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Tax Reform's Provisions Affecting Partnerships, Corporations, and Individuals

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On December 22, 2017, President Donald Trump signed into law sweeping tax reform legislation, the Tax Cuts and Jobs Act (TCJA). What follows are summaries of some of the key provisions affecting partnerships and other pass-through entities, C corporations, individuals, and international business. Commentary on the new provisions is italicized. (All section references are to the Internal Revenue Code of 1986, as amended through the TCJA.)

A. Partnerships and Other Pass-Through Entities

1. Carried Interests and Other Partnership "Profits Interests"

The TCJA's changes to carried interest and other partnership profits interests generally only affect investment funds and partnerships holding real estate for rental or investment, and not partnership "profits interests" held in partnerships that operate other types of businesses.

Under prior law, the character of any income or gain recognized by a partnership or fund flows through and retains its character at the partner level. Thus, fund managers and other holders of partnership "profits interests" are allocated their shares of the capital gain and other income when the fund or partnership sells some or all of its assets. Under prior law, if the capital gain was in respect of assets held by the fund or partnership for more than one year, the fund manager and profits interest holder would pay income tax at the

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maximum rate of 20% on such long-term capital gain. Qualified dividends from US corporations and most non-US corporations entitled to the benefit of a tax treaty with the US are also taxed at a maximum rate of 20%. In addition, such capital gains and dividends are subject to the 3.8% net investment income tax, for a combined federal maximum rate of 23.8%. Short-term capital gains and nonqualified dividends are taxed at ordinary rates (the new maximum rate is 37%), plus the 3.8% net investment income tax.

Under new Section 1061, the law described above remains the same, except that only gain from the sale of assets held by an investment fund or other applicable partnership for more than three years qualifies for long-term capital gain treatment. The three-year holding requirements apply only to "applicable partnership interests" (see discussion below). A Section 83(b) election cannot alter the above treatment. If applicable assets are sold after the one-year holding period but before the three-year holding period, the gain is treated as short-term capital gain (and not as ordinary income).

Any transfer of an applicable partnership interest triggers short-term capital gain to the extent such gain is attributable to assets held not more than three years, if such transfer is to a family member of the transferor, or to a person who has performed services in any applicable trade or business for which the transferor performed a service within the current calendar year or the preceding three calendar years.

The new carried interest provision applies only to an "applicable partnership interest," which in effect is a "profits interest" issued to a service provider in any "applicable trade or business." An applicable trade or business is an activity that consists, in whole or in part, of (i) raising or returning capital, and (ii) either (a) investing in or disposing of "specified assets," or (b) developing specified assets. Specified assets include securities, commodities, real estate held for rental or investment, options or derivative contracts with respect to the foregoing assets, or an interest in a partnership to the extent of the partnership's interest in the foregoing assets. Developing specified assets occurs if representations are made to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with the service provider's choices or actions.

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Accordingly, the new carried interest provision will clearly apply to managers of private equity funds, venture capital funds, and other investment funds. Managers of hedge funds will also be affected, but some hedge funds never held their assets for more than a year in any event.

Significantly, unlike many prior carried interest proposals, the new carried interest provision applies to a manager or general partner who manages or develops a partnership investing in real estate held for rental or investment.

Most portfolio investments held in investment funds, and most real estate held in partnerships for rent or investment, are held for more than three years. Thus, new Section 1061 is not expected to have a substantial impact. But it could in circumstances where a sale is effected within the three-year holding period.

The new Section 1061 limitation will not apply to gain attributable to any asset not held for portfolio investment on behalf of third party investors, to the extent provided in Treasury regulations. *It remains to be seen how broad those regulations will be drafted. Treasury is also directed to impose new reporting requirements in this area.*

The new law does not change the normal rules for determining holding periods, including tacking on the holding period of an asset upon its tax-free contribution to the partnership. It would appear that gain allocated to an applicable partnership interest issued to a fund manager or other service partner within three years of the sale of the partnership's underlying assets could still qualify for long-term capital gain treatment, so long as the fund had held the underlying assets for more than three years. That would be the treatment under prior law. In addition, Section 1061 may apply to the sale of partnership interests within three years of their issuance, but it is not clear. However, Treasury is granted broad authority to issue regulations or other guidance to carry out the purposes of new Section 1061, and such regulations could address the circumstances addressed in this paragraph. On the last issue, Treasury could apply the provision as if the partnership sold all of its assets in a hypothetical sale immediately prior to the transfer.

Section 1061 does not apply to a partnership interest held directly or indirectly by a corporation. On its face, the term corporation includes a subchapter S corporation. *Thus, fund managers and real estate developers might be able to avoid the carried interest rule by holding their profits interests through S corporations. However, as mentioned, regulations promulgated by Treasury could address that strategy.*

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If Section 1061 applies, it modifies the application of Sections 1222(3) and 1222(4) to require that capital assets be held for more than three years to obtain capital gain treatment. *However, a real estate business could generate long-term capital gain by holding for more than one year Section 1231 assets, which would appear is not covered by the language in Section 1061. But again, Treasury could address the issue.*

Section 1061 does not affect the ability of carried interests and partnership profits interests to be received tax-free.

New Section 1061 applies to taxable years beginning after December 31, 2017. There is no grandfathering.

2. Pass-through Business Income Deduction for Individuals

The TCJA adopts the Senate approach for reducing the taxes of the pass-through businesses. New Section 199A generally allows an individual taxpayer a deduction reducing taxable income for 20% of the individual's qualified business income from a partnership, S corporation, or sole proprietorship. Assuming the individual pays tax at the new maximum rate of 37%, the full deduction could in effect lower the individual's tax rate on such income by as much as 7.4% to 29.6%.

