions to the extent possible.

In addition, if the bill is signed before year-end, businesses will be required to take into account certain financial statement implications of this legislation effective for financial statements in the fourth quarter of 2017. Going forward in 2018, there are considerable areas of ambiguity in this legislation, and many areas that create tax planning challenges and opportunities.

Contact

Dustin Stamper
Director,
Washington National Tax Office
Grant Thornton LLP
T +12028614144
E dustin.stamper@us.gt.com

David Sites
Partner
Washington National Tax Office
Grant Thornton LLP
T +12028614104
E david.sites@us.gt.com

Andy Cordonnier
Partner
Washington National Tax Office
Grant Thornton LLP
T +12025211502
E andy.cordonnier@us.gt.con

Eddie Adkins
Partner
Washington National Tax Office
Grant Thornton LLP
T +12025211565
E eddie.adkins@us.gt.com

Sharon Kay
Partner
Washington National Tax Office
Grant Thornton LLP
T +12028614140
E sharon.kay@us.gt.com

Shamik Trivedi
Senior Manager
Washington National Tax Office
Grant Thornton LLP
T +12025211511
E shamik.trivedi@us.gt.com

To learn more visit **gt.com/tax**

Tax Professional Standards Statement

This content supports Grant Thornton LLP's marketing of professional services and is not written tax advice directed at the particular facts and circumstances of any person. If you are interested in the topics presented herein, we encourage you to contact us or an independent tax professional to discuss their potential application to your particular situation. Nothing herein shall be construed as imposing a limitation on any person from disclosing the tax treatment or tax structure of any matter addressed herein. To the extent this content may be considered to contain written tax advice, any written advice contained in, forwarded with or attached to this content is not intended by Grant Thornton LLP to be used, and cannot be used, by any person for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.

Grant Thornton

GT.COM