15 December 2017

'Tax Cuts & Jobs Act' Conference Agreement Released

House and Senate conferees to the "Tax Cuts and Jobs Act" (H.R. 1) today (December 15, 2017) signed and released a Conference Agreement that is expected to be considered by the full House and Senate next week, capping off the most significant legislative achievement to date of the Trump Administration and the first major overhaul of the federal income tax in more than 30 years. The expectation is that President Trump will sign the bill prior to the Christmas holiday. The final conference agreement reflects compromises by the conferees in a host of areas, including a 21% corporate tax rate that will be effective in 2018 – up from 20% in the bills passed by the House and the Senate – and a 37% top individual income tax rate that would apply to joint filers with annual incomes over $600,000.

The Conference Agreement sets deemed repatriation tax rates for the transition to a territorial tax system at 15.5% for earnings held in cash or other specified assets, and 8% for the remainder – rates that are higher than the Senate bill rates of 14.5%/7.5% and House rates of 14%/7%. Additional cost-saving changes were included to accommodate modifications necessary to ensure Republican votes to pass the bill on the House and Senate floors and comply with budget reconciliation instructions that allow for Senate approval by a simple majority vote of a net tax cut of not more than $1.5 trillion over 10 years. The Conference Agreement would cut taxes by $1.456 trillion over 10 years.

The Conference Agreement would provide a deduction for pass-through business owners of 20%, lower than the 23% deduction in the Senate-passed bill but, because of the drop in the top individual tax rate, resulting in a slightly better effective tax rate of 29.6% on income from a pass-through that is not limited. The deduction applies to the first $315,000 of joint income (subject to phase-out) earned from businesses organized as S corporations, partnerships, LLCs, and sole proprietorships. Limitations based on W-2 wages and capital apply above those amounts and for "specified service businesses."

Various changes were made to appease specific lawmakers. Responding to members from high-tax states, the agreement would allow the state and local tax deduction, limited under the House and Senate bills to a property tax deduction up to $10,000, to apply to property and income tax or sales taxes. The refundable portion of the child tax credit was increased to $1,400 to win the support of Senator Macro Rubio (R-FL).

The agreement drops some controversial provisions, including the Senate tax bill's first-in first-out provision for computing basis with regard to securities transactions. Education-related tax preferences that were repealed under the House bill, such as the deduction for student loan interest, were preserved under the agreement. The Senate approach to the deduction for medical expenses, which would reduce the income threshold from 10% to 7.5% of adjusted gross income for two years, won out over the repeal of the deduction proposed by the House.

Also as part of the reconciliation instructions, the bill includes a title to permit drilling in a portion of the Arctic National Wildlife Refuge (ANWR).

Highlights of the Conference Agreement are grouped into the following main topics below:

- Corporate
- International
- Taxation of Pass-throughs
- Financial Services
- Insurance
- Retirement
- Compensation
- Energy
- Exempt Organizations
- Accounting Methods
- Individual Taxes
- Education

CORPORATE

Key Provisions

- 21% corporate tax rate – The corporate rate would be effective January 1, 2018. As in the Senate bill, the Conference Agreement provides that excess deferred tax reserves would be allowed normalization on allowances taken for assets placed in service before the date of enactment.

- Repeal Corporate AMT – The corporate alternative minimum tax (AMT) would be repealed under the Conference Agreement as provided in the House bill. Taxpayers with an AMT Credit can use the credit to offset regular tax liability. Taxpayers would be able to claim a refund of 50% (100% for years beginning in 2021) of the remaining credits (to the extent the credits exceed regular tax for the year) in tax years beginning before 2022. The provision would apply to tax years beginning after 2017.

- Dividends received deduction ("DRD") – The amount of deduction allowable against the dividends received from a domestic corporation would be reduced. Specifically, the deduction for dividends received from other than certain small businesses or those treated as "qualifying dividends" would be reduced from 70% to 50%. Dividends received from 20% owned corporations would be reduced from 80% to 65%.

- Expensing

    - 100% Expensing – Bonus depreciation would be increased from 50% to 100% for "qualified property" placed in service after September 27, 2017 (the date the Unified Framework was released) and before 2023. The Conference Agreement follows the House bill in that the original use of the property need not commence with the taxpayer. The increased expensing would phase-down starting in 2023 by 20 percentage points for each of the five following years. Qualified property would be defined to exclude – as with the section 163(j) interest limitation described below – certain public utility property and floor plan financing property. A transition rule would allow for an election to apply 50% expensing for the first taxable year ending after September 27, 2017.

- The Conference Agreement increases the depreciation limitations for listed property and removes computer or peripheral equipment from the definition of listed property. The changes are effective for property placed in service after December 31, 2017, in taxable years ending after such date.
- Section 179 expensing would be increased to $1 million for "qualified property" (i.e., tangible personal property used in a trade or business) placed in service in tax years beginning after 2017, with a phase-out beginning at $2.5 million; additionally, the term "qualified property" would be expanded to include certain depreciable personal property used to furnish lodging, and improvements to nonresidential real property (such as roofs, heating, and property protection systems).

- Interest limitations – The Conference Agreement would limit the deduction for net interest expense of all businesses by amending Section 163(j). Unlike the House and Senate bills, however, the Conference Agreement drops the additional interest expense limitation that would have been imposed through a worldwide debt cap under what would have been Section 163(n). The revised Section 163(j) limitation would be on net interest expense that exceeds 30% of adjusted taxable income ("ATI"). For the first four years, ATI would be computed without regard to depreciation, amortization, or depletion. Thereafter (beginning in 2022), ATI would be decreased by those items, thus making the computation 30% of net interest expense exceeding EBIT. ATI would otherwise be defined similar to current Section 163(j). Interest expense would need to be related to a "business," which means the interest is properly allocable to a trade or business. Certain activities would be excluded from being a trade or business – e.g., performing services as an employee, a real property trade or business, and certain activities of regulated utilities. A small business exception is keyed to businesses satisfying a gross receipts test of $25 million. The provision is effective for taxable years after 2017.

