POLSINELLI®

Tax

Tax Cuts and Jobs Act: Trump Signs New Tax Law

In this Alert:

Introduction 2
Provisions Affecting Individuals 2
Modifications to Deductions, Exclusions and Credits 2
Alternative Minimum Tax 3
Provisions that will Remain the Same 3
Repeal of the "Individual Mandate" under the Affordable Care Act 3
Provisions Affecting Business 3
Deduction for Pass-Through Entities 3
General Business Tax Reform Provisions 4
Reform of Business Related Exclusions, Deductions, etc. 5
Reform of Business Credits. 7
Changes Impacting the Insurance Industry. 8
Provisions Affecting Executive Compensation and Retirement Benefits 9
Simplification and Reform of Certain Retirement Plan Rules 9
Modification of Annual Deduction Limitation on Employee Remuneration 9
Miscellaneous Changes Impacting Equity-Based Compensation 10
Provisions Affecting Tax-Exempt Organizations 10
Tax-Exempt Bonds 10
Increase in Standard Deductions and Estate Tax Exclusion 10
New Excise Tax on Executive Compensation Paid by Certain Tax-Exempt Organization; Medical Services Excluded 11
Separate Computation of UBI for Each Trade or Business Activity 11
Other Tax-Exempt Organization Provisions 11
Provisions Affecting Estate and Gift Taxes 12
Exemptions Doubled Temporarily; No Estate Tax Repeal 12
Provisions Affecting International Tax 12
Adoption of Dividend Exemption System 12
Transitional Inclusion of Tax Deferred Earnings and Profits 12
Foreign Tax Credit Changes 12
Outbound Base Erosion Measures 13
Limitations on Amounts Paid or Accrued in Hybrid Transactions or with Hybrid Entities 14
Inbound Base Erosion Measures 14
Authors: 15
For More Information 16

On December 22, 2017, President Trump signed into law what's known as the Tax Cuts and Jobs Act. The Act, also sometimes referred to as H.R. 1, contains massive changes to existing tax law the likes of which have not been seen since the Tax Reform Act of 1986. The changes reach far and wide and will impact every individual, nearly all domestic businesses regardless of the type of entity they operate through, many tax-exempt organizations and companies with international operations. Most of the changes take effect on Jan. 1, 2018 but a few provisions have earlier effective dates.

Provisions Affecting Individuals

The Act replaces the existing rate structure with new rates for all classifications of taxpayers. There will be 7 rates ranging from 10 percent to top rate of 37 percent. The basic standard deduction for individuals has been increased to $24,000 for Married Filing Joint (up from $12,700), $18,000 for Head of Household (up from $9,350), and $12,000 for all others (up from $6,350). Taxpayers will no longer benefit from personal exemptions as the new legislation repeals the personal exemption across all filing statuses. In order to comply with budgetary rules, unless otherwise noted, all modifications sunset (they apply for tax years beginning before Jan. 1, 2026). Other changes affecting individuals include – (Note: unless otherwise noted, the below discussion pertains to married filers filing a joint return, different threshold amounts may apply to other taxpayers):

Modifications to Deductions, Exclusions and Credits

1. ***Home Mortgage Interest.*** Under old law, home mortgage interest was deductible for up to $1 million of acquisition indebtedness, plus home equity indebtedness of up to $100,000. Under the Act, taxpayers may treat no more than $750,000 as acquisition indebtedness for indebtedness incurred after Dec. 15, 2017 or after. The higher $1 million limit still applies to indebtedness incurred before Dec. 15, 2017 that is refinanced as long as the refinancing does not exceed the refinanced indebtedness. Additionally, the Act suspends the deduction for home equity indebtedness.
2. ***State and Local Taxes.*** The Act limits the itemized deduction for combined non-business state and local property taxes and income taxes (or sales taxes in lieu of income taxes) to $10,000.
3. ***Charitable Contributions.*** The Act increases the 50 percent percentage limitation for charitable contributions of cash to public charities to 60 percent. The Act eliminates a charitable deduction for payments made in exchange for college athletic event seating rights.
4. ***Miscellaneous Itemized Deductions.*** The Act repeals the deduction for miscellaneous itemized deductions subject to the 2 percent floor. This includes deductions for tax preparation fees and investment fees and expenses.
5. ***Unreimbursed Medical Expenses.*** The Act reduces the threshold for unreimbursed medical expenses from 10 percent of adjusted gross income to 7.5 percent for all taxpayers. Unlike most other provisions in the Act, this benefit is effective for the 2017 tax year.
6. ***Alimony and Separate Maintenance.*** Under the Act, effective for divorce or separation agreements executed after December 31, 2018 or for certain modifications after December 31, 2019 alimony and separate maintenance payments are not deductible by the payor spouse and not included in income by the recipient spouse.
7. ***Moving Expenses.*** The Act repeals the deduction for moving expenses for taxpayers other than certain members of the Armed Forces. In addition, the Act repeals the exclusion from income for moving expense reimbursements except for certain members of the Armed Forces.
8. ***Child Tax Credit.*** The child tax credit increases to $2,000 per qualifying child (up from $1,000). The Act modifies the phaseout threshold so the credit begins to phaseout for taxpayers with AGI in excess of $400,000. Social Security numbers for each qualifying child for whom the credit is claimed must be provided.
9. ***Net Business Losses.*** Excess business losses of a taxpayer other than a corporation are not allowed for the taxable year under certain circumstances. Instead, these losses must be carried forward (no 2-year carryback allowed except in farming business) and treated as part of the taxpayer's net operating loss ("NOL") in subsequent

taxable years. An excess business loss for the taxable year is the excess of the taxpayer's trade or business deductions over aggregate gross income plus a threshold amount. The threshold amount for a jointly-filed return is $500,000 ($250,000 for all other filers), indexed for inflation. In the case of a partnership or S corporation, this provision applies at the partner or shareholder level. Furthermore, these provisions apply after the application of existing passive activity loss rules.

