December 20, 2017

# U.S. Tax Reform

## Congress Passes Tax Reform

### SUMMARY

Today, Congress voted to pass a comprehensive tax reform bill (the "Act"),[1] and the President is expected to sign it into law in the coming weeks. The Act represents the most significant reform of the U.S. tax code in over 30 years.

The Act is generally consistent with the proposals contained in the bill released by the Senate on November 14 (the "Senate bill"), but also incorporates certain provisions of the bill released by the House of Representatives on November 2 (the "House bill"). The Act also removes some provisions that were contained in both earlier draft bills, and includes some new provisions that were contained in neither draft bill. This memorandum describes some of the important provisions of the Act, and highlights certain areas where the Act diverges from the earlier draft legislation. Most of the proposed changes become effective for years after 2017.

**Key Features of the Act:**

- **Individual Tax Rates.** The seven marginal tax rates for individuals are modified, with a top rate of 37% for income in excess of $500,000 for individuals and $600,000 for married couples. The Act's modified rate structure does not apply to taxable years beginning after December 31, 2025, and rates will revert to the rates in effect during 2017 after that date.
- **Corporate Tax Rate to 21%.** The maximum corporate tax rate is reduced from 35% to 21%, effective for taxable years beginning after December 31, 2017, and with no sunset provision.
- **State and Local Tax Deduction for Property and Income/Sales Taxes.** Individuals may deduct state and local property taxes and either income or sales taxes up to an aggregate of $10,000 (the House and Senate bills only allowed a $10,000 deduction for state and local property taxes).

[1] The formal name for the Act is "An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

The Act also includes a provision disallowing prepayment of state and local income taxes before January 1, 2018 to avoid the $10,000 limitation for taxable years after 2017.

- **Interest Deductibility Limited.** The deductibility of net business interest is effectively capped at 30% of EBITDA for five years, and then at 30% of EBIT thereafter (a compromise between the approaches of the House bill and the Senate bill).
- **Modified Version of Senate Passthrough Taxation Regime.** Subject to several modifications (described below), the Act follows the Senate bill's model for passthrough taxation, by allowing a taxpayer other than a corporation to deduct the lesser of (i) 20% of that taxpayer's share of any "domestic qualified business income" of a passthrough (e.g., a partnership, S corporation, or sole proprietorship), and (ii) the greater of (a) 50% of the domestic wages paid with respect to the trade or business and (b) the sum of 25% of such wages and 2.5% of the unadjusted basis of all qualified property used in such trade or business.
- **Shift From "Worldwide" Taxation to "Territorial" Taxation.** A U.S. corporation that owns 10% or more of a foreign corporation will be entitled to a 100% dividends-received deduction for the foreign-source portion of dividends paid by such foreign corporation.
- **Deemed Repatriation Rates.** Like the House and Senate bills, the Act requires deemed repatriation of previously untaxed foreign earnings; however, the Act taxes all earnings held in cash and cash equivalents at a 15.5% rate (14% in the House bill and 14.5% in the Senate bill) and all other earnings at an 8% rate (7% in the House bill and 7.5% in the Senate bill).
- **Anti-Base Erosion and Income Shifting Provisions.** Similar to the Senate bill, the Act includes several anti-base erosion and income shifting provisions, including a base erosion minimum tax ("BEAT"), which is essentially a 10% corporate minimum tax calculated on a base equal to the taxpayer's income determined without tax deductions or other tax benefits arising from "base erosion" payments, and a tax on certain global intangible low-taxed income ("GILTI") that captures the excess return (deemed to be attributable to intangibles) above a statutory 10% return on certain tangible investments. The Act also provides for a special regime (taxed at 13.125%) for foreign-derived intangible income ("FDII") of U.S. corporations, most commonly understood as a "patent box"-like regime to benefit income on U.S. intangibles that are derived from outside of the United States (all described in further detail below).
- **Estate Tax Remains but Exemption Doubled.** The Act follows the Senate bill by retaining the estate tax, but doubling the estate, gift, and generation-skipping transfer tax exemption amount (to $11.2 million per person (or $22.4 million for a married couple) in 2018, adjusted annually for inflation). The House bill would have eliminated the estate tax.
- **Required Holding Period for "Carried Interest" Treatment Increased.** The Act treats capital gain allocated from a partnership interest received as a "carried interest" as short-term capital gain unless the partnership has a holding period for the sold asset of more than three years.
- **No Changes to Identification of Specified Securities.** The Act does not contain the provision in the Senate bill that would have required lots of specified securities purchased at different prices to be sold on a first-in first-out ("FIFO") basis.
- **Excess Business Losses Disallowed.** The Act disallows "excess business losses" (losses attributable to trades or businesses of a taxpayer other than a corporation in excess of a $250,000 threshold amount, or $500,000 for a joint return) for a taxpayer other than a corporation, and carries such losses forward as part of the taxpayer's net operating loss in subsequent taxable years.

