



New Tax Law: Issues for Partnerships, S corporations, and Their Owners

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Introduction

H.R. 1, originally known as the “Tax Cuts and Jobs Act,” was signed into law on December 22, 2017. The legislation significantly changes how individuals, businesses in all industries, multi-national enterprises, and others are taxed. KPMG has prepared a 167-page [report](#) [PDF 1.4 MB] that summarizes and makes observations about the many tax law changes in H.R. 1, including permanent reduction of the corporate tax rate to 21% and mandatory repatriation of previously deferred foreign income.

This report focuses on tax law changes impacting partnerships, S corporations, and their owners. Among other significant changes, H.R. 1 includes a new 20% business deduction that applies to certain partners and S corporation shareholders and new carried interest rules.

This report is one of a series that KPMG has prepared as tax reform legislation has moved through various stages of the legislative process. To read KPMG’s reports and coverage of legislative developments, see [TaxNewsFlash-Tax Reform](#).

Documents

The JCT provided estimates of the budget effects of the conference agreement on H.R. 1. Read [JCX-67-17](#)

Read [JCX-68-17](#) (Distributional Effects of the Conference Agreement for H.R. 1)

Read [JCX-69-17](#) (Macroeconomic Analysis of the Conference Agreement for H.R. 1)

Contents

Individual tax provisions	4
General changes impacting individual taxpayers	4
Changes applicable to partnerships and S corporations	5
20% deduction for certain passthrough income	5
Repeal deduction for income attributable to domestic production activities	8
Loss limitation rules	9
Modified net operating loss deduction.....	10
Limitation on the deduction of net business interest expense	12
Cost recovery	16
Modification of rules for expensing depreciable business assets	16
Temporary 100% expensing for certain business assets.....	17
Requirement to capitalize section 174 research and experimental expenditures ...	18
Applicable recovery period for real property	19
Accounting methods	21
Certain special rules for tax year of inclusion	21
Modify accounting for inventories	23
Increase exemption for capitalization and inclusion of certain expenses in inventory costs	23
Increase exceptions for accounting for long-term contracts.....	23
Miscellaneous provisions applicable to partnerships and S corporations.....	24
Limits on like-kind exchange rules	24
Modify tax treatment of certain self-created property	25
Limitation of deduction by employers of expenses for entertainment and certain fringe benefits	25
Qualified opportunity zones.....	26
Other partnership only provisions.....	27
Short-term capital gain with respect to applicable partnership interests (carried interest).....	27
Modification of the definition of substantial built-in loss in the case of transfer of partnership interest	30
Partnership charitable contributions and foreign taxes taken into account in determining partner loss limitation under section 704(d).....	31
Increase threshold for cash method of accounting.....	32

Repeal of partnership technical termination rules	32
Tax gain on the sale of foreign partner's partnership interest on look-through basis .	33
Other S corporation only provision	36
Provisions applicable to "eligible terminated S corporations"	36
Changes relating to electing small business trusts	38
International	39
Mandatory repatriation	39
Current year inclusion of global intangible low-taxed income by United States shareholders	46
Limit deduction of certain related-party amounts paid or accrued in hybrid transactions or with hybrid entities	51
New limitations on income shifting through intangible property transfers.....	53

Individual tax provisions

General changes impacting individual taxpayers

Rates

The new law retains seven tax brackets but modifies the “breakpoints” for the brackets and reduces the rate for the top bracket to 37%. The **temporary new brackets** are: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The top rate applies to single filers with income over \$500,000 and married joint filers with income over \$600,000.

Standard deduction

The standard deduction is **temporarily increased** to \$24,000 for joint filers and \$12,000 for individual filers, with these deductions indexed annually. At the same time, the deduction for personal exemptions is repealed, while the child tax credit is enhanced and the phase-out thresholds are substantially increased.

Itemized deductions

The revenue cost of these changes is offset by **temporarily modifying or eliminating a number of tax preferences**, many of them significant and long-standing. These include capping the home mortgage interest deduction to interest expenses attributable to mortgage balances no greater than \$750,000 (for mortgages incurred December 15, 2017 or later), eliminating deductions for home equity loan interest, and, most significantly, capping the deduction for state and local taxes at \$10,000. The \$10,000 cap does not apply to state and local real and personal property taxes which are paid or incurred in carrying on a trade or business or an activity described in section 212. The so-called “Pease” limitation on itemized deductions is repealed.

KPMG observation

By suspending miscellaneous itemized deductions and the overall limitations on itemized deductions for the tax years beginning after December 31, 2017 and before January 1, 2026, the new law suspends the ability to take advantage of certain non-business expenses as miscellaneous itemized deductions including unreimbursed business expenses, tax preparation fees, and expenses for the production of income (other than real or personal property taxes).

Estate, gift, and generation-skipping transfer tax

The new law doubles the basic exclusion amount from \$5 million to \$10 million per individual (as indexed for inflation).

Capital gains and qualified dividends

The new law keeps in place the pre-enactment system whereby net capital gains and qualified dividends are generally subject to tax at a maximum rate of 20% or 15%, with higher rates for gains from collectibles and unrecaptured depreciation. The new law retains the same “breakpoints” for application of these rates as under pre-enactment law, except the breakpoints will be adjusted for inflation after 2018. For 2018, the 15%

breakpoint will be \$77,200 for married taxpayers filing jointly, \$51,700 for head of household filers, and \$38,600 for all other filers. The 20% breakpoint will be \$479,000 for married taxpayers filing jointly, \$452,400 for head of household filers, and \$425,800 for all other filers.

Net investment income

The new law also leaves in place the pre-enactment 3.8% net investment income tax.

Changes applicable to partnerships and S corporations

20% deduction for certain passthrough income

For tax years beginning after December 31, 2017 (subject to a sunset at the end of 2025), section 199A of the new law generally allows an individual taxpayer (and a trust or estate) a deduction for 20% of the individual's domestic qualified business income from a partnership, S corporation, or sole proprietorship. However, the deduction generally is subject to a limit based either on wages paid or wages paid plus a capital element. Specifically, the limitation is the greater of: (i) 50% of the wages paid with respect to the qualified trade or business; or (ii) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis (determined immediately after an acquisition) of all qualified property.

Qualified property means tangible property of a character subject to depreciation that: (i) is held by, and available for use in, the qualified trade or business at the close of the tax year; (ii) is used at any point during the tax year in the production of qualified business income; and (iii) for which the depreciable period has not ended before the close of the tax year. For this purpose, the "depreciable period" with respect to qualified property means the period beginning on the date the property is placed in service by the taxpayer and ending on the later of: (i) 10 years after that date; or (ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (without regard to section 168(g)).

A taxpayer's "W-2 wages" generally equals the sum of wages subject to wage withholding, elective deferrals, and deferred compensation paid by the partnership, S corporation, or sole proprietorship during the tax year. In the case of a trust or estate, rules similar to Code section 199 (as in effect on December 1, 2017) would apply for purposes of apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property. The 50% of wages limitation would not apply in the case of a taxpayer with income of \$315,000 or less for married individuals filing jointly (\$157,500 for other individuals), with phase-out over the next \$100,000 of taxable income for married individuals filing jointly (\$50,000 for other individuals), subject to inflation adjustments.

With certain exceptions described below, an individual's qualified business income for the tax year is the net amount of domestic qualified items of income, gain, deduction, and

loss (determined by taking into account only items included in the determination of taxable income) with respect to the taxpayer's "qualified business." If the amount of qualified business income for a tax year is less than zero (i.e., a loss), the loss is treated as a loss from qualified businesses in the next tax year.

A qualified business 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 in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business the principal asset of which is the reputation or skill of one or more of its owners or employees (excluding engineering and architecture), or any business that involves the performance of services that consist of investment and investment managing, trading, or dealing in securities, partnership interests, or commodities. However, the deduction may apply to income from a specified service trade or business if the taxpayer's taxable income does not exceed \$315,000 (for married individuals filing jointly or \$157,500 for other individuals). Under the new law, this benefit is phased out over the next \$100,000 of taxable income for married individuals filing jointly (\$50,000 for other individuals).

Twenty percent (20%) of any dividends from a real estate investment trust (other than any portion that is a capital gain dividend) are qualified items of income, as is 20% of includible dividends from certain cooperatives and qualified publicly traded partnership income. However, qualified business income does not include certain service related income paid by an S corporation or a partnership. Specifically, qualified business income does not include an amount paid to the taxpayer by an S corporation as reasonable compensation. Further, it does not include a payment by a partnership to a partner in exchange for services (regardless of whether that payment is characterized as a guaranteed payment or one made to a partner acting outside his or her partner capacity). Finally, qualified business income does not include certain investment related gain, deduction, or loss.

The 20% deduction is not allowed in computing adjusted gross income; instead, it is allowed as a deduction reducing taxable income. Thus, the deduction does not affect limitations based on adjusted gross income. Moreover, the deduction is available to taxpayers that itemize deductions, as well as those that do not.

The new law also provides a similar deduction for specified agricultural or horticultural cooperatives.

The provision is effective for tax years beginning after December 31, 2017. Importantly, however, the 20% deduction does not apply to tax years beginning after December 31, 2025—i.e., the deduction is temporary unless legislation is enacted extending it.

The JCT has estimated that that the 20% deduction will decrease revenue by approximately \$415 billion over a 10-year period.

KPMG observation

The 20% deduction for certain passthrough income was largely modeled on a Senate bill provision, but was modified in several respects, including extending the deduction's availability to trusts and estates.

The conference report's explanatory statement provides that the deductible amount for each qualified trade or business is determined first. The combined qualified business income amount for the tax year is the sum of the deductible amounts determined for each qualified trade or business and 20% of the taxpayer's qualified REIT dividends and publicly traded partnership income. The taxpayer's deduction for qualified business income amount is generally equal to the lesser of (1) the combined qualified business income amount or (2) an amount equal to 20% of the excess of the taxpayer's taxable income over any net capital gain. The determination of what is a trade or business and what constitutes a specified service trade or business (for instance in the context of the field of health) will be important for purposes of applying the new rules.

A taxpayer would also need to determine to what extent the taxpayer has wages with respect to a trade or business for purposes of determining the limitation for each trade or business. Further, the definition of "W-2 wages" in the new law appears to provide different results for taxpayers that operate a business in an S corporation than for taxpayers that operate as a partnership or sole proprietorship. Wages paid by an S corporation to its owners are W-2 wages, but an equivalent payment made by a partnership or a sole proprietorship to an owner is not.

The addition of the ability to look to 25% of the W-2 wages plus 2.5% of the unadjusted basis (determined immediately after acquisition) of all qualified property for purposes of the limitation on the deduction will provide relief for capital intensive businesses which traditionally have not reported wages at the entity level, such as real estate. It is worth noting that qualified property appears to allow taxpayers to include property acquired prior to the date of enactment and does not require reduction for depreciation under section 168(k).

In addition, the new law may provide a different result for the sale of an interest in a publicly traded partnership than that provided for a sale of an interest in a non-publicly traded partnership. Specifically, the definition of "qualified publicly traded partnership income" includes any gain recognized on the sale of an interest in a publicly traded partnership to the extent that gain is characterized as ordinary income under section 751. Under this rule, recapture of items of deduction that reduced qualified business income in prior years is taxed at the qualified business rate. That seems to be correct from a policy perspective. However, it is unclear whether that would be the case if a taxpayer sells an interest in a non-publicly traded partnership.

The new law directs the Treasury to provide regulations applying the rules for requiring or restricting the allocation of items and wages and such reporting requirements as Treasury determines are appropriate. Further, the new law directs the Treasury to provide regulations (1) applying the provision to tiered entities, and (2) applying the rules in short tax years and years during which the taxpayer acquires or disposes of the major portion of a trade or business or the major portion of a separate unit of a trade or business. In addition, the new law adds the requirement for anti-abuse rules with respect to the manipulation of the depreciable period of qualified property using transactions between related parties and for determining the unadjusted basis of qualified property following a like-kind exchange or involuntary conversion.

The new law appears to provide that qualified business income that is passive income may not benefit from the 20% deduction for purposes of the net investment income tax. As a consequence, liability for the net investment income tax may be unchanged by the provisions intended to benefit businesses conducted through passthrough entities.

The 20% deduction is allowed as a deduction in reducing taxable income. As such, it should be taken into account at the partner or shareholder level. Thus, absent amendment many partnership agreements may not take into account the deduction for purposes of determining partnership tax distributions which may be made starting with the first quarter of 2018. Both the 20% deduction and the 21% corporate tax rate could impact the amount required to be distributed to partners and enhance the cash flow of the partnership or S corporation.

Perhaps most importantly, the 20% deduction in the new law expires after eight years. In contrast, the corporate tax reduction in the law is permanent. This and other differences should be considered by taxpayers evaluating whether to continue to operate business in passthrough form (rather than as a corporation) as a result of the large decrease in corporate tax rates.

Repeal deduction for income attributable to domestic production activities

Under the new law, the deduction for domestic production activities provided under section 199 is repealed for tax years beginning after December 31, 2017.

JCT has estimated that repealing section 199 will increase revenues by approximately \$98 billion from 2018-2027.

KPMG observation

Congress's intent in enacting section 199 was to provide a targeted corporate rate reduction that would allow U.S. companies to compete against international tax systems, while also drawing international companies to the United States and its tax structure. While the new law eliminates the rate reduction created by section 199, a separate provision of the legislation effects a much larger overall corporate rate reduction.

The repeal of section 199 applies to tax years beginning after December 31, 2017, so fiscal year taxpayers would still be able to claim the section 199 deduction for fiscal years ending after December 31, 2017, but beginning before the repeal date. In addition, special rules apply to corporate taxpayers whose tax years straddle the effective date. The rules under section 15 generally result in application of a blended corporate rate to taxable income for the year that straddles the effective date. As a result, fiscal year taxpayers would be eligible for the section 199 deduction as well as partial impact of the 21% corporate tax rate for tax years beginning before January 1, 2018, and ending after December 31, 2017.

Loss limitation rules

The new law includes provisions that expand certain limitations on losses for noncorporate taxpayers for tax years beginning after December 31, 2017, and before January 2, 2026. Specifically, the law makes sections 461(j) (relating to excess farm losses) inapplicable and establishes a new loss limitation for all noncorporate taxpayers.