- Net operating losses – For losses arising in tax years beginning after 2017, the NOL deduction would be limited to 80% of taxable income – compared to the Senate bill that provided for 90% until 2022 and 80% thereafter. The carryback provisions would be repealed, except for losses incurred in a farming trade or business that would be allowed a two-year carryback and NOLs of a property and casualty company that would continue to be subject to a two-year carryback and 20-year carryforward. For others, an indefinite carryforward would be allowed.

- Like-kind exchanges – The nonrecognition of gain in the case of like-kind exchanges would be limited to those involving real property only. Current law continues to apply for like-kind exchanges if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or the property received by the taxpayer in the exchange is received on or before December 31, 2017. Otherwise, the limitation is effective for exchanges completed after 2017.

- Contributions to capital – Section 118 would be retained and continue to apply only to corporations. Thus, contributions to capital would be excluded from the corporation's gross income but new rules would clarify that such contributions do not include any contribution in aid of construction, any other contribution made by non-shareholders (such as a customer or potential customer), and any contribution made by any governmental entity or civic group. The clarification would generally apply to contributions made after the date of enactment.

Deductions

- R&E Amortization – In general, research and experimental (R&E) expenses would be required to be amortized over a five year period, with R&E conducted outside the United States required to be amortized over a fifteen year period. R&E specifically includes expenses for software development. Amortization would be required for expenses incurred in tax years after 2021. The research and development ("R&D") tax credit would be preserved without modification from current law.

- Repeal Section 199 – The domestic production deduction relating to deductions for qualifying receipts derived from certain activities performed in the United States would be repealed for tax years after 2017, following the House bill's effective date.

- Real property cost recovery - The recovery period for real property is maintained. Specifically, nonresidential real property is recovered over 39 years and residential rental property is recovered over 27.5 years with a 15-year recovery period for "qualified improvement property" and a 20-year ADS recovery period. The provision would apply to property placed in service after 2017.

- Employer deductions – Expenses paid for (i) entertainment activities and membership dues, and (ii) transportation or commuting expenses of employees would no longer be deductible after 2017. Expenses for meals and beverages would continue to be deductible at 50% and be expanded temporarily (until 2026) to cover expenses incurred for food and beverages offered for the employer's convenience. Employee awards provided in cash or via gift cards would not qualify as an expense eligible for a deduction by the employer.

- Deduction for unused business credits – The Conference Agreement retained the deduction for unused business credits that had been targeted for repeal by the Senate bill.

Credits

- Orphan Drug Credit – The 50% credit would be reduced to 25% and generally would need to exceed 50% of the average expenses over a three-year period. The reduced credit would apply to amounts paid or incurred in taxable years beginning after December 31, 2017.

- Housing credits – The Conference Agreement made no changes to the low-income housing tax credit; Rehabilitation credits for old and / or historic buildings would be changed. The credit for pre-1936 buildings would be repealed and the credit for certified historic structures would be reduced from 20% to 10% for amounts paid or incurred after 2017, with transition rules to be applied in the case of property owned or leased by the taxpayer on or after 2018.

- FMLA Credit – Employers that pay wages to employees on family and medical leave would receive a general business credit equal to 12.5% of those wages. To be eligible, employers must allow (among other requirements) for at least two weeks of leave and offer the leave to full time and non-full time employees. The FMLA credit would be available for wages paid in 2018 and 2019.

- Work Opportunity Tax Credit/New Markets Tax Credit. The Conference Agreement retains current law with respect to both the Work Opportunity Tax Credit and the New Markets Tax Credit, both of which expire after 2019.

INTERNATIONAL

- 100% exemption for foreign-source dividends – The Conference Agreement generally follows the Senate bill with some exceptions. The Conference Agreement exempts 100% of the foreign-source portion of dividends received by a US corporation from a foreign corporation (other than a PFIC that is not also a CFC) in which the US corporation owns at least a 10% stake. Some particular provisions to note:

    - Holding period - The Conference Agreement requires a holding period of more than one year in the stock of the foreign corporation.

    - Hybrid dividends - The Conference Agreement does not allow an exemption for any dividend received by a US shareholder from a CFC if the dividend is deductible by the foreign corporation when computing its taxes.

    - No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any portion of a distribution treated as a dividend that qualifies as a DRD.

    - Special rules for the sale of foreign corporations – The Conference Agreement applies the dividend exemption to the sale of foreign stock on the gain to the extent of its E&P, and clarifies that the dividend exemption would apply on the gain from the sale of lower tier CFCs to the extent of the CFC's E&P. Only for determining loss on the sale of stock of a 10% owned foreign corporation, a US parent would reduce its basis in the stock of the foreign corporation equal to the amount of any exempt dividend it received from that foreign corporation.

    - Section 367(a)(5) active trade or business exception repealed - Transfers of property used in an active trade or business would no longer qualify as an exception to the current rule that prevents such transfers from qualifying as tax-free organizations, reorganizations, or liquidations. The exception would be removed for transfers after 2017.

    - The Conference Agreement allows an exemption for a US corporation's distributive share of a dividend received by a partnership in which the US corporation is a partner if the dividend would have been eligible for the exemption had the US corporation directly owned stock in the foreign corporation.

    - The effective date is generally for distributions made after December 31, 2017.

- Mandatory toll charge on tax-deferred foreign earnings – The Conference Agreement provides a one-time transitional tax on a US 10%-shareholder's pro rata share of the foreign corporation's post-

1986 tax-deferred earnings, at the rate of either 15.5% (in the case of accumulated earnings held in cash, cash equivalents or certain other short-term assets) or 8% (in the case of accumulated earnings invested in illiquid assets (e.g., property, plant and equipment). A foreign corporation's post-1986 tax-deferred earnings would be the greater of the earnings as of November 2, 2017 or December 31, 2017. The portion of post-1986 earning and profits subject to the transition tax does not include earnings and profits that were accumulated by a foreign company prior to attaining its status as a specified foreign corporation. Similar to both the House and Senate bills, the Conference Agreement allows post-1986 accumulated earnings deficits of any foreign corporations to offset tax-deferred earnings of other foreign corporations. The Conference Agreement also adopts the House provision that allows the netting to generally be done among all affiliated group members. The US shareholder may elect to pay the transitional tax over a period of up to eight years.

