CORDASCO
& COMPANY P.C.
Certified Public Accountants

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TAX CUTS & JOBS ACT 2017

LAW, EXPLANATION & ANALYSIS, DETAILED

December, 2017

ABOUT CORDASCO & COMPANY, P.C.

Cordasco and Company, P.C. is a boutique CPA firm specializing in complicated federal and state tax issues. Cordasco & Company has a dedicated staff of CPA's and trained professionals who have focused their careers on high end, complicated tax matters and compliance. The Cordasco mission is simple: We help our clients capitalize on the rapidly changing tax and accounting environments.

The following is our qualitative analysis of the recently passed Tax Cuts and Jobs Act of 2017. This encompasses the full scope of this legislation and is the back bone of our strategies and quantitative modeling that we do to insure our clients are taking full advantage of the legislation as enacted.

If you have any questions regarding this legislation or its impact on your specific situation, please do not hesitate to contact us at 912-353-7800 or at info@cordascocpa.com

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CHAPTER 1 INDIVIDUAL TAXES (INCOME, AMT, ESTATE AND GIFT)

TAXES AND RETURNS

¶105 Reduction in Individual Income Tax Rates

NEW LAW EXPLAINED

Temporary modification of income tax rates.—The new law replaces the individual income tax rate structure with a new rate structure, beginning after December 31, 2017, and before January 1, 2026, as follows (Code Sec. 1(j)(1) and (2), as added by the Tax Cuts and Jobs Act:

SINGLE TAXPAYERS

FOR TAX YEARS BEGINNING IN 2018

If taxable income is:				
Over—	***but not over—***	***The tax is:***		***of the amount over—***
$ 0	$9,525	10%		$0
9,525	38,700	$952.50 + 12%		9,525
38,700	82,500	4,453.50 + 22%		38,700
82,500	157,500	14,089.50 + 24%		82,500
157,500	200,000	32,089.50 + 32%		157,500
200,000	500,000	45,689.50 + 35%		200,000
500,000		150,689.50 + 37%		500,000

MARRIED INDIVIDUALS FILING SEPARATE RETURNS

FOR TAX YEARS BEGINNING IN 2018

If taxable income is:				
Over—	***but not over—***	***The tax is:***		***of the amount over—***
$ 0	$9,525	10%		$0
9,525	38,700	$952.50 + 12%		9,525
38,700	82,500	4,453.50 + 22%		38,700
82,500	157,500	14,089.50 + 24%		82,500
157,500	200,000	32,089.50 + 32%		157,500
200,000	300,000	45,689.50 + 35%		200,000
300,000		80,689.50 + 37%		300,000

MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

FOR TAX YEARS BEGINNING IN 2018

If taxable income is:				
Over—	***but not over—***	***The tax is:***		***of the amount over—***
$ 0	$19,050	10%		$0
19,050	77,400	$1,905 + 12%		19,050
77,400	165,000	8,907 + 22%		77,400
165,000	315,000	28,179 + 24%		165,000
315,000	400,000	64,179 + 32%		315,000
400,000	600,000	91,379 + 35%		400,000
600,000		161,379 + 37%		600,000

HEADS OF HOUSEHOLD

FOR TAX YEARS BEGINNING IN 2018

If taxable income is:				
Over—	***but not over—***	***The tax is:***		***of the amount over—***
$ 0	$13,600	10%		$0
13,600	51,800	$1,360.00 + 12%		13,600
51,800	82,500	5,944 + 22%		51,800
82,500	157,500	12,698 + 24%		82,500
157,500	200,000	30,698 + 32%		157,500
200,000	500,000	44,298 + 35%		200,000
500,000		149,298 + 37%		500,000

ESTATES AND TRUSTS

FOR TAX YEARS BEGINNING IN 2018

If taxable income is:				
Over—	***but not over—***	***The tax is:***		***of the amount over—***
$ 0	2,550	10%		$0
2,550	9,150	$255 + 24%		2,550
9,150	12,500	1,839 + 35%		9,150
12,500		3,011.50 + 37%		12,500

For tax years beginning after December 31, 2018, the bracket thresholds are to be annually adjusted for inflation (Code Sec. 1(j)(3), as added by the 2017 Tax Cuts Act).