Under pre-enactment law, section 461(j) limited the use of an excess farm loss incurred by a taxpayer (other than a C corporation) that receives an applicable subsidy. Generally, an excess farm loss could be deducted, but only to the extent of the greater of: (i) \$300,000 (\$150,000 in the case of a married taxpayer filing a separate return); or (ii) the taxpayer's total net farm income for the five preceding tax years. Any excess loss would be carried forward and treated as a deduction in the following tax year.

The new law contains a significant change to the treatment of business losses of taxpayers other than C corporations. Under section 461(l) of the new law, any "excess business loss" of the taxpayer (other than a C corporation) is not allowed. For purposes of this rule, an "excess business loss" is an overall loss in excess of \$500,000 for married individuals filing jointly or \$250,000 for others individuals. Any business loss in excess of such threshold amount is treated as part of the taxpayer's net operating loss (NOL) and carried forward to subsequent tax years. These NOL carryforwards are governed by section 172.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Thus, each partner's or shareholder's share of the items of the entity is taken into account in calculating the partner or shareholder's limitation.

The provision applies after application of the passive loss rules of section 469.

The provision generally is effective for tax years beginning after December 31, 2017, but expires after December 31, 2025. The JCT has estimated that the changes to the loss limitation rules will increase revenue by approximately \$149.7 billion over a 10-year period.

KPMG observation

The new law effectively denies business deductions for taxpayers (other than C corporations) for any net business losses in excess of \$250,000 (or \$500,000 in the case of a joint return). To the extent the loss exceeds the threshold amount, it would become part of the taxpayer's NOL and carried forward under section 172 to subsequent years. Although not specifically stated in the statute, to the extent the loss does not exceed the threshold amount but exceeds the taxpayer's other income, it appears that it would also become part of the taxpayer's NOL.

Modified net operating loss deduction

Section 172(a) of the new law limits the net operating loss (NOL) deduction for a given year to 80% of taxable income, effective with respect to losses arising in tax years beginning after December 31, 2017. This limitation is similar to, although more restrictive than, the 90% limitation for NOLs that was in the corporate AMT regime (which is repealed by the new law).

The new law also repeals the pre-enactment carryback provisions for NOLs; the statutory language indicates that this provision applies to NOLs arising in tax years *ending after* December 31, 2017, although it permits a new two-year carryback for certain farming losses and retains present law for NOLs of property and casualty insurance companies. Pre-enactment law generally provides a 2-year carryback and 20-year carryforward for NOLs, as well as certain carryback rules for specific categories of losses (e.g., "specified liability losses" may be carried back 10 years).

The statutory language of the new law provides for the indefinite carryforward of NOLs arising in tax years ending after December 31, 2017, as opposed to a 20-year carryforward.

The JCT has estimated that the provision will increase revenue by approximately \$201.1 billion over 10 years (approximately \$45 billion more than the estimates for each of the House and Senate proposals).

KPMG observation

The new law does not appear to limit the three-year capital loss carryback allowed for corporations or impose a limitation on the utilization of capital loss carryovers.

The new law requires corporations to track NOLs arising in tax years beginning (1) on or before December 31, 2017, and (2) after December 31, 2017, separately, as only the latter category of NOLs would be subject to the 80% limitation.

The application of the 80% limitation to a tax year to which both (i) NOLs subject to the 80% limitation and (ii) NOLs not subject to such limitation can be carried over is not

entirely free from doubt. For example, assume a calendar year taxpayer has \$90 of NOLs carried forward from its 2017 tax year (non-80% limited losses), \$10 of NOLs carried forward from its 2018 tax year (80% limited losses), and \$100 of income in its 2019 tax year. Arguably the taxpayer may utilize (i) all of the 2017 unlimited losses of \$90 and (ii) all of the 2018 limited losses of \$10, as the deduction of the 2018 NOL carryforward allowed under revised section 172(a) would be \$10, which is the lesser of (a) the NOL carryover subject to the 80% limitation (\$10) and (b) 80% of taxable income computed without regard to the NOL deduction (\$80). Alternatively, arguably the taxpayer cannot use any of \$10 NOL from 2018, because the aggregate NOL carryover deduction is limited to 80% of taxable income (again, computed without regard to the NOL deduction), or \$80. Under this interpretation, the available NOLs would be absorbed chronologically, *i.e.*, \$90 of 2017 NOL is absorbed first (and is not subject to the 80% limitation), but no amount of the \$10 of 2018 NOL could be absorbed because the \$80 taxable income limitation had already been utilized by the 2017 NOL carryover. Although it is not free from doubt, there is a good argument that the former approach (allowing the deduction of the \$10 of 2018 NOLs in 2019) ought to apply.

The 80% limitation applies to losses arising in tax years *beginning* after December 31, 2017, whereas the statutory language regarding the indefinite carryover and the elimination (for most taxpayers) of the NOL carryback applies to losses arising in tax years *ending* after December 31, 2017. Accordingly, under the statutory language, the NOLs of fiscal year taxpayers arising in tax years that *begin* before December 31, 2017 and *end* after December 31, 2017 would not be subject to the 80% limitation but (for most taxpayers) may not be carried back and may be carried forward indefinitely. However, the conference report's explanatory statement and the JCT revenue table for the conference agreement describe the effective date for the indefinite carryover and modification of carrybacks differently, indicating that the provision applies to losses arising in tax years *beginning* after December 31, 2017

The changes to the NOL carryover provisions possibly may have a significant effect on the financial statement treatment of loss carryovers incurred in future tax years, given that unused loss carryovers no longer will expire. In addition, the potential 80% limitation on post-2017 NOLs and the elimination of post-2017 NOL carrybacks, combined with the reduction of the corporate tax rate, provides corporations with a significant incentive to accelerate deductions into 2017 and to defer income into 2018. Further, taxpayers may want to consider the interaction of the 80% limitation and the increased expensing allowances described elsewhere in this document. For example, if a taxpayer's deduction for the purchase of property would give rise to an NOL, it may be advantageous to defer the purchase until the succeeding year (if full expensing is still available in that year), since the purchase could then offset 100% (not 80%) of taxable income in that succeeding year. In general, taxpayers may find it beneficial to stagger purchases as long as full expensing is available, or selectively elect out of full expensing for property in one or more depreciation recovery classes during this period, if doing so would avoid creating or increasing NOLs subject to the 80% limitation.

Limitation on the deduction of net business interest expense

The new law amends section 163(j) to disallow a deduction for net business interest expense of any taxpayer in excess of 30% of a business's adjusted taxable income plus floor plan financing interest. The conference report's explanatory statement indicates that the section 163(j) limitation should be applied after other interest disallowance, deferral, capitalization or other limitation provisions. Thus, the provision would apply to interest the deduction for which has been deferred to a later tax year under some other provision.

The new limitation does not apply to certain small businesses, that is, any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) that meets the gross receipts test of section 448(c) (which is modified to \$25 million under section 13102 of the new law) for any tax year. This exception to the limitation applies to taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior tax year that do not exceed \$25 million.

Certain taxpayers may elect for the interest expense limitation not to apply, such as certain real estate businesses and certain farming businesses; businesses making this election are required to use the alternative depreciation system (ADS) to depreciate certain property. For an electing real property trade or business, ADS would be used to depreciate nonresidential real property, residential rental property, and qualified improvement property. For an electing farming business, ADS would be used to depreciate any property with a recovery period of 10 years or more.

Adjusted taxable income generally is a business's taxable income computed without regard to: (1) any item of interest, gain, deduction, or loss that is not properly allocable to a trade or business; (2) business interest or business interest income; (3) the amount of any net operating loss deduction; (4) the 20% deduction for certain passthrough income, and (5) in the case of tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. The new law permits the Secretary to provide other adjustments to the computation of adjusted taxable income. A business's adjusted taxable income may not be less than zero for purposes of the limitation. A clarification is needed to provide that although a partner excludes its share of partnership items of income, gain, loss, deduction or credit from adjusted taxable income to prevent double counting, the partner is be able to include its share of business interest income from the partnership for purposes of making computations under section 163(j) at the partner level.

Business interest is defined as any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for tax purposes is treated as "interest" for purposes of this provision. The term "business interest" does not include investment interest within the meaning of section 163(d). The conference report's explanatory statement indicates that, because section 163(d) does not apply to corporations, a corporation has neither investment interest nor investment income and

interest income and interest expense would be properly allocable to a trade or business unless such trade or business has been explicitly excluded from the provision.

“Floor plan financing interest” is interest paid or accrued for “floor plan financing indebtedness,” which means indebtedness used to finance the acquisition of motor vehicles held for sale or lease. The term “motor vehicle” means any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road; boat; or farm machinery or equipment.

Subject to the exclusions or those business that may elect out, the provision applies to all businesses, regardless of form, and any disallowance or excess limitation would generally be determined at the partnership or S corporation level instead of the partner or shareholder level. Subject to the special rules for partnerships, any business interest disallowed would be carried forward indefinitely.

Special carryforward rules, described below, apply to partners in the case of business interest not allowed as a deduction to a partnership. These special carryforward rules do not apply in the case of an S corporation. The general carryforward rule applies to an S corporation.

The new law prevents a partner (or shareholder of an S corporation) from double counting a partnership’s (or S corporation’s) adjusted taxable income when determining the partner’s (or shareholder’s) business interest limitation. More specifically, a partner’s (or shareholder’s) adjusted taxable income is determined without regard to the partner’s (or shareholder’s) distributive share of the partnership’s (or S corporation’s) items of income, gain, deduction, or loss.

The explanatory statement illustrates the double counting rule with the following example. ABC is a partnership owned 50-50 by XYZ Corporation and an individual. ABC generates \$200 of noninterest income. Its only expense is \$60 of business interest. Under the provision, the deduction for business interest is limited to 30% of adjusted taxable income, that is, $30\% \times \$200 = \60 . ABC deducts \$60 of business interest and reports ordinary business income of \$140. XYZ’s distributive share of the ordinary business income of ABC is \$70. XYZ has net taxable income of zero from its other operations, none of which is attributable to interest income and without regard to its business interest expense. XYZ has business interest expense of \$25. In the absence of a double counting rule, the \$70 of taxable income from XYZ’s distributive share of ABC’s income would permit XYZ to deduct up to an additional \$21 of interest ($30\% \times \$70 = \21), and XYZ’s \$100 share of ABC’s adjusted taxable income would generate \$51 of interest deductions, well in excess of the intended 30% limitation. If XYZ were a passthrough entity rather than a corporation, additional deductions might be available to its partners as well, and so on.

The double counting rule prevents this result by providing that XYZ has adjusted taxable income computed without regard to the \$70 distributive share of the nonseparately stated income of ABC. As a result, it has adjusted taxable income of \$0. XYZ’s deduction for business interest is limited to $30\% \times \$0 = \0 , resulting in a deduction disallowance of \$25.

The new law allows a partner or shareholder to use its distributive share of any excess (i.e., unused) taxable income limitation of the partnership or S corporation in computing the partner's or shareholder's business interest limitation. The excess taxable income with respect to any partnership is the amount that bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30% of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership exceeds the business interest income of the partnership bears to 30% of the adjusted taxable income of the partnership. Any such excess adjusted taxable income is allocated in the same manner as nonseparately stated income and loss.

The explanatory statement provides the following example. Assume partnership ABC, described above, had only \$40 of business interest. ABC has a limit on its interest deduction of \$60. The excess of this limit over the business interest of the partnership is $\$60 - \$40 = \$20$. The excess taxable income for ABC is $\$20 / \$60 * \$200 = \66.67 . XYZ's distributive share of the excess taxable income from ABC partnership is \$33.33. XYZ's deduction for business interest is limited to 30% of the sum of its adjusted taxable income plus its distributive share of the excess taxable income from ABC partnership ($30\% * (\$0 + \$33.33) = \$10$). As a result of the rule, XYZ may deduct \$10 of business interest and has an interest deduction disallowance of \$15.

As noted earlier, special carryforward rules apply to partners and partnership. Excess business interest of a partnership is not treated as paid or accrued by the partnership in the succeeding tax year. Instead excess business interest is allocated to each partner in the same manner as the nonseparately stated taxable income or loss of the partnership. Excess business interest allocated to a partner is treated as business interest paid or accrued by the partner in the next succeeding tax year in which the partner is allocated excess taxable income from the partnership but only to the extent of such excess taxable income. Any remaining excess business interest can be carried forward by the partner and deducted subject to the excess taxable income limitation. A partner's adjusted basis in its partnership interest is reduced (but not below zero) by the amount of excess business interest allocated to the partner. If a partner disposes of its partnership interest, including in a non-recognition transaction, the partner's basis in the interest is increased, immediately prior to the disposition, by the excess of: (i) the amount basis was reduced as described above over (ii) the amount of excess business interest allocated to the partner and treated as paid or accrued in a succeeding tax year.

The provision is effective for tax years beginning after 2017.

The JCT has estimated the provision will increase revenues by approximately \$253.4 billion over 10 years.

KPMG observation

Under the new law, any net interest disallowance applies at the partnership and S corporation level rather than the partner or shareholder level. This affects not only the

determination of any interest disallowance, but also any excess amount (i.e., interest expense capacity) passed through from a partnership or S corporation to its partners or shareholders, respectively. Consideration will need to be given in tiered structures to whether business interest expense is subject to any disallowance given the limitations are applied at each level. There may also be uncertainties created when applying the rules at the partnership or S corporation level when references are made to the rules of section 469 which apply at the partner or shareholder level.

Special rules allow a partnership's and S corporation's unused interest limitation for the year to be used by its partners and shareholders, respectively, and to ensure that net income from the passthrough entity is not double counted at the partner or shareholder level. With respect to the double-counting rule, the new law excludes a partner's or shareholder's distributive share of all items. Clarification may be needed to address how business interest income of a partnership or S corporation is taken into account at the partner or shareholder level for purposes of applying section 163(j).

The new law establishes special carryover rules for partnerships (not S corporations) and permits interest disallowed at the partnership level to be passed through to the partners and deducted in succeeding tax years in which, and to the extent that, the partners are allocated excess taxable income from such partnership. The new law also provides for adjustments to the partners' bases in partnership interests to account for disallowed interest that is passed through.