10. ***Qualified Tuition Programs.*** For taxpayers who participate in qualified tuition programs, the Act modifies Section 529 plans to allow such plans to distribute no more than $10,000 in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, private, or religious elementary or secondary school. This limitation applies on a per-student basis, rather than a per-account basis.

11. ***Student Loans***. The Act modifies the exclusion of student loan discharges from gross income. Under the provision, only certain loans qualify and then only if the discharge was pursuant to the death or total permanent disability of the student.

12. ***Limit on Itemized Deductions.*** The total amount of most otherwise allowable itemized deductions is limited for certain upper-income taxpayers. The Act eliminates the overall limitation on itemized deductions.

13. ***Other Provisions.*** In addition to the above modifications, the Act repeals the deduction for theft losses, limits the deduction for casualty losses to only losses attributable to a Federally declared disaster, limits certain deductions related to wagering/gamblings, and repeals the exclusion from income for qualified bicycle commuting reimbursements.

Alternative Minimum Tax

The Act increases both the exemption amount and the exemption amount phaseouts for the individual alternative minimum tax ("AMT"). The new exemption amounts will be $109,400 for married taxpayers filing a joint return (half of this amount for married filing a separate return) and $70,300 for all other individual taxpayers. The new phaseout threshold amounts will be $1,000,000 for married taxpayers filing a joint return and $500,000 for all other individual taxpayers. The Act repeals the corporate AMT.

Provisions that will Remain the Same

The Act does not impact the American Opportunity tax credit and the Lifetime Learning credit, the deduction for student loan interest, the deduction for qualified tuition and related expenses, (as well as the exclusion for qualified tuition reductions), the exclusion for interest on United States savings bonds used for higher education expenses (and the exclusion for educational assistance programs) or any energy credits.

Repeal of the "Individual Mandate" under the Affordable Care Act

Under the Affordable Care Act, individuals must be covered by a health plan that provides at least minimum essential coverage or be subject to a tax (also referred to as a penalty) for failure to maintain the coverage. The tax is generally imposed for any month that an individual does not have minimum essential coverage and is calculated by using an annual formula. The Act eliminates the individual responsibility payment.

Provisions Affecting Business

Deduction for Pass-Through Entities

The ACT allows so-called pass-through entities to deduct 20 percent of "qualified business income" ("QBI") in determining taxable income for a year. Businesses entitled to the deduction include partnerships (including LLCs taxed as partnerships), publicly-traded partnerships and master-limited partnerships, S corporations, real estate investment trusts, trusts and estates, and sole proprietorships. QBI includes all domestic business income other than investment income (e.g., certain dividends, investment interest income, short-term capital gains, long-term capital gains, commodities gains, foreign currency gains, etc.). Reasonable compensation paid by an S corporation and guaranteed payments paid by a partnership are not included

in the calculation of QBI. There are no restrictions on the deduction for taxpayers with QBI of up to $157,500 for single filers and $315,000 for those filing joint returns. The benefit is phased out over the next $50,000 of QBI for individuals, and $100,000 for joint filers.

Above these amounts, there are two restrictions. First, the 20 percent deduction is limited to the greater of (1) 50 percent of a taxpayer's pro rata share of wages paid by the business, or (2) 25 percent of wages plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property. "Wages" are all amounts subject to withholding (basically what is reported on form W-2), plus deferred compensation. "Qualified property" is property subject to depreciation and used in the taxpayer's trade or business. The 2.5 percent calculation uses the original purchase price or construction cost of the property, and is not reduced by any depreciation or expensing. The 25 percent plus 2.5 percent test should greatly benefit real estate businesses that have a significant amount of depreciable property but few employees.

Finally, QBI above the limits set forth above from "specified service businesses" is not eligible for the deduction. Specified service businesses include health, law, consulting, athletics, financial services (including investing, investment management, trading or dealing), brokerage services, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. The final version of the Act removed references to architecture and engineering services that was present in the House and Senate versions, and it is unclear whether those businesses will nevertheless be ineligible for the deduction because they rely on the "reputation or skill" of employees or owners.

General Business Tax Reform Provisions

1. **Tax Rates.** One of the most publicized part of the Act was the reduction to a single tax rate on corporations of 21%. In connection with this reduction, the Act also modifies the deduction corporations may take on dividends received from other corporations. Corporations may still deduct 100% of dividends received from a corporation that is part of an affiliated group (generally where the taxpayer owns 80% of the corporation paying the dividend), but the deduction is reduced to 65% (from 80%) where the taxpayer owns at least 20% (but less than 80%) of the corporation paying the dividend, and to 50% (from 70%) where the taxpayer owns less than 20%.
2. **Cost Recovery.**
   A. ***Immediate Expensing.*** The Act provides immediate expensing of qualified tangible property placed in service beginning September 27, 2017 and before December 31, 2022. The accelerated cost recovery is reduced by 20% each year for property placed in service after December 31, 2022 and before January 1, 2027. In addition, the accelerated cost recovery applies to used property, provided it was acquired in a taxable, arm's length transaction. Qualified property is essentially property with a recovery period of 20 years or less. A transition rule permits taxpayers to elect to apply a 50% allowance instead of the 100% allowance for a taxpayer's first taxable year ending after September 27, 2017, as well as transition rules to phaseout bonus depreciation on property acquired before September 28, 2017 and place in service after September 27, 2017.