The combined qualified business income amount for the taxable year is the net amount of qualified items of income, gain, deduction and loss. Qualified business income generally includes only items included in taxable income that are effectively connected with a US trade or business (including for this purpose Puerto Rico), other than specified service trades or businesses. Capital gains and losses, interest, REIT dividends, and qualified publicly traded partnership income are not taken into account.

Unlike the House bill's proposal in this area, the deduction is not affected by whether or not the owner is active or passive. Qualified business income does not include reasonable compensation paid to a S corporation shareholder or Section 707(c) guaranteed payments for services made to partners. If the amount of qualified business income for a tax year is less than zero (*i.e.*, a loss), the loss reduces qualified business income in the next tax year.

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Importantly, for pass-throughs (other than sole proprietorships) the deduction generally is limited to the greater of (a) 50% of the taxpayer's pro rata or allocable share of W-2 wages attributable to qualified business income paid by the partnership, S corporation, or sole proprietorship to its true common law employees, or (b) the sum of 25% of such W-2 wages plus 2.5% of the unadjusted basis, immediately after the acquisition, of all qualified property.

For this purpose, a partner's or S corporation shareholder's allocable share of W-2 wages paid to the entity's common law employees is determined in the same manner as the partner's or shareholder's allocable share of wage expense, which for an S corporation shareholder would be his or her pro rata share.

Partnerships or S corporations that use separate companies to hire their employees may want to restructure their operations so that they pay (or are treated as paying) the wages directly (although arguably the statutory language is broad enough to cover separate companies).

The new deduction could create more interest in S corporations and discourage some partnerships from issuing partnership "profits" interests, particularly to rank-and-file employees. Many service providers holding regular partnership interests or partnership "profits interests" also receive fixed, guaranteed payments, but under certain Internal Revenue Service rulings cannot be treated as employees receiving W-2 wages. By contrast, salaries paid to S corporation shareholders are treated as W-2 wages. S corporations also continue to provide self-employment tax savings in respect of net business income.

The Conference Committee, in the final bill, intending to help capital intensive businesses and real estate, adopted another way to obtain the reduced rate relying in part on investment in capital. For purposes of this second limitation, qualified property means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, which is used in the production of qualified business income during the taxable year, and for which the depreciation period has not ended before the close of the taxable year. The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed into service by the taxpayer and ending in the year of the applicable regular recovery period under Section 168 (but in no event less than 10 years).

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For example, assume an individual operates a widget-making business as a sole proprietorship. The business buys a widget-making machine for $100,000 and places it in service in 2020. The business has no employees in 2020. The limitation in 2020 is the greater of (a) 50% of W-2 wages (or $0), or (b) the sum of 25% of W-2 wages ($0) plus 2.5% of the unadjusted basis of the machine immediately after its acquisition (or $2,500, 2.5% x $100,000). The taxpayer's deduction is limited to $2,500.

Partnerships with agreements that qualify for the pass-through deduction and provide for quarterly tax distributions to partners may want to consider amending their tax distribution provisions, as payments under them could be reduced.

A qualified business entitled to this new deduction generally is any trade or business other than a "specified service trade or business." A specified service trade or business is any trade or business activity involving the performance of services (i) in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business the principal asset of which is the reputation or skill of one or more of its employees, or (ii) in investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

It appears that general partners and fund managers in management companies would be treated as engaging in a specified service trade or business and thus would not qualify for this new deduction. Furthermore, it does not appear that any passive investors in management entities qualify for the new deduction.

The catch-all provision—"any trade or business the principal asset of which is the reputation or skill of one or more of its employees"—is an ambiguous standard that is bound to create confusion and litigation. This phrase is used elsewhere in the Code only in Section 1202(e)(3)(A), dealing with the little-used exclusion for qualified small business stock, and there is nothing in the legislative history to Section 1202 or this new rule that clarifies the scope of this language. Taken to its extreme, it could have a broad application, but arguably that was not intended.

Impressive lobbying efforts led the Conference Committee to remove engineering and architecture services from the list of specified service trades or businesses. *However, query how such a business would fare under the catch-all provision.*

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The threshold is reduced for triggering accuracy-related penalties for taxpayers claiming a deduction under Section 199A. An accuracy-related penalty may apply when an understatement exceeds the greater of 5% of the tax required to be shown on the return or $5,000, down from 10%.

The new pass-through income deduction is effective for tax years beginning after December 31, 2017, but is scheduled to sunset at the end of 2025, unless Congress extends it.

a. Some Thoughts on Choice of Entity

Most partnerships, S corporations and other pass-through entities taxed as flow-through entities that can benefit from the pass-through deduction are probably unlikely to want to convert to a C corporation to take advantage of the new 21% maximum corporate rate. Such flow-through entities will have a maximum marginal effective rate of 29.6% (plus the 3.8% Medicare or net investment income tax), while C corporations would still be subject to the dreaded double-tax — an income tax at the corporate level (maximum federal 21% rate), and another income tax on qualified dividends at the shareholder level (maximum federal 20% rate, plus the 3.8% net investment income rate). State and local income taxes would worsen the impact of the double-tax, particularly in high tax states such as California and New York. Moreover, sellers of flow-through entities can sell assets or be deemed to sell assets and pay tax on capital gains at a 23.8% rate. In addition, buyers will still want a "stepped up" tax basis in the assets, which is not possible with a sale of stock of a C corporation owned by individuals on a stand-alone basis without the corporate double-tax applying.

One type of business that might convert to a C corporation is a business that generates substantial taxable income and plans to reinvest its profits in the business, while not planning any time soon to make dividends or sell the business. This analysis could require extensive financial modeling.