Other provisions of note include:

- o The Treasury is given authority to provide guidance in order to avoid double counting and double non-counting of earnings.
- o The Statement of Managers also notes that the conferees are aware that taxpayers may have engaged in "tax strategies designed to reduce the amount of post-1986 E&P in order decrease the amount of the inclusion required under the provision," and thus provides the Treasury with authority to issue guidance to adjust earnings in such cases.
- o For companies that become expatriated during the 10-year period after the date of enactment, the Conference Agreement adopts the Senate provision imposing a full 35% deemed repatriation tax, without the benefit of foreign tax credit offset.

- Overall Domestic Loss – The Conference Agreement provides an election to increase the percentage (but not greater than 100%) of domestic taxable income that may be offset by any pre-2018 unused overall domestic loss and recharacterized as foreign source.

- Anti-base erosion rules for intangible income –

  - o "The Stick"– The Conference Agreement follows the Senate bill and would impose a tax on a US shareholder's aggregate net CFC income that is treated as global intangible low-taxed income (GILTI). GILTI is gross income in excess of extraordinary returns from tangible depreciable assets excluding effectively connected income (ECI), subpart F income, high-taxed income, dividends from related parties, and foreign oil and gas extraction income. The extraordinary return base is equal to 10% of the CFCs' aggregate adjusted basis in depreciable tangible property. Only 80% of the foreign taxes paid on the income would be allowed as a foreign tax credit. All CFCs are aggregated for purposes of the computation. For taxable years beginning after December 31, 2017 and before January 1, 2026 the highest effective tax rate on GILTI is 10.5%. For taxable years beginning after December 31, 2025 the effective tax rate on GILTI is 13.125%.

  - o "The Carrot" – The Conference Agreement maintains the tax incentive in the Senate bill for US companies to earn intangible income from exploiting US intangibles abroad. Income from foreign derived intangible income (FDII) for taxable years beginning after December 31, 2017 and before January 1, 2026 is provided an effective tax rate of 13.125%. For taxable years beginning after December 31, 2025, the effective tax rate on FDII is 16.406%. Eligible income does not include, among other items, financial services income under Section 904(d)(2)(D).

  - The Conference Agreement drops special rules for transfers of intangible property to the US – A Senate bill provision would have allowed US companies to repatriate their intangible property tax-free over a three-year period. The Conference Agreement did not adopt this provision.

- Subpart F modifications – The Conference Agreement makes the following modifications:

  - Repeal of foreign base company oil related income as subpart F income.

  - Repeal of the inclusion based on withdrawal of previously excluded subpart F income from a qualified investment in foreign base company shipping operations.

- Definition of US shareholder – The definition of a US shareholder was changed to include any US person who owns 10% or more of the total value (as well as vote) of shares of all classes of stock of a foreign corporation.

- Modification of stock attribution rules for CFC status – Similar to the Senate Bill, the Conference Agreement changes the stock attribution rules. Under this provision US corporations will be deemed to own the foreign stock that is owned by the US corporation's foreign parent for purposes of determining CFC status. The Conference Agreement clarifies that the provision is intended to target transactions that avoid subpart F by "de-controlling" a foreign subsidiary so that it is no longer a CFC.

- Repeal of 30-day controlled foreign corporation rules – Under the Conference Agreement foreign corporations would be considered controlled foreign corporations as soon as the ownership requirements are met and subject to the subpart F and base erosion rules.

- CFC look-thru rules – The look-thru rule for related CFC dividend, interest and royalties was not made permanent. Thus, the rules expire after 2019.

- Maintains Section 956 investment in United States property rules – Both the House and Senate bill repealed or modified current law Section 956. However, the Conference Agreement adopted neither change.

- Other anti-base erosion provisions – Several provisions address the Conference Agreement effort to prevent erosion of the US tax base.

  - Change in intangibles definition – The Conference Agreement follows the Senate bill and changes the definition of intangible property to include workforce in place, goodwill and going concern value and "any similar item" the value of which is not attributable to tangible property or the services of an individual. The Conference Agreement also confirms the authority of the Treasury Department to require certain valuation methods.

- Hybrid rule – The Conference Agreement follows the Senate bill and denies a deduction for any amount paid to a hybrid company or pursuant to a hybrid transaction if the recipient country treats the payment differently than the US.

- Inversions rules for qualified dividends – Individual shareholders are not allowed reduced rates of tax on qualified dividends received from companies that invert and become surrogate foreign corporations after date of enactment, effective for dividends received after the date of enactment

- Foreign tax credit changes – Similar to the House bill, under the Conference Agreement indirect foreign tax credits would only be available for Subpart F income. No credits would be allowed with respect to any dividends associated with exempt dividends. Foreign tax credits would be used on a current year basis and would not be allowed to be carried forward or back.

- Separate branch FTC basket – The Conference Agreement would establish a separate foreign tax credit basket for branches. This will minimize a corporation's ability to cross-credit between branches and CFCs.

- Worldwide interest allocation – The Senate bill accelerated the effective date of the worldwide interest allocation rules to taxable years beginning after December 31, 2017. The Conference Agreement does not adopt this provision.

- Export sales source rule - The Conference Agreement adopts the Senate bill provision by amending the source of income rules from sales of inventory determined solely on basis of production activities.

- Inbound base erosion rule – The Conference Agreement adopts the Senate bill's new base erosion anti-abuse tax (BEAT) provision. The BEAT applies to corporations (other than RICs, REITs, or S-corporations) that are subject to US net income tax with average annual gross receipts of at least $500 million and that have made related party deductible payments totaling 3% (2% in the case of banks and certain security dealers) or more of the corporation's total deductions for the year. A corporation subject to the tax generally determines the amount of tax owed under the provision (if any) by adding back to its adjusted taxable income for the year all deductible payments made to a foreign affiliate ("base erosion payments") for the year (the "modified taxable income"). Base erosion payments do not include cost of goods sold, certain amounts paid with respect to services, and certain qualified derivative payments. The excess of 10% (5% in the case of one taxable year for base erosion payments paid or accrued in taxable years beginning after December 31, 2017) of the corporation's modified taxable income over its regular tax liability for the year (net of an adjusted amount of tax credits allowed) is the base erosion minimum tax amount that is owed. For tax years beginning after December 31, 2025 the rate is increased form 10% to 12.5%.