   B. ***Applicable recovery period for real property.*** The Act shortens the recovery period for "qualified improvement property" to 15 years. "Qualified improvement property" is any improvement to the interior of a building that is nonresidential real property, provided that the improvement is placed in service after the date the building itself is first placed in service. Previously, there were separate rules for qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property, but under the Act all are subsumed within the definition of qualified improvement property. A provision in the Senate version of the Act to shorten the recovery period for rental and non-residential real property to 25 years was not adopted.

With respect to the alternative depreciation system ("ADS") which must be used for tangible property used predominantly outside the United States, certain tax-exempt use property,

tax-exempt bond financed property and certain imported property covered by an Executive Order, the recovery period is reduced to 20 years from as much as 40 years. Taxpayers may elect to use the ADS for any class of property for any tax year.

3. Small Business Reforms.

A. ***Expansion of section 179 expensing.*** Currently, businesses may elect to immediately expense up to $510,000 of the cost of any Section 179 property placed in service each tax year. Section 179 property includes tangible personal property or certain computer software that is purchased for use in the active conduct of a trade or business, as well as certain "qualified real property," which is defined as qualified leasehold improvement property, qualified retail improvement property and qualified restaurant property that is depreciable and that is purchased for use in the active conduct of a trade or business.

The Act increases the expensing limitation under Section 179 from $510,000 to $1 million. The $1 million amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2.5 million. The provision also modifies the definition of Section 179 property to include certain tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging. In addition, it would modify the definition of qualified real property to incorporate the change to qualified improvement property discussed above and eliminate references to qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. Finally, the provision adds roofs, heating, ventilation and air-conditioning property, fire protection and alarm systems and security systems to the definition of qualified improvement property.

B. ***Cash method of accounting.*** The Act allows corporations and partnerships with a corporate partner to use the cash method of accounting if their average gross receipts have not exceeded $25 million in the three prior years, even if they have inventories (sole proprietorships, S corporations and partnerships without a corporate partner may generally use the cash method). This increases the current gross receipts limit for cash accounting from $5 million and eliminates a requirement that these businesses use the accrual method if they have inventories. Such businesses will also be allowed to use the "completed contract" method or another method of accounting for long term contracts, rather than the "percentage of completion" method. The completed contract method allows business to recognize income and deduct expense when paid, rather than over the life of the contract as it is performed. In addition, any producer or reseller that meets the $25 million gross receipts test is exempted from the application of the uniform capitalization rules of section 263A, which generally require certain costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, rather than deducted as expenses.

C. ***Conversions of S corporations to C corporations.*** S corporations using the cash method of accounting must often recognize income when they revoke that election, become C corporations, and change to the accrual method of accounting. The Act provides that any increase from an adjustment that is attributable to the revocation of a corporation's S corporation status will be taken into account ratably during the six tax-year period beginning with the year of change. The provision applies to any C corporation that (1) was an S corporation on the day before the date of the enactment of the Act, (2) revokes its election to be an S corporation during the two-year period following the date the Act is enacted, and (3) has the same shareholders on the date the Act is enacted and the date the S corporation election is revoked.

Reform of Business Related Exclusions, Deductions, etc.

A. Interest. For the four tax years beginning with 2018, the Act limits yearly interest deductions to 30% of a

taxpayer's earnings before deductions for interest, taxes, depreciation and amortization ("EBITDA"). For tax years beginning in 2022, interest deductions are limited to 30% of the taxpayer's earnings before deduction for interest and taxes, but after deductions for depreciation and amortization ("EBIT"). This means that the limit will be significantly reduced after four years for many businesses because EBIT is likely to be much lower than EBITDA. Disallowed interest may be carried forward indefinitely. The provision exempts businesses whose average annual gross receipts for the past three taxable years does not exceed $25 million. Also, the limitation does not apply to real property business or transmission and distribution businesses that elect out of the limitation. However, real property business who do elect out may be required to use the Alternative Depreciation Schedule, which requires certain assets to be depreciated over 20 years, and therefore may increase recovery time for certain assets. Finally, the limitation does not grandfather interest payable on existing debt, but applies to existing debt.

With respect to interest incurred by pass-through entities, with certain modifications the interest limitation is applied at the taxpayer level rather than at the entity level. For partnerships, a partner's limit on interest deductions is increased by partner's distributive share of "excess income," which basically is the "extra" interest that a partnership would be allowed based on its income for the year. A partnership would have excess income to the extent that the interest paid by the partnership is less than 30% of its income. This allows a partner of a partnership to deduct additional interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest. On the other hand, to the extent interest deductions relating to a partnership are disallowed, the partner may only deduct the disallowed amount against future excess partnership income.

B. ***Modification of Net Operating Loss Deduction.*** The Act limits NOL deductions for losses arising in tax years after December 31, 2017 to 80% of taxable income in any year. Unused NOLs may be carried forward indefinitely, but a provision in the House version of the Act to increase carryforwards to account for the time value or money was not accepted. In addition, the Act eliminates the 2-year NOL carryback, except that it does provides such a carryback for certain losses incurred in the farming business. The new NOL limitation does not apply to property and casualty insurance companies.

C. ***Section 1031 Like – Kind Exchanges of Real Property.*** The Act limits the application of section 1031 solely to real property that is not held primarily for sale.