C corporations that do not reinvest their earnings must be concerned about the 20% accumulated earnings tax and the personal holding company tax, a 20% penalty on undistributed passive income earned in a closely-held C corporation.

In addition, it must be kept in mind that, absent further action by Congress, individual income rates and the pass-through deduction under new Section 199A will sunset at the end of 2025. By contrast, the new 21% corporate income tax rate is permanent, but there is political risk that a new Congress and President might act to increase the rate sometime in the future.

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3. Technical Terminations of Partnerships Repealed

Section 708(b)(1)(B) of the Code is repealed starting in 2018. Prior to repeal, a technical termination of a partnership was triggered if, within any 12-month period, a sale or exchange of 50% or more of the interests in partnership capital and profits occurred. This required the partnership to file a new short-period final return, make new elections, and (most painfully) recover depreciation deductions over a longer period. *With the repeal, provisions in partnership agreements prohibiting a transfer of a partnership interest that would trigger a technical termination are rendered moot.*

4. Gain on Sale of a Partnership Interest is ECI

Gain on the sale of a partnership interest by a non-US holder is treated as effectively connected income (ECI) with a US trade or business (and therefore subject to regular US income tax) to the extent that the selling partner would have been allocated effectively connected gain or loss if the partnership had sold all of its assets at their fair market values on the date of the sale. This amendment to Section 864(c) is intended to codify the ruling in Revenue Ruling 91-32 and to reverse a recent US Tax Court decision that did not follow that ruling.

In addition, under new Section 1446(f), the buyer of the partnership interest is now required to withhold 10% of the amount realized unless the seller certifies that it is not a nonresident alien or foreign corporation, and provides the seller's US identification number. If the buyer fails to withhold the correct amount, the partnership is obligated to deduct and withhold from distributions to the buyer (as a new partner) an amount equal to the amount the buyer failed to withhold. *Accordingly, buyers of partnership interests in partnerships that could be treated as conducting a US trade or business will want to include representations and certifications from sellers in their purchase agreements and associated documents that they are not non-US persons (similar to what is done now in respect of the Foreign Investment in Real Property Tax Act).*

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The new ECI rule is effective for sales and other dispositions on or after November 27, 2017, while the portion of the rule related to withholding applies to sales and other dispositions starting in 2018.

Sellers of partnership interests may still want to seek refunds for any taxes paid in respect of sales occurring prior to November 27, 2017.

5. S Corporation Conversion to C Corporation

Effective for S corporations that revoke their S corporation elections during the two-year period beginning on the enactment date of the TCJA, where the S corporation has the same shareholders before and after the revocation, distributions from the terminated S corporation are treated as made from its nontaxable accumulated adjustment account in the same ratio as the amount of such accumulated adjustments account bears to the amount of such accumulated earnings and profits. Any Section 481(a) adjustments are accounted for over a six-year period.

This provision anticipates that some S corporations will revoke their S corporation status in order to benefit from the new, low C corporate income tax rates. See paragraph A.2.a above for a short discussion of this prospect.

B. Rules Applicable to All Businesses

1. 30% Limitation on Business Interest Deductibility (With an Exception for Real Estate)

Amended Section 163(j) disallows a taxpayer's deductions for business interest expense to the extent such deductions exceed 30% of the taxpayer's adjusted taxable income, plus the taxpayer's business interest income. Adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion (through 2021 only), any business interest expense or income, the new pass-through business income deduction under Section 199A, or any net operating loss carryover deduction. Investment interest income and expense are not affected by amended Section 163(j). Any disallowed interest expense may be carried forward indefinitely.

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Certain taxpayers, such as businesses with average annual gross receipts for the three taxable years ending with the prior taxable year of $25 million or less, regulated public utilities, and businesses using floor plan financing (used mainly by automobile dealerships), are not subject to the new limitation.

Any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business may elect for the new limitation not to apply. *However, if any such election is made, there is a trade-off*: the real property trade or business is required to use the alternative depreciation system (ADS) under Section 168(g) to depreciate its nonresidential real property, residential rental property, and qualified improvement property. The ADS system has longer recovery periods than the usual depreciation rules under the modified accelerated cost recovery system (MACRS), and does not permit accelerated depreciation otherwise allowed under MACRS.

In the case of a partnership, the 30% limitation on business net interest expense is applied at the partnership level. As a result the interest expense passed through to the partners would not be subject to a second limitation. Any disallowed amounts may be carried forward by the partner but can only be deducted against excess taxable income attributed to the partner by the partnership's activities that gave rise to the excess business interest carryforward.

The tax basis of a partner in a partnership is reduced by the amount of excess business interest allocated to the partner, but if the partner sells or otherwise disposes of the partner's partnership interest, the basis in the partnership interest immediately before such disposition is increased by the excess of the amount of the aggregate basis reductions over the excess business interest allocated to the partner that was previously treated as business interest paid or accrued by the partner.

Similar rules, but not all of them, apply to S corporations and their shareholders.

To the extent a C corporation with disallowed interest is acquired, the carryover of such disallowed interest deductions is treated as a net operating loss for purposes of the Section 382 ownership change rules *and thus may be subject to a Section 382 loss limitation*.

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Businesses that may be subject to this limitation (or to the active loss limitation discussed in paragraph B.7 below) in 2018 may want to accelerate deductions in 2017. Even businesses not subject to this limitation now could be in the future if interest rates spike, or their individual circumstances or the overall economy decrease their profits.

The new limitation applies to tax years beginning after 2017. There is no grandfathering.