    - The rate for certain banks and security dealers is 1% higher than the rates described above.
    - Premiums related to reinsurance of life and property and casualty contracts are specifically included as base erosion payments.

- The exception for costs of goods sold does not apply to base erosion payments made to a surrogate foreign corporation that first became a surrogate foreign corporation after November 9, 2017.
- The conference agreement includes a modification to the Senate provision that mostly eliminates the penalty in the BEAT calculation for companies that take advantage of certain business tax credits, including the low income housing tax credit and certain renewable electricity production tax credits.

<u>TAXATION OF PASS-THROUGHS</u>

- Pass-Through Income: Special 20% Deduction – The conference agreement generally follows the Senate bill and provides individuals with a 20% deduction on certain pass-through income. Special limitations apply to "specified service businesses" based on the income of their owners.

  - *General Rule* - An individual taxpayer may deduct 20% of domestic "qualified business income" (QBI) from a partnership, S corporation, or sole proprietorship ("qualified businesses"), subject to certain limitations and thresholds. At the top tax rate of 37%, provided in the conference agreement, if a taxpayer's sole income source is domestic QBI and the application of the deduction is not limited, then the effective tax rate on the domestic QBI would be 29.6%. The deduction is not allowed against Adjusted Gross Income but rather is a deduction to reduce taxable income. Trusts and estates are eligible for the deduction.

  - *Qualified Business Income* - QBI for a taxable year means the net amount of domestic qualified items of income, gain, deduction, and loss with respect to a taxpayer's qualified businesses, which includes any trade or business other than specified services trades or businesses (defined below). In determining a taxpayer's qualified items of income, gain, deduction, and loss, items are taken into account only to the extent included or allowed in the determination of taxable income for the year. REIT non-capital gain dividends and certain cooperative dividends are considered qualified items of income for this purpose. QBI does not include reasonable compensation of an S corporation shareholder, amounts allocated or distributed to a partner who is acting other than in his/her capacity as a partner for services, and guaranteed payments in the nature of remuneration for services. It also does not include certain investment-related items and contains limitations based on "W-2 wages." If the computation of QBI results in a loss for a taxable year, the amount of the loss is carried forward and treated as a loss from a qualified business in the next taxable year.

  - *Limit Based on Wages and Capital* – For taxpayers whose taxable income does not exceed $157,500 for individuals ($315,000 if married filing jointly) there are no limitations. Above those thresholds, the amount of the deduction is limited to the greater of 50% of the W-2 wages, or the sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis of all qualified property. Only those wages that are properly allocable to qualified business income are taken into account. Qualified property includes depreciable tangible property.

  - *Special Further Limitation for Specified Service Businesses* - The deduction does not apply to "specified service businesses," except for taxpayers whose taxable income does not exceed $207,500 (for individuals) or $415,000 (if married filing jointly). The benefit of the deduction is phased out for these taxpayers over a $50,000 range ($100,000 if joint return) for taxable income exceeding the $157,500 for individuals, and $315,000 if married filing jointly. A “specified service business” means any trade or business activity involving the performance of services in the fields of health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, brokerage services, investment management, trading, dealing in securities, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its owners or employees. It does not include engineering or architecture trades or businesses.

  - *Effective Date and Sunset* - The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

Other pass-through items

- Repeal of partnership technical terminations caused by the sale or exchange of a 50% or more interest in the capital and profits of a partnership – Under section 708(b)(1)(B) of current law, a sale or exchange of 50% or more of interests in partnership capital and profits within a 12-month period causes a “technical termination” of the partnership. The conference agreement would repeal section 708(b)(1)(B) for partnership taxable years beginning after December 31, 2017.

- Loss limitation rules applicable to individuals – Excess business losses of a taxpayer other than a C corporation would not be allowed for the taxable year, but would be carried forward. An excess business loss would be the excess of aggregate deductions of the taxpayer attributable to trades or businesses, over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount of $500,000 for married individuals filing jointly and $250,000 for other individuals. For a partnership or S corporation, the proposal would apply at the partner or shareholder level. Each partner’s or S corporation shareholder’s share of items of income, gain, deduction, or loss of the partnership or S corporation would be taken into account in applying the limitation. The provision is effective for taxable years beginning after December 31, 2017 and before January 1, 2026.

- Sales of partnership interests by foreign partners - In *Grecian Magnesite (Grecian Magnesite Mining, Industrial & Shipping Co., SA vs. Comm’r,* 149 T.C. No. 3 (Jul. 13, 2017))*,* the Tax Court declined to follow Revenue Ruling 91-32 (1991-1 C.B. 107.) holding that the gain recognized by a foreign person on its redemption from a partnership engaged in a US trade or business did not result in effectively connected income (ECI). The conference agreement would reverse this decision, reestablishing, by statute, a provision similar to the Rev. Rul. 91-32 holding to treat gain or loss from the sale of a partnership interest by a foreign partner as ECI that is taxable in the US if the gain or loss from the sale of the underlying assets held by the partnership would be treated as ECI. In addition, the conference agreement would require the purchaser of a partnership interest from a partner to withhold 10% of the amount realized on the sale or exchange of the partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or a foreign corporation (similar to the operation of the FIRPTA rules applicable to sales of US real estate by foreign owners). The provision regarding the treatment of gain or loss from the sale of a partnership interest by a foreign partner as ECI would be effective for sales or exchanges occurring on or after November 27, 2017, while the effective date for required withholding on sales of partnership interests would be for sales or exchanges occurring after December 31, 2017.

- Mandatory basis adjustments for sales of partnership interests with built-in losses - The conference agreement would require a partnership to adjust the basis in its assets upon the sale of a partnership interest if the partnership has a built-in loss of more than $250,000 in its assets (as under current law), or if the partner selling a partnership interest would be allocated a loss of more than $250,000 upon a hypothetical taxable disposition by the partnership of all of the partnership's assets for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest. This provision would expand the application of mandatory downward basis adjustments on transfers of partnership interests by taking into account gain and loss allocations to the transferee. The provision is effective for transfers of partnership interests after December 31, 2017.