D. ***Revised Treatment of Contributions to Capital of Corporations.*** The Act provides that any contribution to the capital of a corporation by a governmental entity or civic group, other than as a shareholder, is not a contribution to capital, but instead treated as income to the corporation. In addition, the Act repeals a rule with respect to public utilities that contributions in aid of construction, or by customers or potential customers, are treated as tax free contributions to capital.

E. ***Repeal of Deduction for Income Attributable to Domestic Production Activities.*** The Act repeals the Section 199 deduction. Section 199 allows taxpayers to claim a deduction equal to 9% (6% for certain oil and gas activities) of the lesser of the taxpayer's qualified production activities income or the taxpayer's taxable income for the tax year. Qualified production activities income is income from certain production activities and services performed, including construction, engineering and architecture in the United States, and, for tax years beginning before 2017, in Puerto Rico. The provision is effective for C corporations for taxable years beginning after December 31, 2018, and for others for taxable years beginning after December 31, 2017.

F. ***Fringe Benefit Expenses.*** The Act limits deductions for the cost of food and beverages that businesses provide to workers at the office to 50% of the cost, and disallows other deductions relating to entertainment and recreation and transportation

© 2017 Polsinelli

fringe benefits. The deduction for food and beverage costs is completely eliminated beginning with tax years after December 31, 2025.

G. ***Limitation on Deduction for FDIC Premiums.*** The Act eliminates deductions for FDIC premiums paid by financial institutions with consolidated assets of $50 billion or more, and reduces the deduction for institutions with assets in excess of $10 billion but less than $50 billion.

H. ***Self-created Property Not Treated as a Capital Asset.*** The Act amends section 1221(a)(3) of the Code to exclude from the definition of a "capital asset" patents, inventions, models or designs (whether or not patented), and secret formulas or processes which are held either by the taxpayer who created the property or by a taxpayer with a substituted or transferred basis from the taxpayer who created the property. Thus, gains or losses from the sale or exchange of these assets by such taxpayers will not receive capital gain treatment.

I. ***Repeal of the Special Rule for Sale of Exchange of Patents.*** The Act repeals section 1235 of the code, which means that the holder of a patented invention may not transfer his or her rights to the patent and automatically treat amounts received as proceeds from the sale of a capital asset. Whether such a sale produces capital gain is determined under general principals regarding the sale of property.

J. ***Elimination of Technical Termination of Partnerships.*** The Act eliminates the automatic, or "technical" termination of a partnership when there is a sale of exchange of 50% or more of the total interest in the capital or profits of a partnership within any 12-month period. Inadvertent technical terminations could cause serious reporting issues, and this provision should eliminate these issues.

K. ***Recharacterization of Gains Associated With Carried Interests.*** The Act provides a three-year holding period (rather than the usual one-year holding period) in order for holders of carried interests to receive long term capital gain treatment on the sale of their interests.

L. ***Amortization of Research Expenditures.*** Currently, Taxpayers can choose to deduct Section 174 research and experimentation expenses, and can amortize software development expenditures over 36 months. The Act requires taxpayers to amortize research or experimental expenditures, and software development costs, over five years, or 15 years in the case of foreign research.

M. ***Year of Inclusion of Income.*** A taxpayer is required to recognize income when it has an unrestricted right to the income (for cash basis taxpayers), or when "all events" have occurred that fix the right to receive the income, and the amount of income can be determined with reasonable certainty (for accrual basis taxpayers), absent a specific exception that allows recognition to be deferred. The Act modifies these rules by requiring recognition no later than the year in which the income is accounted for as income on an financial statement of the type that is filed with a regulatory organization or that in a form prescribed by regulation. This new rule does not apply to taxpayers without an applicable financial statement or to income from certain long-term contracts and advance payments. Taxpayers will generally recognize income earlier under this provision if the income is accrued on financial statements earlier than the income would be recognized for tax purposes using the rules described above.

Reform of Business Credits.

A. ***Credit for Testing of Orphan Drugs.*** The Act lowers the credit for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions ("orphan drugs") to 25%. Qualified clinical testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration but before the drug has been approved for sale.

B. ***Rehabilitation Credit.*** Federal law provides a 20% credit for expenditures relating to rehabilitation of historic structures. Historic structures are those

designated as such by listing in the National Register or otherwise designated. There is also a 10% credit for rehabilitation expenditures of non-historic structures built before 1936. The Act repeals the 10% credit relating to non-historic structures. The Act retains the historic structure tax credit, but provides that the credit is recoverable at 20% per year over the five-year period beginning with the year the structure is placed in service after rehabilitation.

C. ***Gain or Loss on Transfer of Partnership Interests by Foreign Partners.*** In the recent case of Grecian Magnesite Mining v. Commissioner, the Tax Court ruled that gain from the sale of a partnership interest by a foreign partner was not US-source income, was not "effectively connected" with a US trade or business, and not taxable in the US. The provision essentially overrules this case, stating that gain or loss from the sale of a partnership interest is effectively connected with a US trade or business, and taxable in the US, to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value on the date of the sale (or exchange). Gain from this hypothetical asset sale by the partnership is allocated to the partners in the same way as income and loss.

The provision also requires the person receiving the partnership interest to withhold 10 percent of the amount realized on the sale (or exchange) of the partnership interest unless the transferor certifies that it is not a nonresident alien individual or foreign corporation. This provision is effective for sales or exchanges on or after November 27, 2017.

Changes Impacting the Insurance Industry.

The insurance industry's business model and state regulatory regime created a subset of rules in the tax laws that were designed specifically to address the complexity of life insurance products and corporate taxation. Under the Act, several changes will have significant impacts on the industry. Such changes include:

A. ***Loss Allowance.*** Life insurance companies are generally allowed a deduction in the taxable year for operations loss carryovers and carrybacks, in lieu of the deduction for NOLs allowed to other corporations. The Act repeals the operations loss deduction for life insurance companies and instead allows the conventional NOL deduction.