## TAX REFORM

Some important features of the Act are as follows:

**Business Taxation:**

- **Corporate Tax Rate.** The maximum corporate tax rate is reduced from 35% to 21%, effective for taxable years beginning after December 31, 2017, and with no sunset provision.
  - Both earlier bills would have lowered the corporate tax rate to 20% rather than 21%. In addition, the lowered rate in the Senate bill would have been effective only for taxable years beginning after December 31, 2018, and the House bill would have taxed personal services corporations at a 25% rate.
- **Deduction for Passthrough "Qualified Business Income."** The Act allows a taxpayer other than a corporation to deduct the lesser of (i) 20% of that taxpayer's share of any "domestic qualified business income" of a passthrough (e.g., a partnership, S corporation, or sole proprietorship) and (ii) the greater of (a) 50% of the domestic wages paid with respect to the trade or business and (b) the sum of 25% of such wages and 2.5% of the unadjusted basis of all qualified property used in such trade or business. Assuming the full 20% deduction, the effective marginal rate is 29.6% in respect of such income for the highest earners. The deduction does not apply to income from certain services businesses (e.g., accounting, law, health, financial services, and other businesses for which the skill or reputation of the owner or employees is the principal asset), except in the case of individuals whose taxable income does not exceed $207,500. Also, qualified business income does not include investment-related income (other than certain dividends from REITs).
  - Under the Senate bill, an individual would have been allowed a 23% deduction, with different income thresholds and limitations. The House bill included a different regime, which would have favored capital owners and otherwise applied a default "70-30" split for active owners.
  - Qualified REIT dividends (REIT dividends other than capital gain dividends or dividends that qualify as qualified dividend income) are entitled to the deduction for passthrough qualified business income.
  - In an attempt to discourage aggressive use of this provision, the Act reduces the minimum understatement percentage before certain accuracy penalties apply.
- **Reduced Dividends-Received Deduction.** To preserve the effective tax rates on dividends received from domestic corporations, a corporation is only able to deduct 65% (down from 80%) of the amount of such dividends in which the receiving corporation owned 20% or more of the stock, and a corporation is only able to deduct 50% (down from 70%) of the amount of such dividends received from other domestic corporations.
- **Immediate Expensing of Capital Expenditures.** Like the Senate bill, the Act allows for temporary 100% expensing for property (other than real estate) acquired or placed in service after September 27, 2017 and before January 1, 2023, with the expensing percentage decreasing by 20% every year thereafter. The Act thus allows corporate taxpayers to claim an immediate deduction at the currently effective 35% corporate tax rate for 100% of the cost of qualified property acquired and placed in service after September 27, 2017 and before year end. The Act also includes the House bill's proposal to retain the phase-down of bonus depreciation for property acquired before September 28, 2017 and placed in service after September 28, 2017.
  - The House bill would only have allowed 100% expensing through 2022, without the subsequent phase-out.
- **Interest Deductibility Limited.** The deductibility of net business interest is effectively capped at 30% of EBITDA for five years, and then at 30% of EBIT thereafter (a compromise between the approaches of the House bill and the Senate bill). The net interest expense disallowance is determined at the entity level (e.g., at the partnership level instead of the partner level). Any disallowed amounts may be carried forward indefinitely, subject to a special rule for partnerships. Real estate firms, regulated utilities, and small businesses (with $25 million or less of gross receipts) are exempt from this limitation. The limitation also does not apply to interest on "floor

plan financing indebtedness" (indebtedness used to finance the acquisition of motor vehicles held for sale or lease or secured by such inventory). There is no grandfathering for preexisting debt.