- Partner loss limitation to include charitable contributions and foreign taxes - Under existing law, Treasury regulations do not take into account a partner's share of partnership charitable contributions and foreign taxes paid or accrued in applying the basis limitation on partner losses. The conference agreement would modify the basis limitation on partner losses to include as losses the partner's share of partnership charitable contributions and foreign taxes. This would conform the basis limitation that applies to partnerships to the treatment of these items by shareholders in an S corporation. The provision is effective for partnership taxable years beginning after December 31, 2017.

- State and Local Tax Deduction – Pass-through entities retained the ability to deduct entity level state and local tax deductions.

- Carried interest – For certain partnership interests held in connection with the performance of certain services, the conference agreement follows the Senate amendment and the House bill in imposing a three-year holding period to treat capital gain as long-term capital gain. The provision is effective for taxable years beginning after December 31, 2017.

FINANCIAL SERVICES

- Private activity bonds – The Conference Agreement rejects the position in the House bill to repeal the exclusion from gross income for interest on qualified private activity bonds.

- Advance refunding bonds – The Conference Agreement repeals the exclusion for interest on any bond issued to advance refund a tax-exempt bond, effective for bonds issued after December 31, 2017.

- Tax credit bonds – The Conference Agreement follows the House bill, and repeals the authority to issue tax credit bonds and direct pay bonds, for bonds issued after December 31, 2017.

- Deductibility of FDIC premiums – No deduction would be allowed for a certain percentage of premiums paid by banks to the Federal Deposit Insurance Corporation for taxable years after 2017. The deduction would be disallowed for taxpayers with consolidated assets of $50 billion or more, and limited for smaller financial institutions. The provision applies to taxable years beginning after December 31, 2017.

- Computing basis in securities for determining gain or loss – The Conference Agreement retains current law, thus rejecting a Senate bill provision that would have required that the cost of any security sold, exchanged or disposed of would have been determined on a first-in first-out basis, except when the average basis method is allowed to compute the cost basis of a security.

INSURANCE

Like the House and Senate versions of the Tax Cuts and Jobs Act, the Conference Agreement contains numerous provisions modifying rules for life insurance and property/casualty insurance companies.

Life insurance tax proposals

- Computation of life insurance tax reserves – In general, the Conference Agreement would amend the method of computing reserves under Section 807(d) so that the amount of the life insurance reserve for any contract would be the greater of the net surrender value of the contract or 92.81% of the tax reserve method applicable to the contract. For variable insurance contracts, the tax reserve would be the greater of: (i) the net surrender value; or (ii) the portion of the reserve that is separately accounted for under Section 817, plus 92.81% of the excess (if any) of the tax reserve method, over the net surrender value. The proposal calls for a recalculation of reserves held on contracts issued before the effective date using the new reserve computation method. The difference between the reserves computed using the old method and the new method would then be taken into account over the subsequent eight years. The provision is effective for tax years after 2017.

- Deferred policy acquisition (DAC) costs – In general, the Conference Agreement retains the 180-month period by which specified policy acquisition expenses are amortized under Section 848, retains the three categories of specified insurance contracts as in current law, and increases the DAC percentages. Thus, the increased DAC percentages in the proposal are as follows: for annuity contracts, 2.09%; for group life insurance contracts, 2.45%; and for all other specified insurance contracts, 9.20%. The provision would be effective for tax years beginning after 2017.

- Life insurance proration of dividends received deduction (DRD) – Identical to the Senate bill, the Conference Agreement would amend and significantly simplify Section 812 so that, for purposes of the life insurance company proration rules, for both the separate and general accounts, the company's share is 70% and the policyholder's share is 30%. The provision is effective for tax years beginning after 2017.

- Adjustment for change in computing reserves – Like the House and Senate bills, the Conference

Agreement reduces the 10-year period provided under Section 807(f) for including income or taking deductions for changes in life insurance reserves attributable to a change in the method of computing the reserve to a 4-year period. This proposal is effective for tax years after 2017.

- Repeal of small life insurance company deduction – In accordance with the House and Senate bills, the Conference Agreement would repeal the special deduction that allows insurance companies with assets below $500 million to deduct 60% of their first $3 million in income related to life insurance. The repeal would be effective for tax years beginning after 2017.

- Net operating loss (NOL) deductions – As provided in the House and Senate bills, the Conference Agreement would repeal the special carryforward period of 15 years and carryback period of 3 years for NOLs of life insurance companies. As such, NOLs of life insurance companies would be subject to the same rules as all other corporations under Section 172. This provision applies to NOLs arising in tax years after 2017.

- Rule for distributions from policyholders' surplus accounts (PSA) – Following the House and Senate bills' approach, the Conference Agreement would repeal the rules for policyholders' surplus accounts under Section 815, imposing a tax on the balance of the PSA as of December 31, 2017. Life insurance company losses would not be allowed to offset the amount of the PSA subject to tax. The proposal would be effective for tax years beginning after 2017. The balance of the PSA as of December 31, 2017, would be subject to tax, payable in eight annual installments.

- Life insurance contracts - The Conference Agreement includes rules related specifically to life insurance contracts from the Senate bill:

    - First, the agreement imposes a reporting requirement on both the acquirer of an interest in an existing life insurance contract and the payor of death benefits. The provision is effective for tax years after 2017.

    - Second, the agreement would reverse the position of the IRS in Revenue Ruling 2009-13 such that no adjustment would be made for the "cost of insurance" (i.e., mortality, expense, or other reasonable charges incurred under the contract) in determining the basis of a life insurance or annuity contract. The proposal is effective for transactions entered into after August 25, 2009.

    - Finally, the proposal provides that the exceptions to the transfer for value rules under Section 101(a) do not apply to a reportable policy sale, which means that some or all of the death benefits could be includible in taxable income. The provision is effective for tax years after 2017.