B. ***Small Life Insurance Deduction.*** The small life insurance company deduction, generally 60% of specified adjusted taxable income, has been repealed.

C. ***Change in Accounting Method.*** The Act provides that income or loss resulting from a change in method of computing life insurance company reserves is taken into account consistent with IRS procedures, generally ratably over a 4-year period, instead of over a 10-year period.

D. ***Distribution Rules.*** The Act repeals the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a stock life insurance company.

E. Taxable income of a property and casualty insurance company is determined as the sum of its gross income from underwriting income and investment income, reduced by allowable deductions. A proration rule applies to property and casualty insurance companies. In calculating the deductible amount of its reserve for losses incurred, existing law required a property and casualty insurance company to reduce the amount of losses incurred by 15% based on the amount from certain income items. This proration rule reflects the fact that reserves are generally funded from certain untaxed income items (e.g., tax-exempt interest, deductible dividends, etc.). The Act replaces the 15% reduction under present law with a reduction of 5.25% divided by the top corporate tax rate. The top corporate tax rate is 21% for 2018 and subsequent years, so the percentage reduction is 25% under the new proration rule for property and casualty insurance companies.

F. ***Specified Policy Acquisition Expenses.*** The Act extends the amortization period for specified policy

acquisition expenses to 180 months. Specified policy acquisition expenses are determined as the portion of the insurance company's general deductions for the taxable year that does not exceed specific percentages, based on the category of the insurance contract. For annuity contracts, the percentage is 2.09%; for group life insurance contracts, the percentage is 2.45%; and for all other specified insurance contracts, the percentage is 9.20%.

Provisions Affecting Executive Compensation and Retirement Benefits

Simplification and Reform of Certain Retirement Plan Rules

1. ***Limitations for Roth IRA Conversions.*** The special rule under prior law that allowed a contribution to one type of individual retirement arrangement (IRA) to be recharacterized as a contribution to the other type of IRA no longer applies to a conversion contribution to a Roth IRA. Thus, this recharacterization cannot be used to unwind a Roth conversion. Recharacterization is still permitted, however, with respect to other IRA contributions.
2. ***Tax-Free Rollovers of Loan Offsets.*** The period in which a loan offset may be rolled over by a retirement plan participant on a tax-free basis will now be longer than the current 60-day period. If the participant wishes to make an equivalent contribution to another tax-qualified plan or IRA, the deadline to do so is now extended to the due date (including extensions) for the participant's individual tax return for the year in which the offset occurred.
3. ***Circumstances of Loan Offset.*** The circumstances under which a loan offset under a tax-qualified retirement plan may occur have been narrowed to: (1) the plan's termination, or (2) the failure to meet the repayment terms of the loan due to the employee's severance from employment. Previously, many circumstances could cause a loan offset to occur under a plan's terms, such as a participant's request for a distribution.
4. ***Retirement Benefits for Bona Fide Volunteers.*** The limitation on retirement length of service awards which may be paid to bona fide volunteers has been doubled to $6,000, and a cost-of-living adjustment is allowed on a go-forward basis.

Modification of Annual Deduction Limitation on Employee Remuneration

The following changes were made to narrow the $1 million annual deduction limitation that applies to certain companies under Section 162(m) of the Code with respect to the compensation arrangements for their chief executive officers and other highly-paid executives.

1. ***Group of Covered Employees Expanded.*** An employee to whom the $1 million deduction limit under Section 162 of the Code applies now includes any executive who is a "covered employee" at any point during the 2017 tax year or afterwards. Thus, an individual remains a covered employee with respect to compensation otherwise deductible by the company for subsequent tax years, including for years during which the individual is no longer employed or has already died. Also, under prior law, the group of covered employees included only the chief executive officer and the next three highest-paid executive officers -- but it excluded the chief financial officer. Going forward, however, the covered group will include a company's chief financial officer. (Note: The inclusion of a company's chief financial officer aligns the group of 162(m) covered employees with the group of named executive officers subject to the SEC reporting rules for publicly-traded companies.) In light of this change, a company subject to the 162(m) limitation may want to review the executive compensation arrangements for its chief financial officer.
2. ***Elimination of Performance-Based Compensation Exception.*** Under prior law, when determining the $1 million annual deduction limitation, companies could exclude certain incentive compensation, commissions, equity-awards, and other payments to a 162(m)-covered employee that were structured as "performance-based" compensation. Going forward, however, performance-

© 2017 Polsinelli

based compensation and commissions will now count toward the $1 million deduction limit.

3. ***Expansion of Corporations Subject to 162(m) Limitations.*** The 162(m) limitations will now cover (a) foreign companies publicly traded through American Depository Receipts and (b) certain privately-held corporations not publicly traded but with public debt.

4. ***Transition Period for Certain Existing Contracts.*** The Act provides for a special transition rule for compensation provided under certain written binding contracts relating to an employee's compensation in effect on Nov. 2, 2017 and which have not been materially modified on or after such date. The scope of this special transition rule will presumably be clarified in future IRS guidance, so employers should be very cautious before amending any existing employment agreements or any other executive compensation arrangements that were in effect on or prior to Nov. 2, 2017.

Miscellaneous Changes Impacting Equity-Based Compensation

1. ***New Type of Equity Grant***. Private companies will now have a new way for certain employees to be granted stock options and restricted stock units (RSUs). If these equity grants are structured properly under the new law, eligible employees will be able to defer income on these awards up to five years from the exercise date of options and the vesting date of RSUs.