- **Net Operating Losses.** Net operating losses arising after December 31, 2017 are deductible only to the extent of 80% of the taxpayer's taxable income, and can be carried forward indefinitely but generally cannot be carried back.
  - Under the House bill, net operating losses would have been deductible to the extent of 90% of the taxpayer's taxable income. The Senate bill had a similar 90% limitation, which would have decreased to 80% after December 1, 2022. The House bill would have increased amounts carried forward by an interest factor to preserve the value of those amounts.
- **Non-Qualified Deferred Compensation.** The Act does not change the taxation of non-qualified deferred compensation.
  - The original versions of the House bill and the Senate bill would have effectively eliminated deferred compensation by replacing the current law treatment of deferred compensation[2] with a new section that generally would have required income inclusion by the employee when the compensation vests (rather than when the compensation is paid). This proposal was subsequently removed from both earlier bills.
- **Limits on Executive Compensation Deductibility.** The Act removes the performance-based pay exception to the $1 million compensation deduction limit for compensation paid to "covered employees" in a publicly traded corporation,[3] so that compensation paid to such "covered employees" is no longer deductible for amounts above $1 million, even for performance-based pay. The Act also expands the definition of covered employees to include the CFO, in addition to the CEO and the three other highest paid officers, and the $1 million deduction limitation will apply to any person who was a covered employee in any tax year after 2016, not solely to individuals who were covered employees in the year compensation is paid.
  - Because the changes become effective beginning in taxable years after 2017, if a calendar-year taxpayer is able to properly deduct compensation in 2017 (as opposed to in 2018), such compensation will remain eligible for the current performance-based pay exception.
  - The Act also follows the Senate bill's transition rule, which provides that the changes will not apply to compensation paid pursuant to a written binding contract which was in effect on November 2, 2017 and which was not modified in any material respect on or after such date. The fact that a plan or contract was in existence on November 2, 2017 is not by itself sufficient to qualify the plan for this exception—the exception ceases to apply to amounts paid after there has been a material modification or renewal of the contract.
- **Some Business Tax Incentives Eliminated.** The Act eliminates some business tax incentives (e.g., the domestic production deduction), but fewer are eliminated than in the House bill. The R&D credit, the credit for the production of electricity from renewable resources (e.g., solar), and the low-income housing credit remain. Up to 80% of certain allowable credits may be used to reduce a taxpayer's base erosion minimum tax liability (see below).
- **Limitations on Certain Business Expense Deductions.** Under prior law, certain employer-provided meals were 100% deductible to the employer, but other meals were only 50% deductible. Consistent with the Senate bill, the Act makes all employer-provided meals only 50% deductible. Also consistent with the Senate bill, an employer may no longer deduct expenses associated with providing any qualified transportation fringe to its employees, and except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation for commuting between the employee's residence and place of employment. Consistent with the House bill and the Senate bill, the Act also repeals the present-law exception

[2] Provided under Section 409A and 457A of the Code.

[3] Provided under Section 162(m) of the Code.

to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business.