The new provision applies only to *business* interest expense of the taxpayer. Nonbusiness interest, such as investment interest expense, continues to be subject to the limitation on investment interest. Payments that are not interest, such as capitalized debt costs that are amortized like OID under Reg. section 1.446-5, are not covered.

The provision includes only taxable interest income in the computation of net business interest expense. Thus, investments in tax-free municipal bonds do not increase a taxpayer's interest expense capacity.

While the new law does not explicitly indicate how the new rule interacts with other interest disallowance and deferral provisions, the conference report's explanatory statement indicates that the provision is intended to apply after other interest disallowance and deferral provisions.

The new provision provides relief for electing real property trades or businesses that agree to use ADS for certain property. Guidance will be needed as to what constitutes a real property trade or business. Taxpayers will then need to determine if and when to make the election.

In addition, there appear to be no special rules for financial services entities. As a result, the determination of net business interest expense is unclear for a company like an insurer that generates significant interest income related to investments as an integral part of its active insurance business.

It should be noted that interest expense can occur as a result of repurchasing one's debt instrument at a premium. Under Reg. section 1.163-7(c), if a borrower repurchases its debt instrument for an amount in excess of its adjusted issue price, the repurchase premium is deductible as interest for the tax year in which the repurchase occurs, unless the deduction for the repurchase premium is disallowed under section 249 or the repurchase premium was the result of certain debt-for-debt exchanges.

Finally, the new provision does not address what happens to a corporation's existing disallowed interest expense for which a deduction was not claimed because of section 163(j). Thus, it should be clarified that a corporation may treat that disallowed interest expense as business interest paid or accrued in a year after the effective date of the provision.

Cost recovery

Modification of rules for expensing depreciable business assets

Under the new law, the section 179 expensing election is modified to increase the maximum amount that may be deducted to \$1 million (up from \$500,000) (the "dollar limit"). The dollar limit is reduced dollar-for-dollar to the extent the total cost of section 179 property placed in service during the tax year exceeds \$2.5 million (up from \$2 million) (the "phase-out amount"). These limits will be adjusted annually for inflation. The changes are effective for property placed in service in tax years beginning after 2017.

Under pre-enactment law, the section 179 deduction for a sports utility vehicle is \$25,000. For tax years beginning after 2017, this limitation will be adjusted annually for inflation.

In addition, the new law expands the availability of the expensing election to depreciable tangible personal property used in connection with furnishing lodging (e.g., beds and other furniture for use in hotels and apartment buildings). The election also may include, at the taxpayer's election, roofs, HVAC property, fire protection and alarm systems, and security systems, so long as these improvements are made to nonresidential real property and placed in service after the date the realty was first placed in service. These expansions to the definition of property eligible for the section 179 expensing election are effective for property placed in service in tax years beginning after 2017.

The JCT has estimated that the provision will decrease revenues by approximately \$26 billion over 10 years.

KPMG observation

The amendment making the inclusion of qualified real property elective may give taxpayers the ability to avoid or reduce their exposure to the dollar limit in certain cases.

Temporary 100% expensing for certain business assets

The new law extends and modifies the additional first-year depreciation deduction (“bonus depreciation”) under section 168(k).

Under the new law, generally, the bonus depreciation percentage is increased from 50% to 100% for property acquired and placed in service after September 27, 2017, and before 2023. It also provides a phase down of the bonus depreciation percentage, allowing an 80% deduction for property placed in service in 2023, a 60% deduction for property placed in service in 2024, a 40% deduction for property placed in service in 2025, and a 20% deduction for property placed in service in 2026. These same percentages apply to specified plants planted or grafted after September 27, 2017, and before 2027. Longer production period property and certain aircraft get an additional year to be placed in service at each rate.

Property that is acquired prior to September 28, 2017, but placed in service after September 27, 2017, remains subject to the bonus depreciation percentages available under pre-enactment law – i.e., 50% for property placed in service in 2017, 40% for property placed in service in 2018, and 30% for property placed in service in 2019. Under the new law, the acquisition date for property acquired pursuant to a written binding contract is the date of such contract.

KPMG observation

Prior legislation, and IRS regulations issued in 2003 interpreting such legislation, provided specific rules for determining the acquisition date of self-constructed property for bonus depreciation purposes. The new law, however, is silent as to the determination of the acquisition date for self-constructed property. Thus, it is unclear whether prior law standards will be used for acquisition date determinations for self-constructed property under the new rules.

The new law changes the definition of qualified property (i.e., property eligible for bonus depreciation) by including used property acquired by purchase so long as the acquiring taxpayer had not previously used the acquired property and so long as the property is not acquired from a related party. In addition, the new law excludes any property used in providing certain utility services if the rates for furnishing those services are subject to ratemaking by a government entity or instrumentality or by a public utility commission, and any property used in a trade or business that has “floor plan financing indebtedness.”

KPMG observation

As in the House and Senate bills, the new law excludes from bonus-eligible qualified property any property used in trades or businesses that is not subject to the limitation of net business interest expense under section 163(j). The new law also expands the exclusion from the interest expense limitation to include property used in a farming business, but subject such property with a recovery period of 10 years or more to ADS

(and by definition such property would not be qualified property eligible for bonus depreciation). While the new law removes qualified improvement property from the definition of qualified property for bonus depreciation purposes, such property appears to remain bonus eligible since it would now have a specified recovery period of 15 years and thus meet the general “20 years or less recovery period” requirement for bonus qualification.

The change in the definition of qualified property could have an important effect on M&A transactions. It increases the incentive for buyers to structure taxable acquisitions as actual or deemed (e.g., pursuant to section 338) asset purchases, rather than stock acquisitions, by enabling the purchasing entity in an asset acquisition to immediately deduct a significant component of the purchase price, and potentially to generate net operating losses in the year of acquisition that could be carried forward (subject, in general, to an 80% of taxable income limitation as described elsewhere in this document) to shield future income. Additional guidance may be needed to address the application of the new rules to basis adjustments under section 754 and the recovery of the section 704(b) basis of property for purposes of section 704(c) under the remedial method.

In addition, the new law creates a new category of qualified property that includes qualified film, television, and live theatrical productions, as defined under section 181(d) and (e), effective for productions placed in service after September 27, 2017, and before 2027. Under the agreement, a production is treated as placed in service on the date of its first commercial exhibition, broadcast, or live staged performance to an audience.

In the case of a taxpayer’s first tax year ending after September 27, 2017, the new law permits the taxpayer to elect to apply a 50% allowance in lieu of 100%.

The JCT has estimated that the provision will decrease revenues by approximately \$86.3 billion over 10 years.

KPMG observation

The new law incorporates the most favorable provisions of both the House and Senate bills by expanding the availability of bonus depreciation to purchased non-original use property, and by instituting a four-year phase down period from 2023 through 2026.

Requirement to capitalize section 174 research and experimental expenditures

The new law provides that specified research or experimental (“R&E”) expenditures under section 174 paid or incurred in tax years *beginning after December 31, 2021* should be capitalized and amortized ratably over a five-year period, beginning with the midpoint of the tax year in which the specified R&E expenditures were paid or incurred. Specified R&E expenditures which are attributable to research that is conducted outside of the United States (for this purpose, the term “United States” includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States) would be capitalized and amortized ratably over a period of 15 years, beginning with the midpoint

of the tax year in which such expenditures are paid or incurred. Specified R&E expenditures subject to capitalization include expenditures for software development.

In the case of retired, abandoned, or disposed property with respect to which specified R&E expenditures are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

The application of this rule is treated as a change in the taxpayer's method of accounting for purposes of section 481, initiated by the taxpayer, and made with the consent of the Secretary. This rule is applied on a cutoff basis to R&E expenditures paid or incurred in tax years beginning after December 31, 2021 (hence there is no adjustment under section 481(a) for R&E expenditures paid or incurred in tax years beginning before January 1, 2022).

The JCT has estimated that this provision will raise approximately \$119.7 billion in the 10-year budget window (taking into account the delayed effective date).

KPMG observation

This provision substantially changes the treatment of R&E and software development costs. Under pre-enactment section 174, a taxpayer may currently expense R&E costs under section 174(a) or elect to treat R&E costs as deferred expenses under section 174(b), and such deferred expenses are allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures). Further, under pre-enactment law, an election to recover section 174 amounts over 10 years is available under section 59(e), which itself would have been repealed under the overall AMT repeal that had been proposed earlier in the legislative process – however, only the corporate AMT has been repealed and modifications have been made to the individual AMT with section 59(e) itself remaining as is. Reg. section 1.174-2 provides a general definition of R&E expenditures, and it does not appear that this definition would change under the new law.

The IRS has had a long-standing rule of administrative convenience that permits taxpayers to treat the costs of developing software as deductible section 174 expenses, whether or not the particular software is patented or copyrighted or otherwise meets the requirements of section 174. See Rev. Proc. 2000-50 and its predecessor Rev. Proc. 69-21. The new law terminates this rule of convenience and requires capitalization of software development expenses otherwise eligible for expensing under Rev. Proc. 2000-50.

Applicable recovery period for real property

Section 168(e) under the new law eliminates the special 15-year recovery period for qualified leasehold improvement property, qualified restaurant property, and qualified

retail improvement property; instead, it seems intended to provide a single 15-year recovery period (20 years for ADS) for qualified improvement property, defined as certain interior improvements to nonresidential real property that are placed in service after the initial placed-in-service date of the realty. However, the legislative text itself seems to include a “technical glitch,” which leaves the applicable recovery periods (both MACRS and ADS) for qualified improvement property uncertain.

KPMG observation

Qualified restaurant property, which under pre-enactment law had a 15-year recovery period, includes section 1250 building and building improvement property. It may include newly constructed property that is otherwise qualified. Since the new law limits the 15-year recovery period to qualified restaurant property that meets the definition of qualified improvement property, a large portion of restaurant building and building improvement property would be required to be depreciated as nonresidential real property over a 39-year recovery period. Additionally, as indicated above, a technical glitch in the legislative text appears to result in uncertainty as to whether qualified improvements of any nature (not just restaurant property) would be eligible for the benefits of a shorter life and bonus depreciation.

In addition, the ADS recovery period for residential rental property under section 168(g) is shortened from 40 years to 30 years.

These provisions are effective for property placed in service after 2017.

Section 168(g) under the new law also requires any real property trade or business that elects out of the interest deduction limitation under section 163(j) to depreciate building property under ADS. As a result, a real property trade or business’s nonresidential real property and residential rental property would be depreciated using the straight-line method over 40 years and 30 years, respectively, and its qualified improvement property would be depreciated using the straight-line method over 20 years. This provision is effective for tax years beginning after 2017.

The JCT has estimated these provisions will decrease revenue by approximately \$4.9 billion over 10 years.

KPMG observation

As described above, the new law’s cost recovery requirements relating to real property trades or business that elect out of the interest deduction limitations apply for tax years beginning after 2017. As such, the election out would affect property already placed in service for the year the election is made. As indicated in the explanation to the Senate bill that was posted on the Budget Committee website, the election out would require the taxpayer to treat a change in the recovery period and method as a change in use.

Accounting methods

Certain special rules for tax year of inclusion

Under the new law, section 451(b) is amended to require that accrual method taxpayers recognize income no later than the tax year in which the item is recognized as revenue on an applicable financial statement (*i.e.*, the all events test is satisfied no later than the year in which the revenue is recognized for financial accounting purposes). This book conformity requirement does not apply, however, either to an item of gross income earned in connection with a mortgage servicing contract, or to any item of gross income for which the taxpayer uses a special method of accounting provided under any other provision of the Code (such as, for example, long term contracts under section 460 or installment agreements under section 453), except for the various rules for debt instruments contained in Subchapter P, Part V of the Code (sections 1271-1288: rules for original issue discount (OID), discount on short-term obligations, market discount, and stripped bonds and coupons).

In the case of a contract containing multiple “performance obligations,” the taxpayer must allocate the contract’s transaction price among the performance obligations for tax purposes in the same manner as the transaction price is allocated for financial accounting purposes.

Additionally, the new law codifies in section 451(c) the deferral method of accounting for advance payment for goods and services provided by the IRS under Revenue Procedure 2004-34.

Finally, for holders of certain debt instruments with OID, the new law directs taxpayers to apply the revenue recognition rules under section 451 before applying the debt-specific rules such as the OID rules under section 1272. As a result, items included in income when received for financial statement purposes (e.g., late-payment and cash-advance fees) are generally includible in income at such time in accordance with the general recognition principles under section 451. The provisions related to OID apply to tax years beginning after December 31, 2018. The period for taking into account any adjustments under section 481 is six years if required by the amendments of the new law.

Other than the OID provisions, the other provisions related to the tax year of inclusion apply to tax years beginning after December 31, 2017, and application of these rules is a change in the taxpayer’s method of accounting for purposes of section 481.

The JCT has estimated that the special rules for tax year of inclusion will increase revenues by approximately \$12.6 billion from 2018-2027.

KPMG observation

The special rules for tax year of inclusion would cause an acceleration in the recognition of income for many taxpayers. For example, under the new law, any unbilled receivables

for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes, as opposed to when the services are complete or the taxpayer has the right to bill; advance payments for goods and revenue from the sale of gift cards are no longer deferred longer than one tax year; and income from credit card fees (such as late-payment, cash advance, and interchange fees) would generally be accelerated.

The new law should also be considered in relation to ASC 606, Revenue from Contracts with Customers. In particular, tax departments would be required to coordinate with the company's financial accounting function to ensure that the transaction price of contracts containing multiple performance obligations (*i.e.*, bundles of both goods and services) is allocated in the same manner for both book and tax purposes. This allocation may have consequences for both federal and state tax purposes.

One potentially problematic area that may arise under this provision involves accounting for manufacturing contracts. Under ASC 606, contract manufacturers will move from an inventory method to a progress measure in recognizing revenue and will no longer maintain inventories. Under the new law, contract manufacturers may be required to recognize revenue before the inventory is sold but continue to be required to maintain inventories and apply section 263A, assuming the contracts are not subject to the percentage of completion under section 460.