2. ***Insiders of Expatriated Corporations.*** Under certain circumstances an excise tax of 15 percent can be imposed on certain insiders who are holders of stock options and receive other stock-based compensation upon a transaction that results in an expatriated corporation. Going forward under the new law, this excise tax will be increased to 20 percent. This change applies to corporations first becoming expatriated corporations after the date of enactment of the Act.

Provisions Affecting Tax-Exempt Organizations

The following provisions of the Act impact tax-exempt organizations.

Tax-Exempt Bonds

The Act provides some welcome certainty for many tax-exempt organizations relative to tax-exempt bond financing. The House version of the Act had proposed an elimination of the ability of entities to issue "private activity bonds" for the benefit of nongovernmental persons, which includes Section 501(c)(3) Bonds that are issued for the benefit of many tax-exempt Section 501(c)(3) organizations. This proposed elimination did not make it into the final bill. The Act does, however, adversely affect many tax-exempt organizations by eliminating their ability to undertake "advance refunding" transactions, where new tax-exempt bonds are issued to refinance existing tax exempt bonds more than 90 days in advance of the redemption date or maturity date of such existing tax exempt bonds. Under current law, tax-exempt Section 501(c)(3) organizations could undertake one "advance refunding" transaction, but the Act eliminates all "advance refundings" after Dec. 31, 2017.

Increase in Standard Deductions and Estate Tax Exclusion

The increase in the standard deduction amount for individual filers and the increase in the estate tax exclusion likely will cause a significant decrease in overall charitable giving. A higher standard deduction means fewer taxpayers will itemize deductions, reducing their incentive to make charitable donations. Only taxpayers who itemize their deductions may deduct charitable contributions. The Tax Policy Center has estimated that before the Act, more than 46 million tax filers would itemize their 2018 returns, but with the passage of the Act, this number could drop to less than 20 million. In the short-term, donors are advised to consider making additional charitable contributions in 2017 since it is uncertain whether their charitable gifts will create a tax benefit in future years. Similarly, the doubling of the estate tax exclusion will reduce the incentive to make testamentary gifts to charities.

New Excise Tax on Executive Compensation Paid by Certain Tax-Exempt Organization; Medical Services Excluded

The Act imposes a 21 percent excise tax on most tax-exempt organizations (defined as "applicable tax-exempt organizations") on the sum of compensation paid to certain employees in excess of $1 million plus any excess parachute payments paid to that employee (defined as a "covered employee").

1. ***Applicable Tax-Exempt Organizations.*** An applicable tax-exempt organization is defined as any organization that:
   - is exempt from tax under Section 501(a) (such as Section 501(c)(3) charitable organizations),
   - is a Section 521(b)(1) farmers' cooperative organization,
   - has income excluded from tax under Section 115(1) (this includes certain governmental entities), or
   - is a political organization described in Section 527(e)(1) for the taxable year.

2. ***Covered Employee.*** A "covered employee" is defined as any current or former employee who:
   - is one of the exempt organization's five highest compensated employees for the current taxable or
   - was a covered employee of the organization (or any predecessor) for any preceding tax year beginning after Dec. 31, 2016.

3. ***Remuneration.*** Compensation is referred to as "remuneration" under the new provision and is defined as "wages" for federal income tax withholding purposes. It also includes remuneration paid by related organizations of the applicable tax-exempt organization. There are certain exceptions to the inclusion in remuneration under the definition including compensation attributable to medical services of certain qualified medical professionals and any designated Roth contribution.

Separate Computation of UBI for Each Trade or Business Activity

Certain tax-exempt organizations are subject to income tax on their unrelated business taxable income ('UBTI"). Under the current unrelated business income ("UBI") rules, an organization that operates multiple UBI activities computes taxable income on an aggregate basis. As a result, the organization may use losses from one UBI activity to offset income from another, thus reducing total UBI. The Act requires tax-exempt organizations with two or more UBI activities to compute UBI separately for each activity. Accordingly, the losses generated by UBI activities computed on a separate basis may not be used to offset the income of other UBI activities. Under the new provision, a net operating loss deduction will be effectively allowed only with respect to the activity from which the loss arose. The inability to offset losses from one UBI activity against income from another may increase an organization's overall UBI tax burden.

Other Tax-Exempt Organization Provisions

1. ***Excise Tax on Investment Income.*** The Act imposes a new 1.4 percent excise tax on the investment income of private colleges and universities and their related organizations with at least 500 students and the fair market value of investment assets, and those of related entities, of at least $500,000 per student.
2. ***Electing Small Business Trusts.*** Under the Act, the charitable contribution deduction of an electing small business trust will be determined by the rules applicable to individuals, rather than those applicable to trusts.
3. ***Partnership Allocations of Contributions.*** The Act modifies the partnership rules to clarify that a partner's distributive share of loss takes into account the partner's distributive share of charitable contributions for purposes of the basis limitation on partner losses.
4. ***UBI Tax Rate.*** Like the C Corporation rate, the top tax rate for UBI is reduced to 21 percent.
5. ***Increase in AGI Limitation.*** The 50 percent Adjusted Gross Income ("AGI") limit for contributions to certain charities is increased to 60 percent.

Provisions Affecting Estate and Gift Taxes

Exemptions Doubled Temporarily; No Estate Tax Repeal

The Act doubles the gift, estate, and generation-skipping transfer tax exemptions from $5.6 million to $11.2 million, but it does not repeal the estate tax. The doubled exemptions will continue to be adjusted annually for inflation, and the "step-up" in basis for assets inherited after death was maintained. Like many of the provisions affecting individuals, the increased exemptions are scheduled to sunset and apply only to gifts made and deaths occurring before 2026, when the exemptions would return to current levels.