Property/casualty insurance tax proposals

- Proration for property/casualty insurance companies – Under the Conference Agreement, the amount by which a property/casualty insurer must reduce its loss reserve deduction would be increased. Specifically, the 15% reduction under current law would be replaced with a 25%

reduction in 2018 and thereafter, the reduction being equal to 5.25% divided by the top corporate tax rate of 21%. Notably, the provision is linked to the corporate tax rate, so that if the corporate tax rate were to be increased in the future, the reduction would decrease accordingly.

- Loss reserve discounting – The Conference Agreement would change the discount rate rules applicable to unpaid loss reserve deductions to require property/casualty companies to use the corporate bond yield curve as determined by the U.S. Department of Treasury to determine the discount rate. The corporate bond yield curve reflects the average for the proceeding 60-month period (rather than the 24-month period in the House bill) of monthly yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available. The present-law three year period for discounting certain lines of business other than long-tax lines is not modified under the conference agreement. The present-law 10-year period for certain long tail lines is extended for a maximum of 14 years. Finally, the election to use company-specific, rather than industry-wide, historical loss payment patterns is repealed. Generally, this provision is effective for tax years after 2017, with special transition rules that apply to pre-effective date losses and expenses.

- Special estimated tax payments – As provided in both the House and Senate bill, the Conference Agreement would repeal the elective deduction available to insurance companies under Section 847 equal to the difference between a company's reserves computed on a discounted basis and reserves computed on an undiscounted basis. Currently, companies that make this election must make a special estimated tax payment equal to the tax benefit attributable to the deduction. This provision is effective for tax years after 2017.

- Modification of insurance business exception to passive foreign investment company (PFIC) rules – Identical to the House and Senate bills, the Conference Agreement would amend the PFIC exception for insurance companies, to apply only if the foreign corporation would be taxed as an insurance company if it were a US corporation and if the applicable insurance liabilities constitute: (1) more than 25% of the foreign company's assets; or (2) at least 10% of the entity's assets if the dip below 25% is due to temporary circumstances. For the purpose of the provision's exception from passive income, applicable insurance liabilities would mean, with respect to any property/casualty insurance or life insurance business: (1) loss and loss adjustment expenses; and (2) reserves (other than deficiency, contingency, or unearned premium reserves) for life and health insurance risks and life and health insurance claims for contracts providing coverage for mortality or morbidity risks. The provision applies to taxable years after December 31, 2017.

SIMPLIFICATION AND REFORM OF SAVINGS, PENSIONS, AND RETIREMENT

- Repeal of special rule permitting recharacterization of IRA contributions – The Conference Agreement follows the House bill and the Senate amendment that repeals the special rule that allows IRA contributions to one type of IRA (traditional or Roth) to be recharacterized as a contribution to the other type with a modification. Under the provision, recharacterization cannot be used to unwind a Roth conversion, but is still permitted with respect to other contributions, including recharacterizing new Roth contributions. The provision is effective for taxable years beginning after December 31, 2017.

- Extended rollover period for the rollover of plan loan offset amounts in certain cases – The Conference Agreement follows the Senate amendment that extends the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution from the current 60 days after the date of the offset to the due date including extensions for filing the Federal income tax return for the taxable year in which the plan loan offset occurs. The provision applies to loan offset amounts distributed from qualified retirement plans, section 403(b) plans or governmental section 457(b) plans solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee[s severance from employment. The provision is effective for plan loan offset amounts treated as distributed in taxable years beginning after December 31, 2017.

- Modification of rules applicable to length of service award programs for bona fide public safety volunteers – The Conference Agreement follows the Senate amendment increasing the aggregate amount of length of service awards that may accrue for a bona fide volunteer with respect to any year of service from $3,000 to $6,000 and adjusts that amount in $500 increments to reflect changes in cost-of-living. The provision is effective for taxable years beginning after December 31, 2017.

COMPENSATION

- Modification of limitation on excessive employee remuneration – The Conference Agreement follows the Senate amendment with a modification to the transition rule with respect to compensation provided pursuant to a written binding contract which was in effect on November 2, 2017. The provision expands the $1 million deduction limit that applies to compensation paid to top executives of publicly traded companies. The bill would eliminate the performance-based compensation and commissions exceptions to Section 162(m) and expand the definition of covered employee to include the CFO. In addition, it would limit the ongoing deductibility of deferred compensation paid to individuals who previously held a covered employee position, even after they no longer hold that position. Thus, once an individual is named as a covered employee, the $1 million deduction limitation would apply to compensation paid to that individual at any point in the future, including after the cessation of services. The provision would expand the applicability of the deduction limitation to foreign companies that are publicly traded on an American Depositary Receipt. Importantly, the definition of publicly-traded companies subject to the deduction limit may include certain additional corporations that are not publicly traded, such as large private C or S corporations. Under the Conference Agreement, the transition rule applies to compensation paid pursuant to a plan under a written binding contract that is in effect on November 2, 2017 even if the employee was not actually a participant in the plan on that date. The provision would be effective for tax years beginning after December 31, 2017.

- Treatment of qualified equity grants – The Conference Agreement allows qualified employees to elect to defer for income tax purposes the inclusion in income of the amount of income attributable to qualified stock. Qualified stock is stock of a corporation if no stock of the employer corporation is readily tradable on an established securities market and the corporation has a written plan under which not less than 80% of all employees who provide services to the corporation are granted stock options or RSUs. The provision applies with respect to stock attributable to options exercised or RSUs settled after December 31, 2017.

ENERGY

- Oil & gas energy tax incentives – The Conference Agreement would not repeal any conventional energy tax credits (the House bill would have repealed the enhanced oil recovery tax credit (section 43) and the credit for producing oil and gas from marginal wells (45I)). Also, the Conference Agreement leaves untouched the deductibility of intangible drilling costs (IDCs), taxpayers' eligibility to take percentage depletion, and the designation of certain natural resource related activities as generating qualifying income under the publicly traded partnership rules (PTP).

- International tax items impacting energy companies – The Conference Agreement follows the House and Senate bills and repeals the foreign base company oil related income (FBCORI) rules. This proposal is effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of US shareholders in which or with which such tax years of foreign subsidiaries end.