2. 100% Expensing of Certain Depreciable Property

All new business investment in qualified depreciable property (not including structures or intangible assets) may be fully expensed in the year of acquisition under amended Section 162(k). This benefit applies to property placed in service after September 27, 2017 through the end of 2022, with an additional year for certain property with a longer production period and certain aircraft. The 100% allowance is phased down 20% per calendar year for property placed in service after 2022. Thus, the allowance is 80% for property placed in service in 2023, 60% in 2024, 40% in 2025, 20% in 2026, and none in 2027.

Qualified depreciable property includes tangible property with a recovery period of 20 years or less under MACRS, certain off-the-shelf computer software, and qualified improvement property. It does not include property primarily used in a real estate trade or business, or to intangibles (such as goodwill or intellectual property). Because public utilities and businesses using floor plan financing indebtedness (used mainly by automobile dealerships) are exempt from the 30% interest limitation, they cannot benefit from the new depreciation rules.

The new rules apply to used property (*i.e.*, property that was not originally placed in service by the taxpayer). *This creates an incentive in the next five years to purchase businesses in asset sales or stock sales treated as asset sales under Code Sections 338(h)(10) and 336(a).* There is an anti-churning rule that could apply on sales between related parties.

The maximum amount a taxpayer may expense under Section 179 is increased to $1,000,000, and the phase-out threshold is increased to $2,500,000. The definition of Section 179 property is expanded

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to include, at the election of the taxpayer, qualified improvement property, certain tangible personal property used to furnish lodging, and certain improvements to nonresidential real property.

3. Section 1031 Cut Back

Tax-free like kind exchanges are now limited only to US real property. *While most Section 1031 exchanges involve real property, in the past Section 1031 exchanges also have been effected by operating businesses, such as newspapers or franchises, or by owners of aircraft.* There are grandfather rules for exchanges if the property disposed of was disposed of on or before December 31, 2017 (*i.e.,* in a forward exchange), or the property received by the taxpayer is received on or before such date (*i.e.,* in a reverse exchange).

Some real estate is sold containing substantial tangible personal property. The sale of such property will no longer qualify under Section 1031.

4. Repeal of the Domestic Production Activities Deduction

Section 199, which provided for a deduction for certain manufacturing and other domestic production activities, is repealed for all taxpayers. *Guidance under former Section 199, which was also limited in part by W-2 wages, may be relevant for the new pass-through deduction under new Section 199A.*

5. Real Estate Cost Recovery

The recovery periods remain at 39 years for commercial real property and 27.5 years for residential real property, despite a proposal in the Senate bill to reduce them to 25 years.

A new definition of qualified improvement property substitutes for the prior definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property. Qualified improvement property has a broad definition, including any improvement to the interior portion of a building that is nonresidential real property if such improvement is placed in service

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after the date such building was first placed in service, *but is narrower than the former rule for restaurant property.* Qualified improvement property is recovered over 15 years on a straight-line basis (under amended Section 168(b)(3)(G)), as was previously the case for qualified leasehold improvement, qualified restaurant, and qualified retail improvement property.

The alternative depreciation system (ADS) recovery period is lowered from 40 to 30 years for residential rental property and is reduced to 20 years for all qualified improvement property. *These reductions are relevant in light of the real estate business election described in paragraph B.1 above.*

6. Limits on Deductibility of Net Operating Losses

Carrying back net operating losses (NOLs) is no longer allowed, except for a one-year carryback related to certain small businesses and farms. However, NOLs can now be carried forward for an indefinite number of years (as opposed to the previous 20 year carryforward rule).

A corporation or other taxpayer may now deduct NOLs only to the extent of 80% of the taxpayer's taxable income (determined without regard to any NOL deduction). The new NOL rules apply to losses arising after 2017. Special rules apply to property and casualty insurance companies.

Under prior law, under the corporate AMT, the use of NOL carryforwards were limited to 90% of taxable income. The limitation has an even harsher impact. (However, pre-2018 losses will apparently avoid the limits of both the 90% AMT and 80% regular tax limitations).

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7. Active Business Losses Limited

Taxpayers have been subject to limits on using passive losses since 1987. Now active business losses are limited to the extent they exceed $500,000 for joint filers and $250,000 for other taxpayers. *Congress had a policy reason for limiting passive losses, but this new active loss limit appears to be just a revenue raiser or trade-off for lower rates.*

For taxable years beginning after December 31, 2017 and before January 1, 2026, excess business losses of taxpayers other than C corporations are not allowed for the taxable year. Such losses are carried forward and treated as part of the taxpayer's NOL carryforward in subsequent years. In addition, NOL carryovers are now generally allowed for a taxable year up to the lesser of the carryover amount or 90% of taxable income (80% for taxable years beginning in 2023).

An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount, which is $500,000 for joint filers and $250,000 for all others.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. The provision applies after the application of the passive loss rules in Code Section 469.

This new loss limitation will be a factor in determining a taxpayer's choice of entity to use a C corporation, or partnership or S corporation.

8. No Capital Gain for Self-Created Patents and Similar Property

Section 1221(a)(3) is amended to exclude any patents, inventions, and secret formulas and processes created by a taxpayer from the definition of capital asset. Section 1235 is also repealed. *Thus, gains from the sale of a patent, invention, or secret formula or process by the creator of such intangible assets will not receive capital gain treatment.*

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9. Meals and Entertainment Deductions and Other Fringe Benefits

No deduction is permitted with respect to any activity generally considered to be entertainment, amusement or recreation. Thus, the previous 50% deduction for entertainment related to business (including associated airplane expenses) is disallowed. Moreover, no deduction is permitted for membership dues in a club organized for business, pleasure, recreation or other social purposes. The new rules apply to amounts paid or incurred after December 31, 2017.