Whether the provision requires certain taxpayers to accelerate the accrual and recognition of market discount is unclear. Market discount arises when a taxpayer purchases a debt instrument on the secondary market at a discount to its principal amount (or its adjusted issue price in the case of a debt instrument with OID). The exception in the provision for special methods of accounting provided under Chapter 1 of the Code specifically provides that it (the exception) does not apply to sections 1271 through 1288, which sections include not only the OID rules but also the market discount rules. On its face the provision, therefore, appears to apply to debt instruments with market discount. The explanatory statement in the conference report, however, states in a footnote that "the provision does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred." The footnote also states that "the provision does not require the recognition of gain or loss from securities that are marked to market for financial reporting purposes if the gain or loss from such investments is not realized for Federal income tax purposes until such time that the taxpayer sells or otherwise disposes of the investment." Section 1276 generally provides that accrued market discount is treated as ordinary income to the extent of gain on the disposition of or receipt of any partial principal payment on any market discount bond, unless a taxpayer makes an election under section 1278(b) to include market discount in income as it accrues. Therefore, the market discount rules under section 1276 appear to require a realization event before a taxpayer must include market discount in income and accordingly it appears that such market discount rules come within the scope of the footnote stating that the provision does not revise the rules associated with when an item is realized for Federal income tax purposes. However, if

instead the provision does apply to debt instruments with market discount and a taxpayer recognizes discount as it economically accrues in an “applicable financial statement” (as defined), then the favorable timing treatment under section 1276 may be limited.

Modify accounting for inventories

Under pre-enactment law, businesses that are required to use an inventory method must also use the accrual method of accounting for tax purposes. An exception from the accrual method of accounting is provided for certain small businesses if for each prior tax year its average annual gross receipts (based on the prior three tax years) do not exceed \$1 million, and a second exception is provided for businesses in certain industries if for each prior tax year their average annual gross receipts (based on the prior three tax years) do not exceed \$10 million.

The new law permits additional businesses with inventories to use the cash method by increasing this threshold to \$25 million. Under the provision, businesses with average annual gross receipts of \$25 million or less (based on the prior three tax years) are permitted to use the cash method of accounting even if the business has inventories. Under the provision, a business with inventories that otherwise qualifies for and uses the cash method of accounting is able to treat inventory as non-incidental materials and supplies or conform to its financial accounting treatment. A change to or from the cash method of accounting as a result of the provision is treated as a voluntary change in the taxpayer’s method of accounting, subject to a section 481(a) adjustment.

Increase exemption for capitalization and inclusion of certain expenses in inventory costs

Under pre-enactment law, a business with \$10 million or less of average annual gross receipts for the prior three tax years was not subject to the uniform capitalization (UNICAP) rules with respect to personal property acquired for resale.

Under the new law, producers or resellers with average annual gross receipts of \$25 million or less (based on the prior three tax years) are fully exempt from the UNICAP rules. This exemption would apply to real and personal property for both resellers and manufacturers. A change in the treatment of section 263A costs as a result of the provision is treated as a voluntary change in the taxpayer’s method of accounting, subject to a section 481(a) adjustment.

Increase exceptions for accounting for long-term contracts

The taxable income from a long-term contract generally is determined under the percentage-of-completion method. Under pre-enactment law, an exception to this requirement was provided for certain businesses with average annual gross receipts of \$10 million or less in the preceding three years. Under this exception, a business could use the completed contract method with respect to contracts that were expected to be completed within a two-year period.

Under the new law, the \$10 million average annual gross receipts exception to the percentage-of-completion method is increased to \$25 million. Businesses that meet the increased average annual gross receipts test are permitted to use the completed-contract method (or any other permissible exempt contract method). The provision applies to contracts entered after December 31 2017, in tax years ending after such date. A change in the taxpayer's method of accounting as a result of the provision is applied on a cutoff basis for all similarly classified contracts; thus there is no change, and no resulting section 481(a) adjustment, in the treatment of contracts entered into before January 1, 2018.

Miscellaneous provisions applicable to partnerships and S corporations

Limits on like-kind exchange rules

The new law limits the like-kind exchange rules under section 1031 to exchanges of real property. Deferral under section 1031, however, is not allowed for an exchange of real property held primarily for sale. In addition, as under pre-enactment law, real property located in the United States is not considered like-kind to real property located outside the United States.

The new section 1031 rules apply to exchanges completed after December 31, 2017. A transition rule is included under which the new section 1031 rules do not apply to any exchange in which the taxpayer disposed of relinquished property, or received replacement property, on or before December 31, 2017.

The JCT has estimated that the provision will raise revenue by approximately \$31 billion over a 10-year period.

KPMG observation

The new law's limitation on the like-kind exchange rules eliminates deferral under section 1031 for exchanges of tangible personal property, including livestock, and intangible property. For tangible personal property, the new law's allowance for full expensing may offset the negative impact of eliminating the gain deferral under section 1031. However, for personal property not subject to full expensing and intangible property, the limitation to section 1031 would have an adverse impact.

Economic interests in unsevered oil and gas, minerals and timber are real property that remain eligible for like-kind exchange treatment (e.g., poolings and unitizations). In addition, under the new law, an interest in a partnership that has made a valid election under Code section 761(a) to be excluded from subchapter K would continue to be treated as an interest in the assets of the partnership and not as an interest in a partnership for purposes of section 1031. However, the new law eliminates the special rule under pre-

enactment law that characterizes certain stock in a mutual ditch, reservoir, or irrigation company as real property eligible for like-kind exchange treatment under section 1031.

Modify tax treatment of certain self-created property

Under the new law, gain or loss arising from the sale, exchange, or other disposition of a self-created patent, invention, model or design, secret formula or process, are no longer treated as the sale of a capital asset under section 1221(a)(3).

This provision applies to dispositions after December 31, 2017.

JCT has estimated that this modification will increase revenues by \$500 million over 10 years.

KPMG observation

The ordinary income treatment represents a paradigm shift from the definition of “capital asset” and various rules for timing and character of income for certain self-created works. Taxpayers who have applied the special character rules to these types of self-created property would find their gains and losses characterized as ordinary under the statutory language. Under the new provision, gain or loss on the disposition of other self-created intangibles, such as personal goodwill, client lists, customer contracts, etc., are still eligible for capital gain treatment. As a result of this law change, valuations will become more important in the context of a sale of a business containing multiple identifiable intangibles.

The new law followed the House bill without modifications. The legislative history notes that the provision is consistent with the principle in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), in that the intent of Congress is that profits and losses arising from everyday business operations be characterized as ordinary income and loss and, as such, the general definition of capital asset should be narrowly applied. However, the new law did not follow the House bill with respect to the proposed repeal of section 1235, which provides capital gain treatment on the transfer of a patent prior to actual commercial use of the patent.

Limitation of deduction by employers of expenses for entertainment and certain fringe benefits

The new law repeals deductions for entertainment, amusement, and recreation when directly related to the conduct of a taxpayer’s trade or business under section 274. The new law provides that no deduction is allowed for (1) an activity considered entertainment, amusement, or recreation, (2) membership dues for any club organized for business, pleasure, recreation, or other social purposes, or (3) a facility or portion of a facility used in connection with any of the above.

The 50% deduction for food and beverage expenses associated with a trade or business is generally retained. However, provisions expand the 50% limitation to certain meals provided by an employer that are currently 100% deductible. The expanded 50% limit applies to food and beverages provided to employees as de minimis fringe benefits, to meals provided at an eating facility that meets the requirements for an on-premises dining facility, and to meals provided on-premises to employees under section 119 for the convenience of the employer. The 50% deduction limit applies for years after 2017 and before 2026. The on-premises meals and section 119 meals expenses and expenses for the related on-premises facilities would be nondeductible after 2025.

The new law disallows any deduction expense of any qualified transportation fringe (as defined in the section 132(f) rules). Separately, the new law disallows the deduction for expenses to provide transportation or to reimburse for the expenses for commuting between the employee's residence and place of employment (unless the expenses are "necessary for ensuring the safety of an employee"). These costs appear to include employee buses, van pools, subway or transit cards, and qualified parking fees.

JCT has estimated this provision will increase revenue over 10 years by approximately \$23.5 billion for meals and entertainment expenses and \$17.7 billion for qualified transportation fringes.

KPMG observation

Meals, including de minimis food and beverages that used to be 100% deductible, are generally 50% deductible under the new law. There remains uncertainty regarding whether the meals provided during a recreational event fall under the meal or recreational deduction limit, such as a meal in connection with a business meeting at a ballgame.

The new law essentially provides the employer with a choice to include certain *de minimis* or convenience of employer meals in employee taxable income and take a 100% tax deduction or exclude the amounts and take a lesser deduction.

Commuting expenses are not deductible under the new law except to ensure the safety of the employee. The factual situations that would satisfy the safety exception remain uncertain. This new law language could be read to suggest that even taxable commuting may not be deductible, but it seems unlikely that this was intended. When the same sort of language was added for spousal travel, the IRS clarified in regulations that taxable spousal travel is still deductible.

Qualified opportunity zones

The new law provides for the temporary deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the sale or exchange of an investment held for at least 10 years in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in and holding at least 90% of its

assets in qualified opportunity zone property. Qualified opportunity zone property includes any qualified opportunity zone stock, any qualified opportunity zone partnership interests, and any qualified opportunity zone business property.

The designation of a qualified opportunity zone is the same as the low-income community designation for the new markets tax credit. The certification of a qualified opportunity fund will be done by the Community Development Financial Institutions (CDFI) Fund, similar to the process for allocating the new markets tax credit.

The new law provides that each population census tract in each U.S. possession that is a low-income community is deemed certified and designated as a qualified opportunity zone effective on the date of enactment. The new law also clarifies that chief executive officer of the State (which includes the District of Columbia) may submit nominations for a limited number of opportunity zones to the Secretary for certification and designation. Finally, the new law clarifies that there is no gain deferral available with respect to any sale or exchange made after December 31, 2026, and there is no exclusion available for investments in qualified opportunity zones made after December 31, 2026.

The creation of qualified opportunity funds is effective on the date of enactment.

The JCT has estimated that the creation of qualified opportunity zones will decrease revenues by approximately 1.6 billion over 10 years.

Other partnership only provisions

Short-term capital gain with respect to applicable partnership interests (carried interest)

The new law adds section 1061 to the Code, addressing the taxation of “applicable partnership interests.” Under the provision, if one or more “applicable partnership interests” were held by a taxpayer at any time during the tax year, some portion of the taxpayer’s long-term capital gain with respect to those interests may be treated as short-term capital gain. At a high level, the provision requires that, to obtain long-term capital gain treatment for applicable partnership interests, the required asset-holding period must be greater than three years.

New Code section 1061 applies only with respect to “applicable partnership interests.” To qualify as such, the partnership interest has to be transferred to, or held by, the taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in any “applicable trade or business.” An “applicable trade or business” is an activity that is conducted on a regular, continuous, and substantial basis and that consists (in whole or in part) of – (1) raising or returning capital; and (2) either – (a) investing in or disposing of “specified assets” (or identifying such specified assets for investing or disposition), or (b) developing specified assets. “Specified assets” include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options

or derivative contracts with respect to the forgoing assets, or an interest in a partnership to the extent of the partnership's interest in the forgoing assets.

Two exceptions may apply to exclude treatment of certain partnership interests as applicable partnership interests. First, an applicable partnership interest does not include a partnership interest held by a corporation. Second, an applicable partnership interest does not include a capital interest that provides the partner with a right to share in partnership capital commensurate with – (1) the amount of capital contributed (determined at the time of receipt of the partnership interest); or (2) the value of the interest included in income under section 83 upon receipt or vesting. This exception appears intended to allow a service partner to earn income as long-term capital gain under the normal rules with respect to a partnership interest received in exchange for contributed capital or to the extent the partner included the value of the interest in income under section 83.

To the extent provided by the Secretary, the three-year holding period in section 1061 does not apply to income or gain attributable to any asset not held for portfolio investment on behalf of “third-party investors.” A third-party investor for this purpose is a person who – (1) holds an interest in the partnership that is not held in connection with an applicable trade or business; and (2) is not and has not been actively engaged (and is not and was not related to a person so engaged) in (directly or indirectly) providing substantial services related to an applicable trade or business to the partnership or any applicable trade or business. This provision appears to be aimed at the “enterprise value” issue and seems to direct the Secretary to promulgate regulations that exclude gain from the intangible asset value associated with a sponsor's investment management business from the application of the new rules.

New Code section 1061 would provide that, upon the transfer of an applicable partnership interest to a related person, the transferor must include short-term capital gain equal to the excess of – (1) the taxpayer's long-term capital gain with respect to such interest for such tax year attributable to the sale or exchange of any asset held for not more than three years as is allocable to such interest; over (2) any amount already treated as short-term capital gain under the primary provision with respect to the transfer of such interest. For this purpose, a related person includes only persons with a family relationship under section 318(a)(1) and persons who performed services in the current calendar year or the prior three calendar years in any applicable trade or business in which or for which the taxpayer performed any service. This provision appears to be aimed at assignment of income issues, although the provision is drafted in a manner that makes it difficult to determine its exact effect.

The new law provides that short-term capital gain treatment applies under section 1061 “notwithstanding section 83 or any election in effect under section 83(b).”

New section 1061 provides authority for the issuance of such regulations or other guidance as are necessary to carry out the purposes of the provision. The provisions covered by the amendment are effective for tax years beginning after December 31, 2017.

The new law does not include rules “grandfathering” applicable partnership interests held as of the effective date of such legislation.

The JCT has estimated that this provision will raise approximately \$1.1 billion over a 10-year period.

KPMG observation

The new section appears intended to address the long-debated tax treatment of carried interests. Various bills have been proposed relating to this issue. The new law has some similarities to those proposals, but a great many differences.

Although not entirely clear, it appears that the three-year holding period described in the bill would be required for sales of assets held (directly or indirectly) by the applicable partnership, or, in the case of the sale of an applicable partnership interest, the applicable partnership interest itself. Rather than treating amounts failing the three-year test as ordinary income (as has been the typical recharacterization under prior versions of proposed carried interest legislation), section 1061 treats such gain as short-term capital gain.