- **Research and Experimental ("R&E") Expenditures.** R&E expenditures which are paid or incurred by a taxpayer in connection with the taxpayer's trade or business (including software development expenditures) must be capitalized and amortized over a five-year period (15 years if attributable to research conducted outside the United States) for taxable years beginning after December 31, 2025. The House bill and Senate bill contained minor differences.
- **Elimination of Corporate AMT.** The Alternative Minimum Tax ("AMT") is eliminated for corporations (the Senate bill would not have eliminated the Corporate AMT).
- **Expanded S Corporation Shareholders.** Like the Senate bill, the Act allows a nonresident alien individual to be a potential current beneficiary of an electing small business trust ("ESBT"), such that such beneficiary can be a shareholder of an S Corporation.
- **Charitable Contributions by Electing Small Business Trusts.** Like the Senate bill, the Act amends prior law by clarifying that the charitable contribution deduction allowed for the portion of an ESBT holding S corporation stock would be determined under the rules applicable to individuals, rather than those applicable to trusts.
- **Taxable Payments During S Corporation Post-Termination Transition Period.** Under existing law, for one year after converting from an S corporation (the "post-termination transition period"), a C corporation may treat distributions as being made out of S corporation E&P (tax-free to the extent of basis) rather than out of C corporation E&P (taxable as dividends). Like the Senate bill, the Act allows distributions from a C corporation made after the post-termination transition period to be treated as made ratably out of both S corporation E&P and C corporation E&P.
- **Technical Terminations of Partnerships Eliminated.** Like the House bill, the Act eliminates the rule that a partnership is treated as terminated if, within any 12-month period, there is a sale or exchange of 50% or more of the total interests in partnership capital and profits (a "technical termination").
- **Taxable Year of Inclusion for Income Recognized on Financial Statements.** Like the Senate bill, the Act requires a taxpayer to recognize an item of income no later than the taxable year in which such item is taken into account on GAAP or similar financial statements. However, the Act's conference report suggests that the scope of this change is narrower than had initially been thought.
- **Like-Kind Exchanges Limited to Real Property.** Deferral of gain on like-kind exchanges is only permitted with respect to real property. However, deferral of gain is still available for like-kind exchanges with respect to property other than real property if the property disposed of by the taxpayer is disposed of before January 1, 2018.
- **Contributions to Capital by Customer or Government.** Narrowing a more broadly worded proposal in the House bill, the Act repeals tax-free treatment for any contribution in aid of construction or any other contribution as a customer or potential customer, and any contribution by any governmental entity or civic group.
- **Limitation on Deduction for FDIC Premiums.** A percentage of amounts paid by insured depository institutions pursuant to an assessment by the FDIC to support the Deposit Insurance Fund is not deductible for institutions with total consolidated assets in excess of $10 billion. The percentage gradually declines to zero in proportion to the institution's consolidated assets.
- **No Provision for Corporate Integration.** The Act does not eliminate the double taxation of corporate profits, referred to as "corporate integration."

**International Taxation:**

- **Shift From "Worldwide" Taxation to "Territorial" Taxation.** A U.S. corporation that owns 10% or more of a foreign corporation is entitled to a 100% dividends-received deduction for the foreign-source portion of dividends paid by such foreign corporation (except for any dividend received by a U.S. shareholder from a controlled foreign corporation that received a deduction with respect to such dividend). However, the Subpart F regime (which requires immediate taxation of certain passive or portfolio income of foreign subsidiaries) is largely preserved. This shift to a territorial system does not change the treatment of U.S. corporations that operate abroad through branches, nor does it exempt from taxation gain arising from the sale of shares of subsidiary corporations (except to the extent otherwise recharacterized as dividends).

- **Mandatory Deemed Repatriation of Offshore Earnings and Profits.** In the last taxable year before January 1, 2018, the foreign earnings of any controlled foreign corporation or other foreign corporation in which a U.S. person owns a 10% voting interest,[4] which have not been repatriated to the United States, and which have therefore not yet been subject to U.S. taxation, would be deemed distributed to the U.S. shareholder. All earnings held in cash and cash equivalents would be taxed at a 15.5% rate (14% in the House bill and 14.5% in the Senate bill) and all other earnings would be taxed at an 8% rate (7% in the House bill and 7.5% in the Senate bill). At the election of the taxpayer, this tax may be paid over a period of eight years. The amount of earnings is determined as of November 2, 2017 or December 31, 2017, whichever is greater. Foreign tax credits triggered by the deemed repatriation are available to offset partially the tax resulting from the deemed repatriation. The benefits of the reduced rates upon repatriation would be recaptured if the U.S. company engages in an inversion transaction within 10 years (i.e., where a foreign corporation acquires a U.S. corporation and former shareholders of the U.S. corporation hold 60-80% of the stock of the combined entity). Special rules apply to defer the tax to a U.S. shareholder that is an S corporation.

- **Tax on "Global Intangible Low Taxed Income" ("GILTI").** GILTI is a newly created concept intended to capture the excess return (deemed to be attributable to intangibles) above a statutory 10% return on certain tangible investments (known as qualified business asset investment, or "QBAI"). GILTI is effectively taxed at 10.5% in 2018, with an allowance for 80% of the credit attributable to related foreign taxes (such that foreign income subject to a 13.125% tax rate or above is effectively exempt from the tax on GILTI). The effective rates change for future years as the amount of GILTI that is taken into account changes under the Act. The Act also provides for a special regime (taxed at 13.125%) for foreign-derived intangible income ("FDII") of U.S. corporations, most commonly understood as a "patent box"-like regime to benefit income on U.S. intangibles that are derived from outside of the United States.