These changes should prompt many to review their estate plans for tax-based formulas that may no longer be needed to defer or minimize estate tax. Since the estate tax will apply to fewer individuals, thanks to the increased exemptions, the focus for many clients will shift to maximizing the step-up in income tax basis at death and the non-tax benefits of irrevocable spendthrift trusts.

Provisions Affecting International Tax

Below we summarize some of the more significant international tax provisions of the Act.

Adoption of Dividend Exemption System

1. ***Dividend Exemption System.*** The Act replaces the current world-wide tax system of taxation with a dividend-exemption system. Under the exemption system, 100 percent of the foreign-source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder would be exempt from U.S. tax.
2. ***Holding Period Requirement.*** In order to avail itself of the dividend exemption, a domestic corporate shareholder must meet a holding period requirement: it must hold the shares for 365 days or more during a 731-day period beginning 365 days before the ex-dividend date.
3. ***Limitation on Hybrid Dividends.*** The dividend exemption is not available for any dividend from a controlled foreign corporation ("CFC") if it is a hybrid dividend. A hybrid dividend is an amount which would otherwise be eligible for the dividend exemption if the CFC received a deduction (or other tax benefit) from foreign taxes. If a CFC receives a hybrid dividend from another CFC, the hybrid dividend is treated as subpart F income.

Transitional Inclusion of Tax Deferred Earnings and Profits

1. ***Inclusion of Tax Deferred Earnings and Profits.*** The Act requires all U.S. shareholders of foreign corporations (other than passive foreign investment companies) to include such entity's post-1986 earnings and profits ("E&P") in income to the extent such E&P has not been previously subject to U.S. tax. Certain E&P deficits would be taken into account.
2. ***Effective Rate of Tax.*** The E&P would be taxed at an effective rate of either 8 percent or 15.5 percent, depending on its character. E&P that has been retained in the form of cash or cash equivalents would be taxed at a reduced rate of 15.5 percent, while E&P that has been reinvested in the foreign subsidiary's business (e.g. property, plant, and equipment) would be taxed at a reduced rate of 8 percent election, the tax liability is payable over a period of up to 8 years.
3. ***Limitation on Use of Foreign Tax Credits.*** Foreign income taxes deemed paid or accrued with respect to the inclusion are only partially creditable against Federal income tax. The portion disallowed is equivalent to the proportion of the reduction in the applicable tax rate. Concomitantly, a U.S. shareholder is not required to gross-up income under section 78 to the extent of the taxes for which no foreign tax credit is allowed. This provision is effective for the last taxable year of a foreign corporation that begins before Jan. 1, 2018.

Foreign Tax Credit Changes

1. ***Repeal of Indirect Foreign Tax Credit for Dividends.*** Because the Act adopts a participation exemption system, it repeals the indirect foreign tax credit rules of § 902, which allow certain U.S. corporate shareholders to claim a foreign tax credit for underlying foreign taxes of

the subsidiary upon the remittance of a dividend.

2. ***Retention of Indirect Foreign Tax Credit for Subpart F Income.*** Because the Act retains the subpart F rules (with minor changes), it also retains the indirect foreign tax credit rules of § 960, that allow certain corporate taxpayers to claim foreign tax credits upon the inclusion of subpart F income. The IRS is granted authority to provide guidance on allocating taxes between items of subpart F income and dividend exemption eligible income.

3. ***Repeal of Title Passage Rule.*** The Act repeals the venerable title passage rule, in favor of sourcing inventory sale income solely on the basis of the location of production.

4. ***Separate Foreign Tax Credit Basket for Branch Income.*** The Act also requires foreign branch income to be allocated to a specific foreign tax credit basket.

Outbound Base Erosion Measures

1. ***Deemed Inclusion of GILTI.*** A U.S. shareholder of a CFC must include in income the CFC's global intangible low-taxed income or "GILTI" as if it were subpart F income. GILTI is in essence the excess of the CFC's income (with certain exclusions) over an amount equal to 10 percent of the CFC's aggregate bases in depreciable tangible property. The Act also requires that GILTI be allocated to a separate foreign tax credit basket, with no carryforwards or carrybacks available. Further, foreign taxes paid with respect to GILTI are limited to 80 percent of the foreign taxes paid (but must be fully taken into account under section 78).

2. ***Deduction for Portion of GILTI Income.*** The Act generally provides a deduction for a portion of GILTI, included in the income of a domestic corporation. For taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the deduction is 50 percent while for taxable years beginning after Dec. 31, 2025, the deduction is lowered to 37.5 percent.

3. ***Deduction for Foreign Derived Intangible Income.*** The Act generally provides a deduction for a portion of the foreign-derived intangible income ("FDII") of a domestic corporation. For taxable years beginning after Dec. 31, 2017, and before January 1, 2026, the deduction is 37.5 percent while for taxable years beginning after Dec. 31, 2025, the deduction is reduced to 21.875 percent. If the sum of FDII and GILTI exceeds the corporation's taxable income without regard to this provision, the amount of the deduction is reduced by the excess.