Significantly, the new section operates only by modifying the application of sections 1222(3) and (4) and requiring a holding period for “capital assets” of more than three years in order to recognize long-term capital gain or loss. The Code contains a number of other provisions, such as section 1231, which result in taxation of gain recognized at long-term capital gain rates without reference to section 1222. Read literally, the new section appears not to impact the application of those provisions, even with respect to assets held for three years or less. On the other hand, the Code also contains provisions, like the REIT capital gain dividend rule in section 857(b)(3)(B), which provide for long-term capital gain treatment by characterizing the relevant income as gain from the sale or exchange of a capital asset “held for more than 1 year.” By virtue of such a provision, long-term capital gain treatment generally would result under section 1222(3). Under a strict reading of section 1061, there is concern that REIT capital gain dividend income allocated to an applicable partnership interest never could satisfy the three-year threshold even if the REIT held the asset generating the relevant gain for significantly longer than three years, since section 857(b)(3)(B) deems the gain to result from the sale or exchange of an asset held only for more than one year.

The exception for applicable partnership interests held by a corporation resolves significant controversy that arose in connection with earlier versions of carried interest legislation as a result of subjecting corporations (which were not rate sensitive) to the complexities and other issues associated with carried interest proposals. The new law resolves this controversy by simply excluding corporations that hold partnership interests from the new rules. Questions have arisen as to whether the reference to a “corporation” for these purposes includes an S corporation.

The provision of an exception for certain capital interests is consistent with prior versions of carried interest legislation, which included provisions intending to permit service partners to earn long-term capital gain with respect to their qualified capital interests. However, the rules defining “qualifying” capital and permissible returns in prior versions of the legislation were significantly stricter and arguably more clearly defined. According to the explanatory statement, if a partner contributes capital to a partnership, then so long as the partnership agreement provides that the partner’s share of partnership capital is commensurate with the amount of capital that he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent. On the other hand, the explanatory statement also indicates that it is not intended that a partnership interest would fail to be treated as transferred in connection with the performance of services merely because a partner contributes capital, and the Treasury Department is directed to provide guidance implementing this intent. Reading the two statements together, it is difficult to determine what amount of income associated with contributed capital would be exempt from reclassification under section 1061.

The scope of the provision addressing transfers of applicable partnership interests to related parties is unclear. Presumably, this provision would cause recognition of gain or loss with respect to capital assets held for more than one year but not more than three years (i.e., capital assets with respect to which section 1061 would characterize gain as short-term capital gain) to the extent attributable to the transferred interest, even in nonrecognition transactions. With respect to gain-recognition transactions, the provision may require recognition of short-term capital gain upon a related-party transfer of a partnership interest held for more than three years to the extent of gain attributable to capital assets held by the partnership for more than one year but not more than three years.

The explanatory statement attempts to clarify the statutory language by providing that short-term capital gain treatment will result “notwithstanding section 83 or any election in effect under section 83(b).” According to the explanatory statement, the fact that a taxpayer has included an amount in income under section 83 upon the acquisition of an applicable partnership interest or has made an election under section 83(b) with respect to such an interest does not change the three-year holding period requirement for obtaining long-term capital gain treatment with respect to the applicable partnership interest.

Modification of the definition of substantial built-in loss in the case of transfer of partnership interest

The new law modifies the definition of a substantial built-in loss for purposes of section 743(d).

Under pre-enactment law, if the partnership has a substantial built-in loss in its property, it must decrease the adjusted basis of partnership property (with respect to the transferee partner) by the excess of the transferee partner’s proportionate share of the adjusted

basis of the partnership property over the basis of its interest in the partnership (mandatory section 743(b) adjustment). The rules determine whether there is a substantial built-in loss at the partnership level by comparing the partnership's adjusted basis in partnership property to the fair market value of its property. If the adjusted basis of all partnership property exceeds the fair market value by more than \$250,000, then the partnership is considered to have a substantial built-in loss and the mandatory section 743(b) adjustment is required to reduce the basis of the partnership assets with respect to the transferee. The purpose of the rule is to prevent the duplication of losses, once by the transferor partner upon the sale of his interest and a second time by the transferee upon the partnership's sale of the partnership property for other than small losses.

The new law modifies the definition of a substantial built-in loss to add a rule that focuses on a partner level determination to further ensure that losses are not duplicated. The expanded definition looks to whether the transfer of the interest has the effect of transferring a loss in excess of \$250,000 to the transferee, rather than just whether the partnership has an overall loss in its assets. Thus, even if the partnership has an overall gain upon the sale of all of its assets, if the transferee would be allocated more than \$250,000 in losses, as a result of its share of gain or loss with respect to particular assets, a mandatory section 743(b) adjustment would be required. Specifically, the new rule provides that a substantial built-in loss exists if the transferee would be allocated a net loss in excess of \$250,000 upon a hypothetical sale of all the partnership's assets in a fully taxable transaction for cash equal the assets' fair market value, immediately after the transfer of the partnership interest.

The JCT has estimated that the provision will raise approximately \$0.5 billion over a 10-year period.

The changes apply to tax years beginning after December 31, 2017.

KPMG observation

This provision can be expected to create additional compliance issues, requiring a partnership to calculate whether it has a substantial built-in loss both at the partnership and the transferee partner level.

Partnership charitable contributions and foreign taxes taken into account in determining partner loss limitation under section 704(d)

The new law provides that a partner's distributive share of a partnership's charitable contributions and foreign taxes paid or accrued are taken into account for purposes of determining the partner's loss limitation under section 704(d).

In the case of a charitable contribution of property in particular, the amount of a partner's section 704(d) limitation is reduced by the partner's distributive share of the partnership's tax basis in the property. If a partnership makes a charitable contribution of appreciated

property, section 704(d) does not apply to the extent that the value of the property exceeds its tax basis.

The provision is effective for tax years beginning after 2017.

The JCT has estimated that the provision will increase revenues by approximately \$1.2 billion over 10 years.

KPMG observation

While the explanatory statement acknowledges that the IRS has taken the position that section 704(d) does not apply to a partner's distributive share of a partnership's charitable contributions (see Private Letter Ruling 8405084), it indicates that the exclusion of such contributions (and foreign taxes) from the section 704(d) limitation is not appropriate.

The modification in the new law generally is consistent with rules that limit an S corporation shareholder's losses and deductions to its tax basis in the S corporation's stock and debt, taking the shareholder's pro rata share of the S corporation's charitable contributions and foreign taxes into account.

This provision was in the Senate bill but not the House bill.

Increase threshold for cash method of accounting

Under pre-enactment law, with certain exceptions, a C corporation or partnership with a C corporation partner could use the cash method of accounting only if, for each prior tax year, its average annual gross receipts (based on the prior three tax years) do not exceed \$5 million. In addition, farm corporations and farm partnerships with C corporation partners could use the cash method of accounting if for each prior tax year their gross receipts do not exceed \$1 million (\$25 million for certain family farm corporations).

Under the new law, section 448(c) is amended to provide that the threshold under the three-year average annual gross receipts test is increased to \$25 million (indexed for inflation for tax years beginning after 2018), and applies to all C corporations and partnerships with C corporation partners (other than tax shelters), including farming C corporations and farming partnerships. The three-year average test is applied annually under the legislation. A change to or from the cash method of accounting as a result of the provision is treated as a voluntary change in the taxpayer's method of accounting, subject to a section 481(a) adjustment.

Repeal of partnership technical termination rules

The new law repeals the "technical termination" rules contained in pre-enactment Code section 708(b)(1)(B). As a practical matter, although technical terminations sometimes can have favorable results, they also can result in unfavorable tax consequences and

additional compliance burdens. Thus, some partnerships may view repealing the technical termination rules as a favorable development.

The JCT has estimated that this provision will raise approximately \$1.6 billion over 10 years.

This provision applies to partnership tax years beginning after December 31, 2017.

KPMG observation

The repeal of the technical termination provisions will have implications that may be viewed favorably or unfavorably by taxpayers, depending on the particular facts and circumstances. For instance, although taxpayers will no longer have to file two short period tax returns for a partnership, M&A transactions may need to more carefully consider who will be responsible for filing the partnership tax return when there is a significant change in ownership. Also, partnerships will no longer have the opportunity to adopt a new section 704(c) method, which was previously the case following a technical termination. As a final point, partnerships will no longer need to “re-life” their assets under section 168(i)(7) (and potentially reduce the amount of annual depreciation) as a result of a technical termination which used to be a significant issue for many partnerships.

Technical termination may still be relevant for state tax purposes for states that do not adopt the federal changes.

Tax gain on the sale of foreign partner’s partnership interest on look-through basis

The new law amends section 864(c) to treat gain or loss on a sale of a partnership interest as effectively connected with a U.S. trade or business to the extent that a foreign corporation or foreign individual that owns the partnership interest (whether directly or indirectly through other partnerships) would have had effectively connected gain or loss had the partnership sold its underlying assets.

In 1991, the IRS issued Rev. Rul. 91-32,¹ which much like the pre-enactment provision held that a foreign partner’s capital gain or loss on the sale of a partnership interest is properly treated as effectively connected with a U.S. trade or business if and to the extent that a sale of the underlying assets by the partnership would have resulted in effectively connected income for the foreign partner. Recently, the Tax Court refused to follow the revenue ruling in determining that a foreign partner was not subject to U.S. tax on a sale of a partnership interest (to the extent the gain was not attributable to U.S. real property interests).²

¹ 1991-1 C.B. 107.

² *Grecian Magnesite Mining, Industrial & Shipping Co. v. Commissioner*, 149 T.C. No. 3 (July 2017).

The new law adopts a look-through rule somewhat similar to that provided in section 897(g)³ to the sale of all partnership interests, not just those that hold U.S. real property interests. Specifically, the new law provides that gain or loss from the sale, exchange, or other disposition of a partnership interest is effectively connected with a U.S. trade or business to the extent that a partner that is a foreign individual or foreign corporation would have had effectively connected gain or loss if the partnership had sold all of its assets at fair market value on the date of the exchange. For this purpose, the gain or loss from the hypothetical asset sale by the partnership is allocated to interests in the partnership in the same manner as nonseparately stated items of income or loss. The amount of the gain or loss treated as effectively connected income under the provision is reduced by the amount so treated with respect to U.S. real property interests under section 897. While the provision applies to gain or loss from the sale, exchange, or other disposition of the partnership interest, it gives broad regulatory authority to determine the appropriate application of the provision, including to various corporate nonrecognition transactions, such as contributions, liquidations, and reorganizations.

The new law also requires that the transferee of a partnership interest withhold 10% of the amount realized on a sale or exchange of the interest unless the transferor certifies that it is not a foreign person and provides a U.S. taxpayer identification number. Such a transferee must withhold if it has knowledge or is notified that the affidavit is false, or if the transferee fails to provide the Service with a copy of the transferor's affidavit in the manner required by regulations. If the transferee fails to withhold the correct amount, the new law imposes an obligation on the partnership to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold, plus interest.

The new law gives the Service authority to prescribe a reduced amount of withholding in situations where it determines that such reduced amount will not jeopardize the collection of tax on gain treated as effectively connected under section 864(c)(8).

The JCT has estimated that the provision will increase revenues by approximately \$3.8 billion over a 10-year period.

The substantive tax provision applies to transfers occurring on or after November 27, 2017; however, the withholding tax obligation only applies to transfers occurring after December 31, 2017.

KPMG observation

This provision is based on the Senate bill with modifications. Much like the rules under section 897(g), it applies to transactions that otherwise would be subject to a nonrecognition provision. However, broad regulatory authority is given to determine the appropriate application of the substantive tax provision, including with respect to a

³ Section 897(g), part of the Foreign Investment In Real Property ("FIRPTA") Tax Act, sources gain on the sale of a partnership interest as U.S. sourced to the extent consideration is received that is attributable to U.S. real property interests held, directly or indirectly, by the partnership.

number of corporate nonrecognition transactions. Hopefully, such guidance will also address the application to partnership nonrecognition transactions, such as contributions or distributions, and mergers and divisions.

This provision affects foreign partners of partnerships engaged, directly or indirectly through one or more partnerships, in a U.S. trade or business, including partners in various fund structures. Partnerships, whether U.S. or foreign, that transfer such interests are required to treat the appropriate amount of gain or loss as effectively connected to a U.S. trade or business and withhold on this amount with respect to any foreign partner under section 1446.

The reason for the requirement to allocate gains on a hypothetical sale of assets in the same manner as nonseparately stated income or loss is unclear. The new law does not define “nonseparately stated items” for purposes of this provision. That term possibly could describe the partnership’s net income or net loss remaining after all items required by section 702(a) to be separately stated are removed, which includes the removal of capital gains and losses and any item that, if separately taken into account by any partner, would result in a differing income tax liability for the partner than if not separately stated. Practitioners colloquially use the term to describe net operating income. Of note, the conference report indicates that the use of “nonseparately stated taxable income or loss of the partnership” for purposes of section 163(j) is the ordinary business income or loss reflected on Form 1065 (U.S. Return of Partnership Income), and a partner’s distributive share of this amount is reflected in Box 1 of Schedule K-1. If the intent of the provision is to use the sharing ratios for operating income, similar to the use in section 163(j), the determination of the amount of gain that is effectively connected seemingly does not make sense. Partnerships often have different sharing ratios in operating income and gains from the sale of assets used in the trade or business. As such, using the ratio of nonseparately stated income to determine the amount of gain or loss on the sale of a partnership interest that is effectively connected with a U.S. trade or business could yield different results from the effectively connected gains or losses allocated to a partner from an actual sale of assets by the partnership that is determined pursuant to the partnership agreement provisions.

The provision requires that gain from the sale, exchange, or other disposition of the interest is treated as effectively connected with the conduct of a U.S. trade or business to the extent it does not exceed the portion of the partner’s distributive share of effectively connected gain from a hypothetical sale of partnership assets. As such, the provision appears to limit effectively connected gain to the gain realized from the exchange of the partnership interest. This result appears to differ from the result under section 751(a) which can result in more ordinary “hot asset” income than the gain otherwise realized on the exchange of the partnership interest. Accordingly, where the partnership holds both appreciated effectively connected assets, and depreciated non-effectively connected assets, it appears that not all of the foreign partner’s effectively connected gain, as determined on a look-through basis, would be recognized under the provision. A similar provision is provided with respect to effectively connected loss from the exchange.