  - The Act does not include the Senate bill's proposal that would have eliminated the potential tax on distributing IP back to the United States.

- **Base Erosion Minimum Tax ("BEAT").** Similar to the Senate bill, the Act includes a base erosion minimum tax, which is essentially a 10% minimum tax (11% for banks and registered securities dealers) calculated on a base equal to the taxpayer's income determined without tax deductions or other tax benefits arising from "base erosion" payments. A "base erosion payment" is generally an amount paid or accrued by a taxpayer to a related foreign person that is deductible to the taxpayer, but does not include cost of goods sold (except for payments to companies that invert after November 9, 2017) or qualified derivative payments. This provision only applies to corporations that have average annual gross receipts of at least $500 million (for the three prior tax years) and that have a "base erosion percentage" of at least 3% (2% for banks and registered securities dealers). The base erosion percentage means, for any taxable year, the percentage determined by dividing the corporation's base erosion tax benefits by the total deductions allowed with respect to the corporation. Up to 80% of certain allowable credits may be used to reduce the taxpayer's BEAT liability.

  - The Act does not include the House bill's proposal that would have subjected domestic corporations to a 20% excise tax on payments to a foreign affiliate.

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4 In the case of a foreign corporation that is not a controlled foreign corporation, at least one U.S. shareholder must be a domestic corporation.

- **U.S. Tax on Sale of Certain Partnership Interests.** Overturning a recent case decided by the Tax Court, but consistent with the IRS's position at least since a 1991 revenue ruling, the Act provides that a non-U.S. partner in a partnership recognizes gain or loss treated as "effectively connected" to a U.S. trade or business upon the sale of the partner's partnership interest, to the extent that the partner would be treated as having effectively connected income in a hypothetical sale of all the assets of the partnership. The transferee in such transaction must withhold 10% of the amount realized, unless the transferor certifies that it is not a nonresident alien or foreign corporation. This provision was in the Senate bill but not in the House bill.
- **No Worldwide Proportionality on Interest Deduction.** The Act does not include the provision from the House and Senate bills that would have limited the deductible net interest expense of a U.S. corporation to the extent the U.S. corporation's share of its multinational group's global net interest expense exceeds a certain percentage of the U.S. corporation's share of the group's global equity.
- **Denial of Deduction for Interest and Royalty Payments Involving Hybrid Entities.** As in the Senate bill, the Act denies a deduction with respect to certain payments of interest or royalties between related parties where the recipient is not required to include the payment in income under the tax law of its country of residence, is allowed a deduction with respect to such amount, or is a "hybrid entity" (i.e., is treated as a passthrough entity for U.S. tax purposes but not for foreign tax purposes, or vice versa).
- **Definition of "U.S. Shareholder" of a Controlled Foreign Corporation.** As in the Senate bill, the Act broadens the definition of "U.S. Shareholder" to include a person who owns 10% or more of a foreign company's stock by value (in addition to those who own 10% or more by vote, which was the test under prior law) for the purposes of determining whether a foreign corporation is a "controlled foreign corporation" and for purposes of the various changes described above.
- **No Holding Period for Controlled Foreign Corporations for Subpart F Inclusions.** The Act eliminates the requirement that a controlled foreign corporation must be controlled for an uninterrupted period of 30 days before Subpart F inclusions apply.
- **Inclusions for Increased Investment in United States Property.** Unlike the House and Senate bills, the Act does not eliminate Section 956 of the Code, which treats increased investment in United States property by a controlled foreign corporation as income currently includible for the U.S. parent. Combined with the new 100% dividends received deduction for U.S. corporate shareholders of a controlled foreign corporation, this means that the U.S. corporate parent would have includible income as a result of increased investment in U.S. property by a controlled foreign corporation, but would not have includible income if such controlled foreign corporation made an equal distribution to the U.S. corporation (even if then used to invest in U.S. property).
- **No Preferential Rates for Dividends From Inverted Companies.** Shareholders are not eligible for the lower rates that apply to certain "qualified" dividends if those dividends are received from a corporation that has engaged in an inversion transaction (i.e., where U.S. shareholders hold an inversion percentage in the 60-80% range). Unlike in the Senate bill, this provision applies only to foreign corporations that engage in inversion transactions after the date of enactment.
- **Source of Income From Sales of Inventory.** Income from the sale of inventory produced within the United States and sold outside the United States (and vice versa) is sourced solely based on the production activities with respect to the inventory.
- **Repeal of Active Trade or Business Exception for Outbound Transfers.** As in the Senate bill, the Act taxes outbound property transfers to a foreign corporation that otherwise would qualify for tax-free treatment, even if such property is for use by the foreign corporation in an active trade or business.
- **Outbound Transfers of Intangible Property.** As in the Senate bill, the Act confirms IRS authority on recent guidance in Treasury regulations proposed in September 2015, by providing that upon an outbound transfer of goodwill (foreign or domestic), workforce in place, or going concern value, a U.S. transferor would be subject to either current gain recognition or to a special