The deduction for 50% of business meals and entertainment associated with operating a business (such as meals consumed by employees on work travel) is still permitted, and is expanded to include meals provided through an in-house cafeteria.

Deductions for employee transportation fringe benefits (e.g., parking and mass transit) are denied, but the exclusion from income for such benefits received by an employee is retained. In addition, no deduction is allowed for commuting expenses, except as provided for the safety of the employee.

10. Local Lobbying Expenses Disallowed

Section 162(e), which previously disallowed certain deductions related to lobbying at the federal and state government levels, is amended to also disallow deductions for lobbying at the local government level. The effective date is any such expense incurred on or after the date of enactment of the TCJA.

11. Research and Development Deduction

The deduction under Code Section 174 will be repealed. Instead, all such research and development costs (including for both in-house and outside computer software development) related to research conducted in the US will be subject to amortization over five years, and such costs for research conducted outside the US will be subject to fifteen year amortization. The new provisions apply to amounts paid or incurred in taxable years beginning in 2022.

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The new rules will create an incentive to purchase software, which can be recovered under depreciation rules over three years. If these provisions are not repealed first, in 2022 taxpayers will have the compliance burden of identifying the property subject to five-year and fifteen-year amortization.

12. Possible Acceleration of Accrual of Expenses and OID

Amended Section 451(b) requires an accrual method taxpayer under the all-events test to recognize gross income no later than the taxable year in which such income is taken into account as revenue in an applicable financial statement or other financial statement under rules implemented by Treasury.

In addition, Section 451(b) applies to income recognition rules for original issue discount (OID) instruments, market discount on bonds, and OID on tax-exempt bonds, stripped bonds and stripped coupons. Thus, for example, to the extent amounts are included in revenue for financial statement purposes when received (such as late-payment fees, cash-advance fees, or interchange fee), such amounts are generally includable in taxable income at such time.

The new provisions in Section 451(b) do not apply to taxpayers lacking an applicable or other specified financial statement or to mortgage servicing rights. Installment sales under Section 453 and long-term contracts under Section 460 are not affected.

The ruling in Revenue Procedure 2004-34, allowing accrual method taxpayers to elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income is also deferred for financial reporting purposes, is codified.

The new provisions are generally effective for 2018, except that in the case of income from a debt instrument having OID, the provision first applies in 2019.

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C. C Corporations

1. Corporate Tax Rate Reduction

Under the TCJA, the maximum federal corporate tax rate is reduced from 35% to 21%. In addition, the progressive rate structure is replaced with a flat tax rate of 21%. There is no special rate for personal service corporations.

The lower rates will have various ripple effects. For example, the "step up" in tax basis in an acquisition of assets has less value in negotiations with sellers, and any used net operating loss carryforwards have less value than prior to the rate change.

The corporate dividends received deduction is reduced so as to maintain the previously effective rate on such income of about 7% from 20-percent or more owned corporations and about 10% from less than 20% owned corporations. *In other words, dividends received by a corporation do not enjoy most of the benefit of a rate reduction.*

The new rate and associated provisions are permanent and effective for tax years beginning after December 31, 2017.

2. Repeal of Corporate Alternative Minimum Tax

The TCJA repeals the corporate alternative minimum tax (AMT) effective for tax years beginning after December 31, 2017. Any AMT credit carryovers to tax years after that date generally can be utilized to the extent of the corporation's regular tax liability. In addition, for tax years from 2018 through 2022, the prior year minimum tax credit is refundable equal to 50% (or 100% after 2022) of the excess of the minimum tax credit for the taxable year over the amount of the credit allocable for the year against regular tax liability.

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3. Contributions to Capital by Governmental Entities and Civic Groups

Section 118 is amended to provide that tax-free non-shareholder contributions generally do not include any contributions by a government entity or civic group. Such contributions are sometimes made by a local government or civic group as an incentive to locate business operations in the locality, but such contributions can no longer be made tax-free.

4. $1 Million Deduction Cap Amendments

Under Section 162(m), in general, compensation paid to each covered executive of a public corporation is not deductible to the extent it exceeds $1 million in the taxable year. A widely used exception for performance-based compensation is now repealed (a transition rule generally excludes from the new rule compensation paid pursuant to a written binding contract in effect on November 2, 2017, for as long as it is not materially modified or renewed). The amendments to Section 162(m) also clarify that the disallowance rule applies to the principal executive officer, principal financial officer, and the top three compensated employees, and that once an executive is identified as covered after 2016, such executive always remains covered (*so that a corporation can now have more than five covered executives*). The universe of companies that Section 162(m) applies to has been expanded to include C corporations with total assets exceeding $10 million that have either 2,000 or more shareholders, or 500 or more shareholders that are not accredited investors.

5. New Equity Grant Plan

New Section 83(i) permits employees of private companies to elect to defer income on stock options and restricted stock unit (RSU) grants, but only if 80% of more of the company's full-time employees receive the grants. Employees can be awarded varying amounts, but count only if they receive more than a de minimis award. The election must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever comes first. The tax-free receipt rule does not apply to

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the chief executive officer, chief financial officer, any shareholder holding 1% or more of the company's stock, or the four highest paid employees. The income deferral election generally applies with respect to stock attributable to options exercised or RSUs settled after December 31, 2017.

6. Tax Exempt Organizations

A net operating loss in respect of one tax-exempt organization's unrelated trade or business may not be used to offset income of another unrelated trade or business. The net operating loss may be carried forward to a future year to offset income from the same unrelated trade or business.