The withholding provision imposed on transferees applies to transfers of partnership interests where a foreign partner's gain on the disposition of the interest would be effectively connected gain. It appears that the withholding provisions apply to nonrecognition exchanges. The withholding regime differs from the withholding regime imposed under section 1445 with respect to the sale or exchange of an interest in a partnership that holds U.S. real property interests in that the only explicit exception from 10% withholding is if the transferor certifies it is not a foreign person, although the IRS is given latitude to provide for reduced withholding and additional exceptions in appropriate circumstances. Note further that the withholding regime applies to transferees where the transferor is a foreign partnership, and there yet there still remains an obligation to withhold by the foreign partnership under section 1446(a) with respect to its foreign partners. Without additional exceptions or coordination, duplicative or over-withholding could result.

Finally, the provision also differs from the section 1445 regime in that an obligation is imposed on the partnership to withhold on distributions to the transferee in an amount that the transferee failed to withhold, plus interest. The new law does not indicate the applicable rate of interest. This puts an onus on the partnership to determine whether there was sufficient withholding, and in some cases could raise questions as to what the amount realized was on which withholding should have been done (in cases of nonrecognition transfers, for example).

Other S corporation only provision

Provisions applicable to “eligible terminated S corporations”

The new law contains two generally favorable provisions applicable to “eligible terminated S corporations.” The provisions appear to be based on an expectation that some S corporations may revoke their S corporation status following enactment of the new law. For purposes of both provisions, an eligible terminated S corporation is any C corporation: (i) that was an S corporation on the day before the date of enactment and revokes its S corporation election in the two-year period beginning on the date of such enactment; and (ii) the owners of the stock of which (determined on the date on which such revocation is made) are the same as, and such owners hold the stock in the same proportions as, on the date of enactment.

The first provision relates to accounting method changes required as a result of an S corporation's conversion to a C corporation. Specifically, the new law provides that, in the case of an eligible terminated S corporation, any section 481 adjustment arising from an accounting method change attributable to the corporation's revocation of its S corporation election will be taken into account ratably during the six-tax year period beginning with the year of the method change. Thus, a corporation that must change a method of accounting as a result of the revocation of its S corporation election would include any income resulting from that change over six tax years (as opposed to e four-years).

The second provision revises the treatment of distributions made by certain corporations following their conversion to C corporation status. Under pre-enactment law, distributions by an S corporation generally are treated as coming first from the S corporation's accumulated adjustments account ("AAA"), which effectively measures the income of the S corporation that has been taxed to its shareholders but remains undistributed. If AAA is exhausted by the distribution, the excess distribution is treated as coming from any earnings and profits ("E&P") of the corporation generated when it was a C corporation (or inherited from a C corporation under section 381). For a shareholder, distributions out of AAA generally are more favorable, as such distributions are tax-free to the extent of the shareholder's basis in its S corporation stock and then give rise to capital gain. In contrast, distributions out of E&P are treated as dividends and taxed accordingly.

If a corporation's S corporation election terminates, special rules apply to distributions made by the resulting C corporation during the post-transition termination period ("PTTP"). The PTTP begins on the day after the last day of the corporation's last tax year as an S corporation and generally ends on the later of: (i) the day that is one year after that day; or (ii) the due date for filing the return for such last year as an S corporation (including extensions). However, the PTTP may be extended in certain situations. A distribution of cash made by a C corporation with respect to its stock during the PTTP is applied against and reduces the shareholder's basis in the stock to the extent the amount of the distribution does not exceed the corporation's AAA. Thus, cash distributions by a former S corporation may be subject to the generally beneficial S corporation treatment of distributions, but only during the PTTP. After expiration of the PTTP, any distributions made by the former S corporation would be treated as coming first from the corporation's E&P and thus taxable as a dividend to the extent thereof.

The new law extends in part the generally beneficial treatment of distributions for certain former S corporations beyond the PTTP. Specifically, a distribution of money by an eligible terminated S corporation following the PTTP would be treated as coming out of the corporation's AAA or E&P in the same ratio as the amount of the corporation's AAA bears to the amount of the corporation's accumulated E&P.

The JCT has estimated that the changes applicable to eligible terminated S corporations will decrease revenue by approximately \$6.1 billion over a 10-year period.

The provisions generally are effective as of the date of enactment.

KPMG observation

Under pre-enactment law, an S corporation that became a C corporation may have been under pressure from its shareholders to distribute cash equal to its AAA during the PTTP because the AAA effectively represents the income of the corporation with respect to which the pre-C corporation conversion shareholders have already been taxed. Thus, the shareholders may have wanted to avoid the additional layer of tax on that income that arises if the distribution is characterized as a dividend. Allowing a portion of post-PTTP distributions to be treated as coming from AAA as the new law does may allow the

corporation to avoid the resulting strain on its liquidity. However, this favorable treatment does not change the general treatment of a distribution from AAA, i.e., that the portion of the distribution attributable to AA will reduce stock basis and result in capital gain to the extent the distribution exceeds basis.

Changes relating to electing small business trusts

For a corporation to qualify as an S corporation, ownership of the corporation's stock is limited to certain permitted shareholders; one type of trust permitted to own stock in an S corporation is an electing small business trust (an "ESBT"). The portion of an ESBT that owns stock in an S corporation is treated as a separate trust and the S corporation's income allocated to the ESBT is taxed to the trust itself (rather than to the trust's beneficiaries).

To qualify as an ESBT, a trust must meet certain requirements, including that a nonresident alien individual may not be a potential current beneficiary of an ESBT. This is consistent with a rule that precludes a nonresident alien individual from owning stock in an S corporation.

As noted above, an ESBT's allocable share of the corporation's income is taxed to the trust; that income is taxed at the highest individual tax rate. Because an ESBT is a trust, the charitable contribution deduction applicable to trusts—rather than individuals—applies to the ESBT. A trust generally is allowed a deduction for any amount of gross income (without limitation) which is paid for a charitable purpose; no carryover of excess deductions is allowed. In contrast, an individual's charitable contribution deduction is limited to certain percentages of adjusted gross income, with a carryforward of amounts in excess of the limitation.

The new law amends prior law to provide that the charitable contribution deduction allowed for the portion of an ESBT holding S corporation stock is determined under the rules applicable to individuals, rather than those applicable to trusts. The provision applies to tax years beginning after December 31, 2017.

Further, the new law allows a nonresident alien individual to be a potential current beneficiary of an ESBT. The provision is effective on January 1, 2018.

The JCT has estimated that the changes relating to ESBTs will decrease revenue by approximately \$300 million over a 10-year period.

KPMG observation

This provision may expand the number of corporations that elect S corporation status, as well as the ability of S corporation shareholders to engage in gift and estate tax planning. Prior proposals would have made the same change. However, other aspects of the new law may make operating a business as an S corporation less desirable (and thus the

expansion of potential current beneficiaries to include nonresident alien individuals may affect only a limited number of corporations).

International

In the context of international tax, the new law substantially eliminates any element of deferred taxation of foreign income -- generally income is taxed as earned, or is permanently exempt from U.S. taxation. Despite allowing permanent exemption for a residual class of income, the new law generally retains pre-enactment subpart F to provide full and immediate taxation of the classes of income that are captured by pre-enactment law, and furthermore subjects a new, very broad, class of income (“global intangible low-taxed income”) to immediate taxation at a reduced rate. In all of these respects, the new law generally follows the approach set forth in the Senate bill. As a transition from the former deferral regime to these new rules, existing untaxed earnings of “specified foreign corporations” are deemed repatriated and taxed at a reduced rate that depends upon the extent to which the earnings are matched by cash held offshore.

The new law also contains provisions intended to curtail base erosion. Interest expense is limited to 30% of adjusted taxable income⁴ (discussed above) and deductions are disallowed for transactions involving related parties and hybrid instruments or transactions. The new law also adopts (with modifications) a novel new alternative minimum tax focused on deductible payments made by U.S. persons (including domestic partnerships and S corporations) to related foreign persons originally proposed in the Senate bill.

Certainly, the sum total of these changes represents a significant expansion of the base of cross-border income to which current U.S. taxation applies.

Mandatory repatriation

Section 965 of the new law includes a transition rule to effect the participation exemption regime. This transition rule provides that the subpart F income of a specified foreign corporation (SFC) for its last tax year beginning before January 1, 2018, is increased by the greater of its accumulated post-1986 deferred foreign income (deferred income) determined as of November 2 or December 31, 2017 (a measuring date). A taxpayer generally includes in its gross income its pro rata share of the deferred income of each SFC with respect to which the taxpayer is a U.S. shareholder. This mandatory inclusion, however, is reduced (but not below zero) by an allocable portion of the taxpayer’s share of the foreign E&P deficit of each SFC with respect to which it is a U.S. shareholder and the taxpayer’s share of its affiliated group’s aggregate unused E&P deficit.

The transition rule includes a participation exemption, the net effect of which is to tax a U.S. shareholder's mandatory inclusion at a 15.5% rate to the extent it is attributable to the shareholder's aggregate foreign cash position and at an 8% rate otherwise.

KPMG observation

The new law includes two measuring dates for determining an SFC's deferred income. The new law's November 2 measuring date adds complexity to the transition rule because it requires each SFC to calculate its deferred income on a date that is not likely to coincide with regular reporting cycles. Additionally, the inclusion of the December 31 measuring date requires SFCs to compute their deferred income twice because the E&P taken into account under the transition rule is the greater amount.

SFC and U.S. shareholder definitions

An SFC is a foreign corporation that is a controlled foreign corporation (CFC) or foreign corporation that has at least one domestic corporate U.S. shareholder. The new law revises the definition of "U.S. shareholder" in section 951(b) to include any U.S. person that owns at least 10% of the vote *or* value of a foreign corporation. However, this change is made effective for tax years of foreign corporations beginning after December 31, 2017, and thus, does not apply for purposes of the new law's transition rule.

The new law removes section 958(b)(4) for the last tax year of foreign corporations beginning before January 1, 2018 and all subsequent tax years and for the tax years of a U.S. shareholder with or within which such tax years end. Thus, "downward attribution" of stock ownership from foreign persons is taken into account for purposes of determining whether a U.S. person is a U.S. shareholder of a foreign corporation for purposes of the new law's transition rule.

KPMG observation

A "U.S. shareholder" includes domestic corporations, partnerships, trusts, estates, and U.S. individuals that directly, indirectly, or constructively own 10% or more of an SFC's voting power. As a result, non-corporate U.S. shareholders are exposed to inclusions under the new law's transition rule if the SFC is a controlled foreign corporation or any foreign corporation with at least one domestic corporate U.S. shareholder, even though the participation exemption regime for dividends from foreign subsidiaries in the new law only applies to corporate U.S. shareholders.

The new law's repeal of section 958(b)(4) applies for purposes of determining whether a foreign corporation is an SFC and also for purposes of determining whether a U.S. person is a U.S. shareholder. For example, if a domestic corporation owns 9% of a foreign affiliate, and the remaining 91% of the foreign affiliate is owned by the domestic corporation's foreign parent, the foreign affiliate is an SFC and the domestic corporation is a U.S. shareholder of the affiliate. Therefore, the domestic corporation would have to include its pro rata share of the foreign affiliate's deferred income, although the amount of the domestic corporation's mandatory inclusion would be based solely on its direct and

indirect ownership (here, 9%) of the foreign affiliate and only take into account E&P accrued during periods the foreign affiliate was an SFC. Also, foreign income taxes paid or accrued by the foreign affiliate are not attributed to the domestic corporation's mandatory inclusion because the domestic corporation does not own at least 10% of the foreign affiliate's voting stock. These consequences could affect the domestic corporation's estimated tax liability.

Deferred income and E&P deficits

Deferred income is an SFC's E&P accumulated in tax years beginning after December 31, 1986, for the periods in which the corporation was an SFC, determined as of the measuring date (i.e., November 2 or December 31, 2017) and that are not attributable to effectively connected income that is subject to U.S. tax or amounts that if distributed would be excluded from a U.S. shareholder's gross income under the section 959 previously taxed income (PTI) rules (either previously or in the tax year to which the transition rule applies) (post-1986 E&P). For these purposes, an SFC's post-1986 E&P are not reduced for dividends during the mandatory repatriation year, other than dividends distributed to another SFC.

A U.S. shareholder can reduce, but not below zero, its pro rata share of an SFC's post-1986 E&P by an allocable portion of the shareholder's pro rata share of its SFCs' post-1986 E&P deficits (aggregate E&P deficit); the new law clarifies that hovering deficits are included for these purposes. A U.S. shareholder allocates its aggregate E&P deficit to its SFCs with positive post-1986 E&P in proportion to the amount of their post-1986 E&P. The post-1986 E&P of an SFC that is reduced by an allocable portion of a U.S. shareholder's aggregate E&P deficit is treated as PTI beginning with the SFC's last tax year that begins before January 1, 2018. Additionally, if an SFC's post-1986 E&P deficit is used to offset another SFC's post-1986 E&P, the E&P of the SFC with the post-1986 E&P deficit is increased, for tax years beginning with the SFC's last tax year that begins before January 1, 2018, by the amount of the offset.

After allocating its aggregate E&P deficit, a U.S. shareholder that would otherwise have deferred income (i.e., the aggregate of the U.S. shareholder's pro rata share of its SFCs' post-1986 E&P exceeds its aggregate E&P deficit) can reduce its deferred income by its share of its affiliated group's aggregate unused E&P deficit. An affiliated group's "aggregate unused E&P deficit" is the sum of each group member's "unused E&P deficit," which generally is the amount by which a group member's aggregate foreign E&P deficit exceeds the aggregate of its pro rata share of its SFCs' post-1986 E&P. An affiliated group's aggregate unused E&P deficit is allocated to each group member based on the relative amount of each member's deferred income. Note that these rules which mandate netting first within a chain owned by a single shareholder and then across to chains owned by other members of an affiliated group appear to be changed within consolidation by the rule announced in Notice 2017-07 that would treat all members of the consolidated group as a single U.S. shareholder. The transition rule includes a rule that adjusts the application of these affiliated group "netting" rules to group members that are not wholly owned (measured by value) within the group.