rule that requires inclusion of deemed royalties following such transfer, even if the value of the transferred property was created exclusively through offshore activities. The provision also confirms the IRS's authority to specify the method to be used to determine the value of the intangible property transferred.

**Individual Taxation:**[5]

- **Individual Tax Rates.** The seven marginal tax rates for individuals are modified, with a top rate of 37% for income in excess of $500,000 for individuals and $600,000 for married couples.
  - The House bill would have included only four brackets, maintaining the top marginal rate of 39.6%, as well as a "catch-up" provision to phase-out the benefit of the tax rate on the lowest tranche of income for the highest earners. The Senate bill would have had seven brackets, but with a top rate of 38.5%. In both earlier proposals, the top bracket would have applied to married couples only with income in excess of $1 million.
- **Doubled Standard Deduction and Eliminated Personal Exemptions.** The standard deduction is doubled, such that the first $12,000 of income for an individual is tax-free ($24,000 for married couples). Personal exemptions, on the other hand, are eliminated.
- **Changes to Itemized Deductions.** The limitation on the total amount of itemized deductions for high-income taxpayers (known as the "Pease" limitation) is repealed (although the limitation would have been less significant with the new limitations on the state and local tax and mortgage interest deductions). All "miscellaneous itemized deductions" that formerly could have been claimed if their aggregate amount exceeds 2% of the taxpayer's adjusted gross income are eliminated (e.g., deductible investment expenses from passthrough entities). The Act eliminates certain deductions such as the deduction for moving expenses, but retains, at least in part, many of the deductions that the House bill would have eliminated (e.g., student loan indebtedness, medical expenses, personal casualty losses).
- **State and Local Tax Deduction.** Individuals may deduct state and local property taxes and either income or sales taxes up to an aggregate of $10,000. The Act also includes a provision disallowing prepayment of state and local income taxes before January 1, 2018 to avoid the $10,000 limitation for taxable years after 2017. This change is most significant for high earners in states with high income taxes.
  - The House bill and Senate bill would have allowed individuals to deduct only $10,000 of state and local property taxes, not income or sales taxes.
- **Charitable Deduction.** The Act preserves the charitable deduction, with several minor changes.
- **Mortgage Interest Deduction.** The Act preserves the mortgage interest deduction for existing mortgages, and maintains the deduction for newly purchased homes up to $750,000, but suspends the deduction for interest on home equity indebtedness.
  - The House bill would have maintained the deduction for newly purchased homes only up to $500,000, whereas the Senate bill would have maintained the full $1,000,000 deduction for newly purchased homes previously allowable.
- **No Deduction for Alimony.** Under prior law, alimony payments were deductible to the payor and includible in the income of the recipient. Similar to the House bill, the Act reverses prior law by eliminating the deduction for alimony payments and not including such payment in the income of the recipient. Because alimony is typically paid from the higher-earning party, this will generally result in higher overall tax liability. These changes only apply to agreements executed after December 31, 2018.

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5 Similar to the Senate bill, but different from the House bill, many of the individual taxation changes, such as the altered tax brackets, the doubled standard deduction, and the changes to the mortgage interest and state and local tax deductions, only apply through December 31, 2025.