- BEAT tax modified to accommodate renewables – The Conference Agreement modifies the senate-proposed Base Erosion Anti-abuse Tax (BEAT) regime by allowing banks and other entities to use certain renewable energy production and investment tax credits against the BEAT, subject to a 20% haircut.

- Electric plug-in vehicles – The Conferees chose not to repeal the tax credit for new, 4-wheeled, battery powered electric vehicles (repealed in the House bill for vehicles placed in service in taxable years beginning after 12/31/2017).

- New restrictions on renewable energy production and investment incentives – The Conference Agreement does not adopt the House proposals to eliminate the renewable electricity PTC inflation adjustment factor, revisit the rules defining beginning of construction of renewable energy facilities, or terminate the permanent 10% investment tax credit available for geothermal and solar technologies.

- Renewable electricity and biofuel producers – The Conference Agreement would not extend the incentives for certain renewable electricity technologies (fiber-optic solar property, fuel cells, microturbines, combined heat and power systems, thermal energy property and small wind systems). Likewise, the Conference Agreement does not address credits for residential energy efficiency property (qualified geothermal heat pump property, qualified small wind property and qualified fuel cell power plants). The Conference Agreement also does not extend a number of other temporary tax incentives for renewable electricity, including expired credits for production of hydropower; biomass and waste to energy. Similarly, the Conference Agreement does not extend expired fuel tax incentives for biodiesel; renewable diesel; second generation biofuels, alternative fuels, and alternative fuels mixtures. The nuclear production tax incentives modification, featured in the House bill, also was not included in the Conference Agreement. Lawmakers have discussed possibly clearing up this backlog of expired provisions by moving a separate tax extenders bill attached to a government spending bill either in late December or mid-January.

EXEMPT ORGANIZATIONS

The Conference Agreement made changes to a number of provisions related to tax-exempt entities, and eliminated a number of provisions that had appeared in previous versions of the legislation. Many tax-exempt entities remain concerned about the legislation's overall effect on charitable giving, given the effects of the increase in the individual standard deduction and the doubling of the exemption amounts for the estate tax.

The Conference Agreement does NOT include the following provisions that appeared in previous versions:

- Elimination of tax-exempt treatment of private activity bonds
- Changes to the net-investment tax on private foundations
- Enhanced reporting for donor advised funds
- Provision affecting art museums with limited activity
- Relief from excess business holdings excise tax for certain foundations
- Tax treatment of taxpayer funded research shared with the public
- Charitable mileage adjusted for inflation
- Repeal of the Johnson amendment, permitting greater political speech by tax-exempt entities

The Conference Agreement does include the following provisions affecting tax-exempt entities:

- UBIT must be computed separately for each line of business with any loss allocable only to the line from which it arose effective after December 31, 2017, does not apply to losses carried forward occurring before December 31, 2017
- Excise tax on executive compensation on income over $1 million retained with clarifications and changes including increase in tax to 21% and special exemption for licensed medical personnel effective after December 31, 2017
- Elimination of exclusion for advance refunding bonds effective for bonds issued after December 31, 2017
- Elimination of deduction for college event seating rights effective after December 31, 2017
- Increase in AGI percentage limit for cash contributions to public charities
- Repeal of substantiation exception for certain contributions reported by the donee organization effective for contributions made in taxable years beginning after December 31, 2016
- Fringe transportation benefits treated as UBIT effective after December 31, 2017
- Charitable contributions and foreign taxes taken into account in determining limitation on allowance of partner's share of loss effective after December 31, 2017
- Excise tax on net investment income of certain private colleges and universities with clarifications and changes, effective after December 31, 2017

ACCOUNTING METHODS

The accounting method reforms in the Conference Agreement are beneficial to taxpayers but are confined to small businesses, with one significant exception that is generally applicable and generally not beneficial to taxpayers. Notably absent from the Conference Agreement (as well as the House and Senate bills) are proposals that were included in the Camp bill, such as repeal of the last-in/first-out (LIFO) and lower-of-cost-or-market (LCM) accounting methods (along with recapture of LIFO reserves and LCM positive adjustments), and limitations on the cash method of accounting.

The Conference Agreement generally would require an accrual method taxpayer to recognize income that is subject to the all-events test no later than the taxable year in which the income is taken into account on the taxpayer's financial statements (except for income from mortgage servicing rights). The conference Agreement states that the provision is not intended to accelerate the realization (as opposed to the recognition) of income that is reported on financial statements so, for example, the provision would not accelerate income from securities that are being marked to market for financial reporting purposes or income from investments in corporations and partnerships that are accounted for under the equity method for financial reporting purposes.

In addition, the Conference Agreement would apply this rule in lieu of the original issue discount (OID) rules. Accordingly, this provision would overturn the *Capital One* case so that items such as late-payment fees, cash-advance fees, and interchange fees would be included in taxable income when received if these items are treated as income when received on the taxpayer's financial statements. Moreover, this provision would require taxpayers to accrue market discount to the extent that the taxpayer's financial statements accrue market discount. This could include any portion of market discount that is associated with credit risk rather than interest rate increases, which could nullify the return filing position of many taxpayers that the market discount rules do not apply to market discount related to the issuer's creditworthiness. The provision would be effective for taxable years beginning after 2017, so its application would alter the tax treatment of market discount and other debt instruments subject to the OID rules that were previously acquired by the taxpayer.

The Conference Agreement states that this provision should not be construed as overriding the application of any other "special methods of accounting" (except for the OID rules), such as the installment method of accounting and certain long-term contract methods of accounting. However, beyond its application to income that is subject to the all-events test, the exact scope of this provision remains very unclear.

This provision also would codify Revenue Procedure 2004-34, which permits taxpayers to defer the inclusion of income from certain advance payments to the following year if the income also is deferred on the taxpayer's financial statements.

The small business accounting method provisions in the Conference Agreement follow the House bill and include the following:

- The $5 million annual gross receipts threshold for the use of the cash method of accounting for corporations (and partnerships with a corporate partner) would be increased to $25 million and indexed to inflation.

- The requirement that such businesses satisfy the requirement for all prior years would be repealed, and the increased threshold would be extended to farms.