KPMG observation

The new law requires computation of post-1986 E&P without regard to certain current year dividends. In particular, it is clear that dividends paid by an SFC to its U.S. shareholders during the mandatory repatriation year fail to reduce the E&P available for mandatory repatriation (although such E&P may be converted to PTI and thus not taxed upon receipt).

The new law's definition of post-1986 E&P only includes E&P of a foreign corporation accumulated during periods when the foreign corporation was an SFC. The new law does not, however, define post-1986 E&P by reference to the period that a U.S. shareholder has directly or indirectly owned an SFC. Thus, it appears that a U.S. shareholder must include its pro rata share of an SFC's post-1986 E&P that accumulated during periods the foreign corporation was an SFC as a result of another U.S. shareholder's ownership.

The new law recognizes that basis adjustments to the stock of SFCs may be necessary to account for a U.S. shareholder's inclusion of deferred income or such shareholder's use of a SFC's deficit to offset deferred income. The new law anticipates that the Treasury will issue regulations that will address the timing of adjustments to the basis of the stock of SFCs. These anticipated regulations would appear to be aimed at alleviating the potential for gain recognition on the distribution of amounts treated as PTI as a result of the transition rule. The new law also anticipates regulations that will reduce the basis of SFCs with deficits.

Participation exemption

Under the new law's participation exemption in section 965(e), a U.S. shareholder is taxed at reduced rates on its mandatory inclusion. The portion of the inclusion attributable to the U.S. shareholder's aggregate foreign cash position is taxed at 15.5% and the remaining portion is taxed at 8%. The participation exemption uses a deduction to achieve these reduced rates. The amount of a U.S. shareholder's deduction is the sum of the amounts necessary to tax its mandatory inclusion attributable to its aggregate foreign cash position at 15.5% and the remaining portion at 8% using the highest corporate tax rate in effect for the year of the inclusion.

A U.S. shareholder's "aggregate foreign cash position" is the greater of: (i) the aggregate of its pro rata share of its SFCs' cash positions as of the close of their last tax year beginning before January 1, 2018; or (ii) one half of the aggregate of its pro rata share of its SFCs' cash positions as of the close of their last two tax years ending before November 2, 2017. An SFC's "cash position" generally is the sum of its cash, net accounts receivable, and fair market value of certain other liquid assets (e.g., actively traded personal property, commercial paper, certificates of deposit, government securities, short-term obligations, and foreign currency). In Notice 2018-07, the IRS clarified that accounts receivable or payable and short term obligations between related SFCs will be disregarded to the extent that the SFCs share common ownership under a U.S. shareholder (thus following the consolidation regime). The notice also notes that certain

financial instruments and derivatives (e.g., notional principal contracts, options, forwards, etc.) will be identified as cash equivalents in forthcoming regulations but that such regulations will include exceptions for “bona fide hedging transactions.”

The new law includes a “double counting” rule that prevents a U.S. shareholder from taking into account the cash position of an SFC attributable to the SFC’s net accounts receivable, actively traded personal property, or short-term obligations, if the U.S. shareholder demonstrates to the satisfaction of the Secretary that it takes into account such amount with respect to another SFC. Non-corporate entities are treated as SFCs for purposes of determining a U.S. shareholder’s aggregate foreign cash position if an SFC owns an interest in the entity and the entity would be treated as an SFC of the U.S. shareholder if it was a foreign corporation. The determination of a U.S. shareholder’s aggregate foreign cash position is subject to an anti-abuse rule. Notice 2018-17 sets forth a series of examples that highlight the types of transactions resulting in double-counting or double non-counting that will be mitigated through forthcoming regulations.

KPMG observation

The new law ties the calculation of its deduction to the corporate income tax rate, even though its deduction applies to corporate and noncorporate U.S. shareholders. It is possible that section 962 may be elected by individual U.S. shareholders (including partners and S corporation shareholders that own 10% of a CFC through a partnership or S corporation) to mitigate this negative impact.

As noted above, amounts included by U.S. shareholders under the transition rule and post-1986 E&P of SFCs that are reduced by deficits are treated as PTI for purposes of section 959. Foreign currency movements between the date PTI is created and the date of distribution may generate foreign currency gain and losses under section 986(c). The explanatory statement accompanying the conference agreement anticipates that the Treasury will provide regulations that will allow a similar participation exemption to reduce the amount of such gain or loss.

The new law provides a list of assets that are considered to be included in the U.S. shareholder’s cash position. The new law does not provide that “blocked” assets (i.e., those that cannot be distributed under local law) are excluded from a U.S. shareholder’s cash position.

The new law’s double counting rule limits, but does not eliminate, the potential for the cash positions of a U.S. shareholder’s SFCs to be double counted. For example, the new law’s double counting rule does not appear to apply to short-term obligations between SFCs with different U.S. shareholders. Also, if a calendar-year-end U.S. shareholder has a calendar year end SFC and a fiscal-year-end SFC, it appears that the U.S. shareholder’s aggregate foreign cash position applies to the deferred income of both SFCs. Specifically, the U.S. shareholder determines its aggregate foreign cash position once, notwithstanding that it includes the deferred income of its calendar year end SFC in its tax year ending December 31, 2017, and the deferred income of its fiscal year end

SFC in its tax year ending December 31, 2018. That is, it appears that for purposes of determining the rate at which its fiscal year end SFC's deferred income is taxed, the U.S. shareholder's aggregate foreign cash position is not reduced for the amount of its calendar year end SFC's deferred income that was already attributed to its aggregate foreign cash position. Notice 2018-07 provides a method to mitigate double counting of the aggregate cash position when a U.S. shareholder holds interests in SFCs with respect to which the section 965 inclusion will occur in different taxable years (e.g., a calendar year U.S. shareholder owning both 11/30 and 12/31 year-end CFCs). Specifically, the aggregate foreign cash position that is taken into account in the inclusion year will be the lesser of the U.S. shareholder's aggregate foreign cash position in or aggregate section 965(a) inclusion in that taxable year. Further, in determining a U.S. shareholder's aggregate cash position, any amount taken into account in a subsequent taxable year will be reduced by the amount taken into account in the preceding taxable year.

Foreign tax credits

The new law allows the use of section 902 deemed paid foreign income taxes associated with the taxable portion of the mandatory inclusion. Partners or S corporation shareholders that make a section 962 election would be able to claim foreign tax credits as if they were a domestic corporation. Foreign tax credits are disallowed to the extent that they are attributable to the portion of the mandatory inclusion excluded from taxable income pursuant to the participation deduction (55.7% of the foreign taxes paid attributable to the cash portion of the inclusion taxed at 15.5%; 77.14% of the foreign taxes paid attributable to the non-cash portion of the inclusion taxed at 8%). Foreign tax credits disallowed may not be taken as a deduction. The U.S. shareholder's section 78 gross-up is equal to the portion of the foreign taxes attributable to the U.S. shareholder's net mandatory inclusion (i.e., the foreign taxes attributable to the gross mandatory inclusion less such taxes attributable to the participation deduction).

KPMG observation

The new law allows foreign income taxes associated with the taxable portion of a U.S. shareholder's mandatory inclusion to offset the U.S. tax on such amount. The new law "haircuts" the foreign tax credits associated with a U.S. shareholder's mandatory inclusion by 55.7% for foreign income taxes associated with the portion of the inclusion attributable to the shareholder's aggregate foreign cash position and 77.1% for foreign income taxes associated with the other portion of the inclusion. These percentages are equal to the amount of the U.S. shareholder's mandatory inclusion that is offset by the participation exemption that is calculated using a corporate tax rate of 35%. As noted above, the amount of the participation exemption may be reduced to the extent that the corporate tax rate is 21% for the tax year of the mandatory inclusion; however, the amount of disallowed FTCs does not appear to be similarly adjusted. Additionally, a U.S. shareholder's section 78 gross-up appears to exceed the amount of foreign taxes allowed as a credit when the corporate tax rate is 21% because, although the amount of the haircut remains unchanged, the amount of foreign taxes attributable to the U.S. shareholder's net mandatory inclusion would increase due to a reduction in the amount

of the participation exemption. As a result, it appears that the net impact on US tax liability ought to be the same whether an amount is included in income during 2017 or during 2018.

The new law does not address the use of foreign tax credit carryforwards to offset a U.S. shareholder's mandatory inclusion or the carryforward of foreign tax credits not used in the tax year in which a U.S. shareholder takes into account its mandatory inclusion. Thus, it appears that the pre-enactment rules regarding foreign tax credit carryforwards apply to the transition rule. As a result, it appears that a U.S. shareholder can use existing foreign tax credit carryforwards against its mandatory inclusion and the foreign tax credit carryforward period remains 10 years.

Overall foreign loss recapture

The conference report did not discuss the impact of the mandatory inclusion on a U.S. shareholder's overall foreign loss (OFL) or separate limitation losses (SLLs).

Net operating loss election

The new law allows taxpayers to elect out of using net operating losses (NOLs) to offset the mandatory inclusion from the transition rules. This rule allows taxpayers to avoid reducing their foreign source income from the mandatory inclusion to preserve the use of foreign tax credits in such year and it allows taxpayers to preserve their NOLs for future use.

Payment

Section 965(h) under the new law provides that the tax assessed on a U.S. shareholder's mandatory inclusion is payable in the same manner as its other U.S. federal income taxes and that such tax assessed may be paid over an eight-year period. The new law requires that 8% of the tax be paid in each of the first five years, 15% in the sixth year, 20% in the seventh year, and 25% in the eighth year. Only the U.S. federal income tax due on the mandatory inclusion is eligible to be paid in installments. The new law would accelerate the payment of the tax upon the occurrence of certain "triggering events," which include an addition to tax for failure to timely pay any installment due, a liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 case), or a cessation of business by the taxpayer to the date of such triggering event. The new law does not provide for any exceptions to acceleration.

S corporations – Special deferral election

Section 965(i) under the new law provides that if an S corporation is a U.S. shareholder of an SFC, each shareholder of the S corporation may elect to defer paying its net tax liability on its mandatory inclusion until its tax year that includes a "triggering event" with respect to the liability. A net tax liability that is deferred under this election appears to be assessed as an addition to tax in the electing shareholder's tax year as the bill provides

that the electing shareholder (and the S corporation) would be liable, jointly and severally, for the net tax liability and related interest of penalties.

A “triggering event” for purposes of this provision includes the corporation ceasing to be an S corporation, a liquidation or sale of substantially all of the assets of such S corporation, a cessation of business by such S corporation, such S corporation ceases to exist, or similar circumstances, and a transfer of any share of stock of the S corporation (including by death or otherwise) except that the transfer is not a triggering event if the transferee enters into an agreement with the Secretary under which the transferee is liable for net tax liability with respect to the stock. However, if the transfer is a triggering event (because the transferee does not assume the tax liability) then it is a triggering event only with respect to so much of the net tax liability as is properly allocable to the transferred stock.

An S corporation shareholder that elects to defer paying its net tax liability under the new law’s transition rule may also elect to pay this liability in equal installments over an 8-year period after a triggering event has occurred. However, this election is available only with the consent of the Secretary if the triggering event is a liquidation, sale of substantially all of the S corporation’s assets, termination of the S corporation or cessation of its business, or a similar event. The first installment must be paid by the due date (without extensions) of the shareholder’s U.S. federal income tax return for the year that includes the triggering event.

If any S corporation shareholder elects to defer paying its net tax liability, the S corporation is jointly and severally liable for the payment of the deferred tax and any penalty, additions to tax, or additional amounts attributable thereto, and the limitation on collection is not treated as beginning before the triggering event.

KPMG observation

The new law provides a deferral election that is available only to shareholders of S corporations that hold the S corporation stock at the time of the mandatory repatriation of deferred foreign income. This applies generally to S corporations that held stock in a CFC or SFC as of December 31, 2017, in situations where the CFC or SFC has income that has not been included in the shareholder’s income (i.e., deferred foreign income). The S corporation shareholders can elect to defer tax on the inclusion until a “triggering event.” As a result of the deferral election, there is potentially a very lengthy deferral on the tax on the repatriation income. Once a triggering event occurs, the shareholder who elected deferral can then choose to use the 8-year installment method to pay the tax.

Current year inclusion of global intangible low-taxed income by United States shareholders

Section 951A under the new law requires a U.S. shareholder of a CFC to include in income its “global intangible low-taxed income” (“GILTI”) in a manner similar to subpart F income. New section 250 generally allows a deduction for corporate shareholders equal

to 50% of GILTI, which is reduced to 37.5% starting in 2026. In general, GILTI is determined at the U.S. shareholder level as the excess of all CFCs' net income over a deemed return on tangible assets

In general, when a U.S. person is (i) a 10% U.S. shareholder of a CFC (taking into account the broad constructive ownership rules applicable in subpart F) on any day during the CFC's tax year during which the foreign corporation is a CFC; and (ii) the U.S. person owns a direct or indirect interest in the CFC on the last day of the tax year of the foreign corporation on which it is a CFC (without regard to whether the U.S. person is a 10% shareholder on that day), then the U.S. person would be required to include in its own income its pro rata share of the GILTI amount allocated to the CFC for the CFC's tax year that ends with or within its own tax year. A U.S. shareholder would increase its basis in the CFC stock for the GILTI inclusion, which generally would be treated as "previously taxed income" for subpart F purposes.

KPMG observation

One of the most important provisions in the new law would impose a tax on a U.S. shareholder's pro rata share of its CFC's GILTI. Similar to other amounts calculated under subpart F, the GILTI is included in a U.S. shareholder's income each year without regard to whether that amount was distributed by the CFC to the U.S. shareholder during the year.

This provision reflects a concern that shifting to a territorial tax system could exacerbate base erosion incentives because any shifted profits could be permanently exempt from U.S. tax. The inclusion of GILTI in a U.S. shareholder's income is intended to reduce those incentives further by ensuring that CFC earnings that exceed a deemed return on its tangible assets are subject to some measure of U.S. tax (at a rate potentially as low as 10.5% through 2025⁵ when the 50% deduction described above is allowed).