A new 21% excise tax is imposed on a covered employee on remuneration paid by a tax-exempt organization for the taxable year to any covered employee in excess of $1,000,000, plus any "excess parachute payment" paid by such organization to such employee. A covered employee is one of the five highest compensated employees of the organization for the taxable year, plus any person who was a covered employee at any time after 2016. An "excess parachute payment" means any payments contingent on the employee's termination of employment, the aggregate present values of which equal or exceed three times the employee's "base amount" (which generally is the average of the previous five-years' compensation*). In addition to the top executives of tax-exempt organizations, this excise tax could apply to highly compensated football and basketball coaches of private universities. There was an exception added for compensation paid to doctors, nurses and veterinarians.*

A new 1.4% excise tax is generally imposed on the net investment income of certain private colleges and universities the aggregate investment assets of which is at last $500,000 per student.

By almost doubling the standard deduction for individuals, millions more individuals will no longer itemize deductions on their individual tax returns. *This will lessen their incentive to make contributions to charitable organizations, since they will no longer be entitled to claim charitable deductions if they use the standard deduction.*

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D. Individuals

1. Tax Rate Reduction

The previous seven current individual income tax brackets remain, but with different taxable income thresholds and slightly lower rates, as follows:

Former Rates	New Rates
For joint filers:	**For joint filers:**
10%: $0 to $19,050	10%: $0 to $19,050
15%: Over $19,050 to $77,400	12%: Over $19,050 to $77,400
25%: Over $77,400 to $156,150	22%: Over $77,400 to $165,000
28%: Over $156,150 to $237,950	24%: Over $165,000 to $315,000
33%: Over $237,950 to $424,950	32%: Over $315,000 to $400,000
35%: Over $424,950 to $480,050	35%: Over $400,000 to $600,000
39.6%: Over $480,050	37%: Over $600,000
For single filers:	**For single filers:**
10%: $0 to $9,525	10%: $0 to $9,525
15%: Over $9,525 to $38,700	12%: Over $9,525 to $38,700
25%: Over $38,700 to $93,700	22%: Over $38,700 to $82,500
28%: Over $93,700 to $195,450	24%: Over $82,500 to $157,500
33%: Over $195,500 to $424,950	32%: Over $157,500 to $200,000
35%: Over $424,950 to $426,700	35%: Over $200,000 to $500,000
39.6%: Over $426,700	37%: Over $500,000

In earlier versions, both House and Senate bills would have included joint filers with income between $600,000 and $1 million in a 35% tax bracket. Still, the final legislation lowers the maximum ordinary income rate from 39.6% to 37%.

The new individual rates and brackets will expire at the end of 2025, unless a future Congress extends them.

The House's proposal to impose on individual taxpayers with adjusted gross income of $1,000,000 or more a 6% tax to eliminate the benefit of the 12% bracket was not adopted in the final bill.

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The standard deduction is almost doubled to $24,000 for married individuals, $18,000 for heads of households, and $12,000 for all other individuals. *This is a major benefit to the lower income individuals.* The child care tax credit is doubled to $2,000 and has a larger refundable portion, and the income levels at which the credits begins to phase out was increased to $400,000 for joint filers and $200,000 for all others.

Personal exemptions for family members and dependents are repealed until 2026, unless a future Congress acts. *For federal payroll withholding tax purposes, employees may no longer claim personal exemptions. The Internal Revenue Service has announced it will work with payroll companies to update withholding tax tables, but that will take some time.*

Capital gain and qualified dividend rates were unchanged, but the breakpoints where rates increase are now indexed for inflation.

Many income tax thresholds are increased by an inflation index. The inflation index was keyed to the consumer price index (CPI), but now will be based on chained CPI, *a less generous measure*.

2. Repeal or Reduction in Itemized Deductions

The following rules are generally effective from 2018 to 2025, unless renewed by a future Congress.

Deductions by individuals for state and local income taxes, and non-business property and sales tax, are eliminated, with the following exception. Individuals may claim deductions for state and local income taxes, and state and local (non-business) property or sales taxes, up to a cap of $10,000 per year. Taxpayers may pick and choose what deductions make up the $10,000 cap.

In states such as New York and Maryland that start taxable income with federal taxable income, but that back out deductions for state income taxes, taxpayers may want to select property taxes first, as that deduction is generally recognized for state and local income tax purposes as well. For upper income taxpayers, this deduction limitation will offset much of the benefit from the lowering of the individual rates. Before the

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Conference Committee agreed to lower rates for upper income taxpayers, many such taxpayers in high tax states would have ended up paying substantially more income tax under both the House and Senate bills.

The cap does not apply to state and local property taxes or sales taxes paid or accrued in connection with a trade or business or income-producing activity.

A prepayment of 2018 state and local income taxes by year-end will not be deductible in 2017. No similar provision was set forth relating to real property taxes, but query whether or not a deduction can be claimed for property taxes not yet due.

The limit on loan size for the mortgage interest deduction is lowered for joint filers from $1 million to $750,000, and for individuals from $500,000 to $375,000, for houses financed after December 14, 2017. There is a transition rule for binding written contracts in place before December 15, 2017, if the residence is purchased before April 1, 2018. There is also a refinancing exception that applies to the extent of the refinanced debt. *This mortgage interest deduction limitation, combined with the limitation on deducting state and local income taxes described above, may ultimately lower the values of houses owned by upper income taxpayers in states that have high taxes and expensive housing.*

Interest deductions attributable to home equity loans up to $100,000 are no longer permitted, even if loan proceeds are used to improve the homeowner's residence.