- The cash method of accounting for these businesses would apply even if the business has inventories, and these businesses would be completely exempt from the uniform capitalization (UNICAP) rules and the percentage-of-completion accounting method for long-term contracts.

- These businesses would be permitted to use the percentage-of-completion accounting method for contracts that are expected to be completed within two years.

INDIVIDUAL TAXES

For individuals, the Conference Agreement would eliminate several itemized deductions, but tax incentives for home mortgage interest and charitable contributions would be retained (in modified form). The controversial state and local tax deduction would be repealed, except for up to $10,000 in real estate and income (or sales) taxes. In addition and as discussed above, tax benefits that encourage work, higher education, and retirement security would be retained, but modified. The ACA “shared responsibility payment” (or individual mandate tax penalty) also would be reduced to $0 effective beginning in 2019.

The Conference Agreement would repeal many other exemptions, deductions, and credits for individuals in the pursuit of rate reduction, simplicity, and fairness. Significantly, all of the individual tax provisions would expire at the end of the 2025 under the Conference Agreement – potentially leaving it up to a future Congress to extend them or make them permanent.

- Rates - The Conference Agreement would reform (but not consolidate) individual income tax rates such that:

    - the 10% rate would apply to the first $9,525 in taxable income for single filers and the first $19,050 for joint filers;

    - the 15% rate would be eliminated and a new 12% rate would apply to taxable income in excess of $9,525 for single filers and $19,050 for joint filers;

    - a new 22% rate would apply to taxable income in excess of $38,700 for single filers and $77,400 for joint filers;

    - the 25% rate would be eliminated and a new 24% rate would apply to taxable income in excess of $70,000 for single filers and $165,000 for joint filers;

    - the 28% and 33% rates would be eliminated and a new 32% rate would apply to taxable income in excess of $160,000 for single filers and $315,000 for joint filers;

    - the 35% rate would apply to taxable income in excess of $200,000 for single filers and $400,000 for joint filers; and

    - the 39.6% rate would be eliminated and a new 37% rate would apply to taxable income in excess of $500,000 for single filers and $600,000 for joint filers;

- Capital gains and dividends – Under the Conference Agreement, net capital gains and qualified dividends would continue to be taxed at the current 0%, 15%, and 20% rates, and also would continue to be subject to the 3.8% net investment income tax.

- Other changes

  - The standard deduction would be set at $24,000 for joint returns, and $12,000 for single filers; the Conference Agreement would not repeal the additional standard deduction for the elderly and the blind.

  - Personal exemptions would be repealed (the Conference Agreement would provide the Treasury Department authority to continue applying the current wage withholding rules through the end of 2018).

  - The Pease limitation on itemized deductions would be repealed.

  - The indexing of income tax brackets and other income thresholds for inflation would be changed from the Consumer Price Index for urban consumers (CPI-U) to the chained CPI (resulting in slower adjustments to the brackets and thresholds).

  - The Alternative Minimum Tax would be retained for individuals, but the exemption amount would be increased from $84,500 to $109,400 for joint returns and from $54,300 to $70,300 for single filers, while the beginning of the phase-out of the exemption would be significantly increased from $160,000 to $1,000,000 for joint returns and from $120,700 to $500,000 for single filers.

  - The estate, gift, and generation-skipping taxes would be retained with a doubled $10 million basic exclusion that is indexed for inflation.

  - The child tax credit would be increased from $1,000 to $2,000 (and the age limit for a qualifying child increased by one year to age 18), up to $1,400 of the child tax credit would be refundable, the earned income threshold for the refundable child tax credit would be reduced from $3,000 to $2,500, and a new non-refundable $500 credit would be available for other dependents.

  - Certain self-created property (i.e., patents, inventions, model or design) would no longer be treated as a capital asset and the disposition would be treated as ordinary in character. The provision applies to dispositions of property after December 31, 2017.

- Phase-outs – The Conference Agreement would not phase out any of the individual income tax rates for upper-income taxpayers. Furthermore, the phase-out for the child tax credit would be significantly increased from $75,000 to $200,000 for single filers and from $110,000 to $400,000 for joint filers.

- Modification and repeal of current tax expenditures - The Conference Agreement would modify or eliminate several individual income tax deductions, exclusions and credits, including:

- The principal cap on deductible home mortgage interest for new mortgages (after December 15, 2017) would be reduced immediately from $1 million to $750,000 (reverting to $1 million after 2025 regardless of when the mortgage was entered into), and the deduction would be retained for second homes but no longer be available for home equity lines of credit.

- The deduction for state and local taxes for individuals would be repealed, other than taxes on trade or business income and $10,000 of property and income (or sales) taxes.

- The 50% AGI limitation for charitable contributions would be increased to 60%.

- All itemized deductions subject to the 2% floor would be repealed (e.g., home office deductions, license and regulatory fees, dues to professional societies, and subscriptions to professional journals and trade magazines)

- The deductions for tax preparation, moving expenses, and alimony payments (after 2018) would be repealed.

- The deduction for medical expenses would apply to expenses that exceed 7.5% of AGI in 2017 and 2018, and expenses that exceed 10% of AGI thereafter.

- The exclusions for bicycle commuting and moving expense reimbursements would be repealed.

- The Conference Agreement does not include the provision in both the House and Senate bills that would have extended the ownership period for the exclusion of gain from the sale of a principal residence generally from 2 out of the 5 previous years to 5 out of the 8 previous years, and made the exclusion would only be available once every 5 years.

EDUCATION

Generally, the Conference Agreement follows the Senate bill's approach by preserving numerous provisions of the tax code impacting higher education. Accordingly, the Conference Agreement makes no changes to the current higher education tax credits, and it retains the student loan interest deduction, the qualified tuition and related expenses deduction, exclusions from income for qualified tuition reductions, employer-provided education assistance, and interest income from US savings bonds used for qualified tuition and related expenses.

Additionally, similar to the Senate bill, the Conference Agreement would impose a 1.4% excise tax on the net investment income of private colleges and universities with: (1) assets (other than those used directly in carrying out the institution's educational purposes) valued at the close of the preceding tax year of at least $500,000 per full-time student; (2) at least 500 tuition-paying students; and (3) more than 50% of tuition-paying students located in the US.