- **Excess Business Losses Disallowed.** The Act disallows "excess business losses" (losses attributable to trades or businesses of a taxpayer other than a corporation in excess of a $250,000 threshold amount, or $500,000 for a joint return) for a taxpayer other than a corporation, and carries such losses forward as part of the taxpayer's net operating loss in subsequent taxable years.

- **No Further Limits on Exclusion of Gain From Sale of Principal Residence.** The Act does not change rules regarding the exclusion of gain on the sale of a principal residence.
  - Under the House bill, gain on the sale of a principal residence would have been excludable only if the taxpayer lived in the residence for five of the previous eight years, and would have been phased out by one dollar for every dollar by which the taxpayer's adjusted gross income exceeds $250,000 ($500,000 for married couples). The Senate bill would have generally followed the House bill, without the phase-out provision.

- **Application of Self-Employment Tax to Allocations of Passthrough Income.** The Act retains the current rules on the application of payroll taxes to amounts received through a passthrough entity.

- **Elimination of Individual Mandate.** Like the Senate bill, the Act reduces the individual shared responsibility payment imposed under the Affordable Care Act for failure to maintain essential health coverage (the "individual mandate") to zero.

- **No "Rothification" of Retirement Accounts.** The Act preserves the tax treatment of traditional defined contribution plans (e.g., 401(k)s), which allow the employee to invest pre-tax money (only subject to tax on withdrawal).

- **No Changes to Identification of Specified Securities.** The Act does not contain the provision in the Senate bill that would have required lots of specified securities purchased at different prices to be sold on a first-in first-out ("FIFO") basis.

- **Individual AMT Not Eliminated.** Like the Senate bill (but unlike the House bill), the Act retains the individual AMT, although with increased exemption amounts. The increased threshold for the individual AMT is phased out gradually, returning to the previous exemption levels after the 2025 taxable year. However, the AMT is expected to apply to fewer taxpayers with the limitations on the deductibility of state and local taxes.

- **Elimination of Certain Employee Exclusions and Deductions.** The exclusion for qualified moving expense reimbursement, as well as the qualified bicycle reimbursement, is eliminated. Notably, however, the exclusions for adoption assistance programs and dependent care programs are untouched (unlike in the House bill).

- **Estate, Gift, and Generation-Skipping Transfer Taxes.** The Act follows the Senate bill, doubling the estate, gift, and generation-skipping transfer tax exemption amount (to $11.2 million per person (or $22.4 million for a married couple) in 2018, adjusted annually for inflation). The Act does not repeal the estate and generation-skipping transfer taxes, as the House bill would have done. No other changes are made to the estate and gift tax regime.

- **Self-Created Intangibles Not Capital Assets.** Like the House bill, the Act excludes certain self-created intangibles (patents, inventions, models or designs, or secret formulas or processes) from the definition of a "capital asset" so that any gain or loss on the sale or exchange of such property will not receive capital gain treatment. This provision does not apply to goodwill.

- **Required Holding Period for "Carried Interest" Treatment Increased.** The Act treats capital gain allocated from a partnership interest received as a "carried interest" as short-term capital gain unless the partnership has a holding period on the sold asset of more than three years.

**Changes Applicable to Tax-Exempt Organizations:**

- **Excise Tax for Compensation in Excess of $1 Million.** Tax-exempt organizations are subject to a 21% tax on compensation in excess of $1 million paid to any "covered employee," which, for this purpose, includes the organization's five highest-paid employees for the tax year and any person that was a "covered employee" for any tax year after 2016.

- The excise tax was 20% under the House and Senate bills.

- **No Application of UBIT to Public Pension Plans.** Following the Senate bill, the Act does not cause state and local government pension plans, which are generally exempt from tax, to be subject to the "unrelated business income tax." The House bill would have done so.
- **Investment Income Excise Tax on Private Colleges and Universities.** Certain large private college and university endowments are subject to a 1.4% excise tax on net investment income. However, unlike in the House bill, the excise tax that applies to private foundations is unchanged.

Questions regarding the Act may be directed to any member of the Tax Group. Contact information is available on the final page of this memorandum.

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