The deduction for miscellaneous itemized deductions subject to the 2% floor is eliminated. Among the many types of such deductions eliminated include fees paid to investment advisors, a partner's share of fees for fund managers and other investment expenses passed through from funds, tax preparation expenses, unreimbursed employee expenses, and home office deductions.

The above-the-line deduction for moving expenses incurred in connection with starting a new job at a new workplace has been repealed, except for military personnel. Conforming rules were made to employer reimbursements.

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The overall limitation on otherwise allowable itemized deductions based on taxable income (former Code Section 68) has been repealed. *As this was in effect a hidden rate increase, it is a welcome change for upper income taxpayers (although it is less important now with the limits on deductions for state and local taxes and mortgage interest). The loss of federal itemized deductions is likely to result is some increase in taxable income for state and local taxable income purposes, as most states and localities imposing income tax start with federal taxable income.*

3. Alternative Minimum Tax Cut Back

The individual alternative minimum tax (AMT) is not repealed, but it has been rendered much less important. The exemptions have been increased to $109,400 for joint filers and $70,300 for all others, and the phaseout of the exemption thresholds is increased to $1,000,000 for joint filers and $500,000 for all others. *In prior years, the most important deduction that subjected many individual taxpayers to the AMT was the deduction for state and local taxes. With the new $10,000 cap on deducting state and local taxes, many individuals formerly subject to the AMT taxpayers will now avoid it.*

4. Estate Tax

The TCJA preserves the federal estate tax, but effective in 2018 the federal estate, gift and generation skipping transfer (GST) tax exemptions are temporarily doubled to $11.2 million per person. The TCJA continues the portability feature that allows the estate of the first spouse to die to elect to transfer his or her unused federal estate and gift tax exemption to the surviving spouse (but as under current law, the unused GST exemption is not portable). The new rules apply to estates of people who die after December 31, 2017 and before January 1, 2026 (and also to gifts made during that time frame). *The change will reduce the number of multimillion-dollar estates that are subject to the 40 percent tax, before returning to the current exemption levels, indexed for inflation, on January 1, 2026. Heirs and legatees will continue to receive a stepped-up basis as of the date of death for purposes of any subsequent sale of inherited assets. Note that unrelated to the new law, the annual gift tax exclusion for 2018 will increase to $15,000 per donee.*

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E. International Business

The amendments to US international tax provisions are numerous and complex. Here are some of the highlights.

1. Territorial Tax System

A territorial system for taxing the earnings of foreign subsidiaries of US companies has been adopted. Under the new system, dividends received from a foreign subsidiary by its US parent company (or any 10%-or-greater corporate shareholder by vote or value) in respect of stock held for at least one year are generally exempt from tax to the extent attributable to foreign source income. This result is accomplished by means of a 100% dividends-received deduction under new Section 245A. Only US corporations (except for real estate investment trusts (REITs) and regulated investment companies (RICs) can claim the dividend. The foreign subsidiary cannot be a passive foreign investment company (PFIC) that is not a controlled foreign corporation (CFC).

The exemption does not apply to gains from the sale of shares, except for gains recharacterized as a dividend under Code Section 1248. Sellers may want to consider the benefits of selling assets of foreign subsidiaries as opposed to stock.

As a conforming amendment, Section 902, which provide for the deemed-paid tax credit with respect to dividends received by a US corporation that owned 10% or more of its voting stock, is repealed (except it still applies to subpart F income).

Dividends exempted reduce the US parent company's tax basis in the stock of its foreign subsidiary, but only for purposes of determining a loss on the future sale or liquidation of the stock of the foreign subsidiary.

The new dividend received deduction rules apply to distributions made after December 31, 2017.

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2. "Unlocking" Trapped Earnings

A one-time transition tax at a rate of 15.5% for cash or cash equivalents (and net accounts receivable) and 8% for other assets is imposed on the earnings and profits of foreign subsidiaries, whether distributed or not to their US parent companies. This provision is intended to "unlock" the trapped cash held offshore by US multinationals.

The tax is imposed in respect of a foreign subsidiary's post-1986 non-US earnings and profits that have not been previously taxed by the US (including as subpart F income). The tax applies to all CFCs, as well as to any foreign corporation in which a US person owns a 10% voting interest (except for PFICs that are not CFCs). At the election of the taxpayer, the tax liability is payable over a period of up to eight years.

Special rules apply to S corporations. Their shareholders are allowed to avoid the deemed dividend until the S corporation changes its status, sells substantially all of its assets, ceases to conduct business, or the shareholder transfers its S corporation stock. *This provision may lead some S corporations not to convert to C corporations in the near future.*

3. Taxing Offshore Intangibles Income

Pursuant to new Section 951A, a US shareholder's income includes a new category of "global intangible low-taxed income" (GILTI) earned by CFCs of US shareholders on intangible assets. Such income is the excess of (i) the US shareholder's pro rata share of its CFC's net income, with certain adjustments (including less subpart F income and dividends received from related persons), over (ii) 10% of its pro rata share of the adjusted bases of the CFC's depreciable tangible property used in the production of such income. Such income for C corporation shareholders is subject to tax at 50% of the usual rate (*i.e.*, a 10.5% rate) through 2025, and at a 62.5% rate (*i.e.*, 13.125%) in 2026 and later years, while individual shareholders of a CFC are subject to tax at 100% of their usual rate (*i.e.*, a maximum of 37%).

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A corporate US shareholder is also eligible to use 80% of its deemed paid foreign tax credits against its GILTI. As a result, a corporate US shareholder generally would not pay any residual US tax if the foreign effective tax rate on such income is greater than 13.125%. If the foreign tax rate on such income is 0%, then the residual tax rate would be 10.5%. (This explains why this new tax is sometimes referred to as a minimum tax.)