A domestic corporation's FDII is its deemed intangible income multiplied by the percentage of its deduction eligible income that is foreign-derived. The domestic corporation's deemed intangible income means the excess of deduction eligible income over 10 percent of its aggregate bases in depreciable tangible property used to produce deduction eligible income. Deduction eligible income means the net income of a domestic corporation without regard to (1) subpart F income; (2) GILTI; (3) CFC dividends; (4) domestic oil and gas income; and (5) foreign branch income. Foreign-derived deduction eligible income means any deduction eligible income of the taxpayer that is derived in connection with (1) property that is sold by the taxpayer to any person who is not a United States person for a foreign use or (2) services provided by the taxpayer that are provided to any person not located within the United States.

4. ***Changes to Taxation of Outbound Transfers of Intangibles***. The Act also includes several measures intended to discourage outbound intangible property transfers. First, it modifies the definition of intangible property by including workforce in place, goodwill (both foreign and domestic), and going concern value and eliminates the requirement that the item of property have substantial value independent of the services of an individual. Second, the proposal codifies some of the recent changes to transfer pricing regulations which have been the subject of controversy, including valuing intangible property on an aggregate basis and the realistic alternatives principle.

5. ***Repeal of Active Trade or Business Exception.*** The Act repeals the active trade or business exception of section 367, pursuant to which certain outbound transfers of assets used in an active trade or business may qualify wholly or partially for non-recognition.

Limitations on Amounts Paid or Accrued in Hybrid Transactions or with Hybrid Entities

1. ***Disqualified Related Party Amounts.*** The Act denies deductions for disqualified related party amounts paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party, or (2) such related party is allowed a deduction with respect to such amount. A disqualified related party amount does not include any item of subpart F.
2. ***Hybrid Transaction and Entities.*** A hybrid transaction is any transaction wherein one or more payments are treated as interest or royalties for Federal income tax purposes but are not so treated for foreign tax purposes. A hybrid entity is any entity which is either: (1) treated as fiscally transparent for Federal income tax purposes but not so treated for foreign tax purposes, or (2) treated as fiscally transparent for foreign tax purposes but not so for Federal income tax purposes.

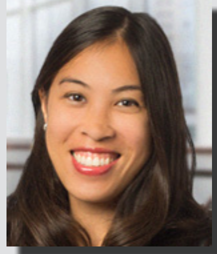
Inbound Base Erosion Measures

1. ***Minimum Tax on U.S. Investments of Foreign Companies.*** The Act levies a minimum tax on certain foreign companies with U.S. investments. An applicable taxpayer is required to pay a base erosion minimum tax amount. This amount is the excess of 10 percent of the modified taxable income of the taxpayer for the taxable year over the regular tax liability of the taxpayer (12.5 percent for taxable years beginning after Dec. 31, 2025). Modified taxable income, is taxable income without regard to any base erosion tax benefit of a base erosion payment. A base erosion payment generally includes any deductible amount paid or accrued by a taxpayer to a foreign related party (including amounts paid in connection with the acquisition of depreciable property). Base erosion payments do not include payments for cost of goods sold or payments on which withholding tax is imposed. An applicable taxpayer means a corporation other than a regulated investment company, a real estate investment trust, or an S corporation if its average annual gross receipts for the preceding three-year period are at least $500 million, and the base erosion percentage of the corporation for the taxable year is four percent or higher.
2. ***Enactment of Thin Capitalization Rules.*** The Act also introduces thin capitalization rules, pursuant to which every business, regardless of its form, would be subject to a disallowance of interest expense deductions in excess of 30 percent of the business's adjusted taxable income. Adjusted taxable income is a business's taxable income computed without regard to business interest expense, business interest income, net operating losses, and depreciation, amortization, and depletion (for tax years beginning after Jan. 1, 2022, depreciation, amortization and depletion are not added back to adjusted taxable income). However, this limitation does not apply to any taxpayer whose average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $25 million.

© 2017 Polsinelli

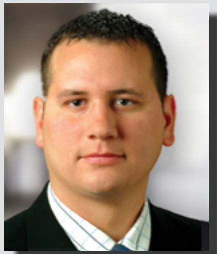
Authors:

William J. Sanders
Shareholder | Practice Chair
816.360.4240
bsanders@polsinelli.com



Virginia Y. Duong
Associate
202.777.8923
vduong@polsinelli.com

John T. Woodruff
Shareholder
816.360.4255
jwoodruff@polsinelli.com



D. Scott Lindstrom
Shareholder
816.360.4255
slindstrom@polsinelli.com

Jeffrey A. Goldman
Shareholder
312.873.3670
jgoldman@polsinelli.com

W. Andrew Douglass
Shareholder | Practice Chair
312.873.2933
adouglass@polsinelli.com

Thomas J. Schenkelberg
Shareholder
816.360.4124
tschenkelberg@polsinelli.com

Thomas M. Ruane
Shareholder
202.777.8923
truane@polsinelli.com

© 2017 Polsinelli

For More Information

For questions regarding this alert or to learn more about how it may impact your business, please contact one of the authors, a member of our **Tax** practice, or your Polsinelli attorney.

To learn more about our **Tax** practice, or to contact a member of our Tax team, visit www.polsinelli.com/services/tax or visit our website at polsinelli.com.

About this Publication

Polsinelli provides this material for informational purposes only. The material provided herein is general and is not intended to be legal advice. Nothing herein should be relied upon or used without consulting a lawyer to consider your specific circumstances, possible changes to applicable laws, rules and regulations and other legal issues. Receipt of this material does not establish an attorney-client relationship.

Polsinelli is very proud of the results we obtain for our clients, but you should know that past results do not guarantee future results; that every case is different and must be judged on its own merits; and that the choice of a lawyer is an important decision and should not be based solely upon advertisements.

Polsinelli PC. Polsinelli LLP in California.

© 2017 Polsinelli