Both the reduction in the corporate tax rate and the exemption from income of dividends received from CFCs are described as increasing the competitiveness of U.S. corporations and levelling the playing field with foreign multinationals. It is worth noting that an immediate tax, which in many cases would be imposed on most of a CFC's earnings, even at an effective rate of 10.5% for corporate shareholders (after taking into account the 50% deduction described above) would be comparatively unfavorable to the CFC regimes of most of the major trading partners of the United States, which typically tax CFC earnings in much more limited circumstances.

GILTI. In general, GILTI is described as the excess of a U.S. shareholder's net CFC tested income over its "net deemed tangible income return," which is defined as 10% of its CFCs' "qualified business asset investment," reduced by certain interest expense taken into account in determining net CFC tested income.

⁵ The effective tax rate on GILTI would be commensurately higher starting in 2026 after the GILTI deduction is reduced to 37.5%.

Under the new law, the full amount of GILTI is included in a U.S. shareholder's income. Corporate shareholders would be allowed a deduction equal to 50% of GILTI for 2018 through 2025, which would be decreased to 37.5% beginning in 2026. The deduction for GILTI is limited when the GILTI inclusion (including the section 78 gross up for foreign taxes attributable to the GILTI inclusion) and "foreign derived intangible income" (FDII) exceed the corporation's taxable income, determined without regard to the GILTI and FDII deductions. Because the GILTI deduction is limited by taxable income, net operating losses would be absorbed against the gross amount of GILTI before any GILTI deduction is allowed, and there is no carryforward for the foregone portion of any GILTI deduction due to the limitation to taxable income. Non-corporate U.S. shareholders would be subject to full U.S. tax on GILTI inclusions, based on applicable rates.

The new law clarifies that applicable U.S. shareholders can make a Code section 962 election with respect to GILTI inclusions, pursuant to which the electing shareholder would be subject to tax on the GILTI inclusion based on corporate rates, and would be allowed to claim FTCs on the inclusion as if the shareholder were a corporation. Although the interaction of the corporate-level GILTI deduction with Code section 962 is not entirely clear, reducing an electing shareholder's GILTI inclusion by the GILTI deduction would be consistent with treating the electing shareholder as a domestic corporation, which fits within the general framework of section 962.

Tested income. The new law defines "net CFC tested income" as, with respect to any U.S. shareholder for any taxable year, the excess of the shareholder's aggregate pro rata share of the tested income of each CFC for which the shareholder is a U.S. shareholder for such taxable year over the aggregate pro rata share of the tested loss of each such CFC. For this purpose, "tested income" of a CFC generally is described as the gross income of the CFC other than: (i) ECI; (ii) subpart F income; (iii) amounts excluded from subpart F income under the Code section 954(b)(4) high-tax exception; (iv) dividends received from a related person (as defined in Code section 954(d)); and (v) foreign oil and gas extraction income, over deductions allocable to such gross income under rules similar to Code section 954(b)(5) (or to which such deductions would be allocable if there were such gross income). Tested loss is defined to mean the excess of deductions allocable to such gross income over the gross income.

Net deemed tangible income return. Under the new law, the "net deemed tangible income return" is defined as 10% of the excess of the aggregate of each CFCs' qualified business asset investment ("QBAI") over the amount of interest expense taken into account in determining the shareholder's net CFC tested income, to the extent the interest income attributable to the expense is not taken into account in determining the shareholder's net CFC tested income. QBAI is determined as the average of the adjusted bases (determined at the end of each quarter of a tax year) in "specified tangible property" that is used in the production of tested income and that is subject to Code section 167 depreciation. The conference report's explanatory statement indicates that specified tangible property would not include property used in the production of a tested loss, so a CFC that has a tested loss in a taxable year would not have any QBAI for that year.⁶ For

⁶ Footnote 1536 of the conference report's explanatory statement at page 642.

purposes of computing QBAI, the adjusted basis of property would be determined under the alternative depreciation rules of Code section 168(g), and by allocating the depreciation deductions ratably to each day during the period in the tax year to which the depreciation relates.

KPMG observation

The net deemed tangible income return is determined by applying a 10% fixed rate of return to QBAI, and reducing the result by the interest expense taken into account in determining net CFC tested income, to the extent the interest income attributable to the expense is not taken into account in determining net CFC tested income. As a result, interest expense incurred between a U.S. shareholder's CFCs generally will not reduce the deemed return, but the deemed return will be reduced for interest expense incurred by a CFC as a result of third party debt owed to an unrelated person or to related CFCs that are owned outside the U.S. shareholder's chain. In many cases, the deemed return on tangible assets will be negligible, for example because (i) the CFC's primary value-driver is intangible assets (notably, no relief is given for a return on intangible assets even when a taxpayer has purchase basis in the assets); or (ii) the CFC's tangible property is substantially depreciated. In such cases, the tax base on which the tax is imposed in many cases may be a U.S. shareholder's ratable share of tested income without reduction for any sort of exempt return.

Deemed-paid foreign tax credit. For any amount of GILTI that is includible in a U.S. corporate shareholder's income, the new law provides for a limited deemed paid credit of 80% of the foreign taxes attributable to the tested income (as defined above) of the CFCs. The foreign taxes attributable to the tested income are determined using an aggregate computation at the U.S. shareholder level, as the product of (i) the domestic corporation's "inclusion percentage", multiplied by (ii) the aggregate foreign income taxes paid or accrued by each of the shareholder's CFCs that are properly attributable to tested income of the CFC that is taken into account by the U.S. shareholder under section 951A. Thus, taxes attributable to a CFC that earns a tested loss for a taxable year do not appear to be taken into account.

The inclusion percentage is the ratio of the shareholder's aggregate GILTI divided by the aggregate of the shareholder's share of the tested income of each CFC. This ratio presumably is intended to compare the amount included in the U.S. shareholder's income and subject to tax in the United States (the GILTI) to the amount with respect to which the relevant foreign taxes are imposed (the tested income) to determine the relevant percentage of foreign taxes that should be viewed as deemed paid for purposes of the credit.

The new law computes the section 78 gross-up by reference to 100% of the related taxes, rather than by reference to the 80% that are allowable as a credit. Although the gross up amount is included in income as a dividend, it is not eligible for the Code section 245A 100% DRD, but is eligible for the GILTI deduction.

In addition, the new law creates a separate basket for these deemed paid taxes to prevent them from being credited against U.S. tax imposed on other foreign-source income. Moreover, any deemed-paid taxes on GILTI are not allowed to be carried back or forward to other tax years.

KPMG observation

The explanatory statement includes a simple example illustrating the interaction of the 50% deduction with the 20% haircut on foreign tax credits, which concludes that U.S. tax would not be owed when the effective foreign tax rate on the underlying income is 13.125%. This conclusion is misleading for several reasons, including: (i) a taxpayer may not have sufficient income to take the full GILTI deduction, due to a current-year loss from other activities or an NOL carryforward; (ii) there will always be leakage of the foreign tax credit when there is at least one tested loss CFC because, although the GILTI inclusion is computed by allowing an offset for tested losses, the denominator of the “inclusion percentage” is the aggregate of all tested income without offset for tested losses; and (iii) taxpayers may be required to allocate expenses to the GILTI basket, precluding them from obtaining the full benefit of taxes paid with respect to their “tested income.”

In addition, because there is no carryforward or other provision to mitigate the consequences of timing differences between U.S. and foreign income tax laws, it is possible that U.S. shareholders whose CFCs generally are subject to significant foreign taxes may nonetheless owe residual U.S. tax in a particular year if significant income is recognized in that year for U.S. tax purposes but not for foreign tax purposes. For large multinationals this issue may be mitigated by the ability to average across CFCs, but cyclical businesses nevertheless could be especially susceptible to this problem. Moreover, by precluding carryover, the new deemed FTC provision may put some taxpayers in a position where they are better off deducting rather than crediting the relevant foreign taxes they are deemed to pay under the provision.

These rules are effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, the GILTI rules (including the GILTI deduction) will increase revenues by \$112.4 billion over 10 years.

KPMG observation

To mitigate the impact of these rules in 2018, U.S. shareholders with a calendar year should consider electing a November 30 year end for their CFCs, in which case the income of their CFCs would not be subject to the tax until December 1, 2018. In the case of a U.S. shareholder with a fiscal year, that U.S. shareholder generally would be exempt from the tax until the first day of the CFC’s fiscal year beginning in 2018 (for example, a CFC with a September 30 year-end would become subject to the tax beginning October 1, 2018).

Limit deduction of certain related-party amounts paid or accrued in hybrid transactions or with hybrid entities

Section 267A of the new law disallows a deduction for any disqualified related-party amount 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 if (i) there is no corresponding income inclusion to the related party under local tax law or (ii) such related party is allowed a deduction with respect to the payment under local tax law. A disqualified related-party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under section 951(a) (i.e., a “subpart F” inclusion). A related party for these purposes is determined by applying the rules of section 954(d)(3) to the payor (as opposed to the CFC referred to in such section).

A hybrid transaction is any transaction, series of transactions, agreement, or instrument under which one or more payments are treated as interest or royalties for federal income tax purposes but are not so treated for purposes of the tax law of the foreign country of which the entity is resident or is subject to tax.

A hybrid entity is one that is treated as fiscally transparent for federal income tax purposes (e.g., a disregarded entity or partnership) but not for purposes of the foreign country of which the entity is resident or is subject to tax (hybrid entity), or an entity that is treated as fiscally transparent for foreign tax law purposes but not for federal income tax purposes (reverse hybrid entity).

The new law also grants the Secretary authority to issue regulations or other guidance necessary or appropriate to carry out the purposes of the provision and sets forth a broad list of issues such guidance may address. Such guidance may provide rules for the following: (1) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity; (2) applying the provision to branches or domestic entities; (3) applying the provision to certain structured transactions; (4) denying some or all a deduction claimed for an interest or a royalty payment that, as a result of the hybrid transaction or entity, is included in the recipient’s income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country’s generally applicable statutory tax rate by at least 25%; (5) denying a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system that provides for the exclusion of a substantial portion of such amount; (6) determining the tax residence of a foreign entity if the entity is otherwise considered a resident of more than one country or of no country; (7) exceptions to the provision’s general rule to (a) cases in which the disqualified related-party amount is taxed under the laws of a foreign country other than the country of which the related party is a resident for tax purposes, and (b) other cases that the Secretary determines do not present a risk of eroding the U.S. income tax base; and (8) requirements for record

keeping and information reporting in addition to any requirements imposed by section 6038A.

The provision is effective for tax years beginning after December 31, 2017 and does not appear to contain grandfathering rules.

KPMG observation

The new law attempts to neutralize the effects of hybrid mismatch arrangements by denying deductions for interest and royalty payments made to related parties under hybrid arrangements that give rise to income that is not taxed in any jurisdiction (stateless income). Similar proposals have been included as part of President Obama's FY 2017 Budget Proposal and in the recommendations issued pursuant to Action 2 of the OECD BEPS project (Recommendations).

The new law's provision is written broadly and would appear to apply to many of the transactions and structures addressed by the Recommendations, including the use of hybrid instruments and payments to and from reverse hybrids and disregarded payors. For example, an interest payment made with respect to a hybrid financial instrument held by a related party could be affected if there is no corresponding income inclusion by the related party.

The new law does not appear to be limited to interest or royalties paid by a U.S. payor and may apply to such payments made by a U.S. person or a non-U.S. person, including payments between foreign related parties.

Other portions of the Recommendations may be implemented through Treasury Regulations. These provisions could include rules that apply to imported mismatch arrangements, branch structures or domestic entities, and deductible dividends that are excluded pursuant to a participation exemption. The explanatory statement accompanying the conference agreement anticipates that the Treasury will issue regulations that apply the provision to branches (domestic or foreign) and domestic entities even if such entities do not meet the statutory definition of a hybrid entity. As a result, interest or royalty payments by a U.S. LLC that has elected corporate status for U.S. tax purposes to its foreign parent could be affected under regulations if the foreign parent does not have an income inclusion as a result of the U.S. LLC being treated as disregarded under the tax laws of the country of the foreign parent.

Hybrid entities also potentially implicate the dual consolidated loss rules. Specifically, a domestic corporate owner of a foreign hybrid entity is subject to the dual consolidated loss rules, if the foreign hybrid entity incurs a loss for U.S. tax purposes. The new law does not alter the dual consolidated loss rules.

New limitations on income shifting through intangible property transfers

The new law amends the definition of intangible property in section 936(h)(3)(B) (which applies for purposes of sections 367(d) and 482) to include workforce in place, goodwill, going-concern value, and “any other item” the value or potential value of which is not attributable to tangible property or the services of an individual. The new law also removes the flush language of section 936(h)(3)(B), which limits section 936(h)(3)(B) to intangibles that have substantial value independent of the services of any individuals, to make clear that the source or amount of value of an intangible is not relevant to whether that type of intangible is within the scope of section 936(h)(3)(B).

Additionally, the new law clarifies the authority of the Commissioner to specify the method used to value intangible property for purposes of both the section 367(d) outbound transfer rules and the section 482 intercompany pricing rules. Specifically, when multiple intangible properties are transferred in one or more transaction, the IRS may value the intangible properties on an aggregate basis when that achieves a more reliable result. The law also codifies the realistic alternative principle, which generally looks to the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

The provision applies to transfers in tax years beginning after December 31, 2017. Additionally, the new law states that no inference is intended with respect to the application of section 936(h)(3)(B) or the authority of the Secretary to provide by regulation for such application with respect to tax years beginning before January 1, 2018.

KPMG observation

The new law provision is identical to the provision in the Senate bill. By expanding the scope of section 936(h)(3)(B), this provision would make it more difficult for a U.S. person to transfer intangible property outbound without incurring tax. The provision also resolves prospectively long-standing uncertainties regarding the scope of section 936(h)(3)(B) and, in particular, the application of section 367(d) to outbound transfers of goodwill, going concern value, and workforce in place. Although recent regulations under section 367 required that outbound transfers of goodwill and going concern value are taxable under section 367(a) or (d), the IRS expressly declined to address whether goodwill, going concern value, and work force in place are section 936(h)(3)(B) intangibles.

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