These new rules reduce the benefit of the territorial tax regime and are intended to encourage US companies to transfer their offshore intangibles back to the US However, the US's new 21% maximum corporate rate will likely still be higher than a low tax country's rate. In addition, the new rule, with its reliance on a 10% return on investment in capital, appears to create an incentive for US multinational companies to invest in plant and equipment in overseas subsidiaries located in low tax countries. The more equipment an overseas subsidiary has, the more tax-free income it can earn. The 10% rate of return is also fairly generous.

US purchasers of foreign subsidiaries need to understand how the new rules could impact their acquisitions. US individual investors need to be careful about investing in non-US companies that could trigger this tax, which would be imposed at ordinary income rates. Individuals, whether investing directly or through pass-through entities, do not fare as well under the new tax as C corporations.

The new rules are effective for tax years of foreign corporations beginning after December 31, 2017, and for taxable years of US shareholders in which or with which such taxable years of foreign corporations end.

4. New Tax on Outbound Payments

Section 59A imposes a new minimum tax on the excess of deductible payments to foreign affiliates over taxable income of 5% in 2018, 10% in 2018 through 2025, and 12.5% in 2026 and later years, for certain large US corporations. This new "base erosion" (BEAT) tax applies to any amounts paid or incurred by a taxpayer to a foreign person that is a related party and with respect to which the payment is deductible under regular deduction rules. A related party for this purpose is determined under typical rules under Sections 267(b) and 707(b)(1), except that 25% is substituted for 50%. The new tax does not apply to costs of goods sold or charges for intercompany services if such payments have no markup. The new rules apply only to a C

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corporation (and its affiliated group) that has average annual gross receipts for the three-taxable-year period ending with the preceding year of at least $500 million and the "base erosion percentage" of such corporation is 3% or higher. They do not apply to RICs, REITs, or S corporations. The new rules apply to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.

5. 30 Percent Limitation on Interest Deductibility

As explained in paragraph B.1 above, new Section 163(j) disallows a taxpayer's deductions for business interest expense to the extent such deductions exceed 30% of the taxpayer's adjusted taxable income.

The Senate and House bills had proposed imposing an additional restriction on interest deductions if a multinational group's net interest expense exceeded 110% of the US corporation's share of the group's global EBITDA, but this provision was not adopted in the final bill.

With these new rules in place, the prior, complex "earnings-stripping" rules under Section 163(j) that non-US investors had to take into account in lending funds to their US subsidiaries have been repealed.

6. Active Trade or Business Exception Repealed

Under previous law, US persons were generally able to transfer assets of a foreign branch used in an active trade or business to a foreign subsidiary on a tax-deferred basis. This active trade or business exception is now repealed, effective for transfers after December 31, 2017.

In addition, under new Section 91, if a US corporation transfers the assets of a foreign branch to a foreign subsidiary, the US corporation is generally required to recapture previously-deducted losses of the foreign branch incurred after December 31, 2017 (reduced by any gain recognized on such transfer). New Section 91 generally applies to transfers made after December 31, 2017.

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7. CFC Attribution Rules Expanded

US shareholders that directly or indirectly own or invest in at least 10% of the stock of a foreign corporation that was not treated as a CFC under prior law could cause such foreign corporation to be a CFC under new "downwards" attribution rules.

The definition of a 10% US that is counted towards CFC status is expanded to include any US person that owns 10% of the stock of the foreign corporation by value (as well as the former rule, still in effect, looking to 10% of voting power).

8. Gain on Sale of a Partnership Interest is ECI

See discussion in paragraph A.4 above.

F. Code Provisions Unchanged

The following tax provisions were proposed for substantial change in either or both of the House or Senate bills, but after Conference Committee deliberations, escaped entirely or largely unchanged in the final tax bill:

- Interest paid on indebtedness used to purchase a second home is untouched in the final bill.
- A married couple filing jointly can exclude up to $500,000 in capital gains on the sale of their homes, as long as they have used it as a primary residence for at least two of the last five years. The House and Senate bills had proposed more strict timing rules, but none appeared in the final bill.
- Under current law investor with shares of stock purchased at different times and prices are permitted to trace what shares to sell, and typically will select high tax basis shares. The Senate bill had a provision mandating a first-in, first-out method.
- The Work Opportunity Tax Credit, Low-Income Housing Credit, and New Markets Tax Credit remain, as does the Rehabilitation Tax Credit, with substantial modifications to the latter (buildings

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built before 1936 are ineligible unless they're on the National Register of Historic Places or located in a Registered Historic District).

- The tax benefits for private activity bonds (used to fund low-income housing and other projects) remain.
- A House bill proposal to subject state and local entities, including state and lower employee retirement funds, to the unrelated business income tax was not adopted in the final bill.
- Code Section 956, which requires a US shareholder of a controlled foreign corporation (CFC) to include in its income the earnings of the CFC reinvested in the US, remains in place.
- Under a Senate proposal, which was not adopted in the final bill, all Section 501(c)(3) charitable organizations would have been able to engage in political speech, with their donors still eligible to claim the charitable contribution deduction for any donations.
- The final bill does not include earlier proposals that would have eliminated the ability to defer taxation on vested compensation and have drastically changed the treatment of stock options.
- Prior versions of the House bill would have changed the self-employment tax treatment of pass-through entities, but they were not touched in the final bill.
- Employer-paid adoption expenses remain excluded.
- A proposal to defer deductions for litigation costs that attorneys advance to clients in contingent fee cases was not adopted.

In addition, no changes were made to the following, despite discussions they could be addressed:

- The 3.8% net investment income tax.
- Contributions to 401(k) retirement plans.