Simplification of kiddie tax. Effective for tax years beginning after December 31, 2017, and before January 1, 2026, the new law simplifies the "kiddie tax" by effectively applying ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child (Code Sec. 1(j)(4), as added by the 2017 Tax Cuts Act). As a result, taxable income attributable to earned income is taxed, as under prior law, according to a single individual's tax brackets and rates. Taxable income attributable to net unearned income is taxed according to the brackets applicable to trusts and estates, with respect to both ordinary income and income taxed at preferential rates.

COMMENT

A child's "kiddie tax" is no longer affected by the tax situation of his or her parent or the unearned income of any siblings.

Maximum rates on capital gains. The new law generally retains the prior-law maximum rates on net capital gain and qualified dividends. The breakpoints between the zero- and 15-percent rates ("15-percent breakpoint") and the 15- and 20-percent rates ("20-percent breakpoint") are the same amounts as the breakpoints under prior law, except the breakpoints are indexed using the C-CPI-U (see ¶125) in tax years beginning after 2018) (Code Sec. 1(j)(5)(A) and (C), as added by the 2017 Tax Cuts Act). Thus, for 2018, the 15-percent breakpoint is $77,200 for joint returns and surviving spouses (one-half of this amount ($38,600) for married taxpayers filing separately), $51,700 for heads of household, $2,600 for estates and trusts, and $38,600 for other unmarried individuals. The 20-percent breakpoint is $479,000 for joint returns and surviving spouses (one-half of this amount for married taxpayers filing separately), $452,400 for heads of household, $12,700 for estates and trusts, and $425,800 for other unmarried individuals (Code Sec. 1(j)(5)(B), as added by the 2017 Tax Cuts Act).

Therefore, in the case of an individual (including an estate or trust) with adjusted net capital gain, to the extent the gain would not result in taxable income exceeding the 15-percent breakpoint, such gain is not taxed. Any adjusted net capital gain that would result in taxable income exceeding the 15-percent breakpoint but not exceeding the 20-percent breakpoint is taxed at 15 percent. The remaining adjusted net capital gain is taxed at 20 percent.

COMMENT

As under prior law, unrecaptured section 1250 gain generally is taxed at a maximum rate of 25 percent, and 28-percent rate gain is taxed at a maximum rate of 28 percent.

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 11001(c) of the Tax Cuts and Jobs Act.

¶110 Alternative Minimum Tax (AMT) for Individuals

NEW LAW EXPLAINED

Exemption amount and phaseout thresholds for individuals temporarily increased.—The AMT exemption amounts and phaseout thresholds are temporarily increased for individuals for tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 55(d)(4), as added by the Tax Cuts and Jobs Act. Beginning in 2018, the AMT exemption amounts are:

- $109,400 for married individuals filing jointly or surviving spouses;
- $70,300 for single or head of household filers; and
- $54,700 for married individuals filing separately (i.e., 50 percent of the amount for married individuals filing jointly) (Code Sec. 55(d)(4)(A)(i), as added by the 2017 Tax Cuts Act).

The threshold amounts for phaseout or reduction of the AMT exemption amount are also temporarily increased after 2017. The phaseout threshold is $1 million for married individuals filing jointly or surviving spouses, and 50 percent of this amount for all other individuals. Thus, the phaseout threshold is $500,000 for an individual filing as single, head of household, or married filing separately (Code Sec. 55(d)(4)(A)(ii), as added by the 2017 Tax Cuts Act).

COMMENT

The exemption amount continues to phase out 25 percent for each $1 that AMTI exceeds certain threshold amounts. Thus, the AMT exemption amount is completely phased out for an individual for 2018 when AMTI reaches $1,437,600 if married individual filing jointly or surviving spouse, $781,200 if filing as single or head of household, and $718,800 if married filing separately.

COMMENT

The AMT exemption amount and phaseout threshold for an estate or trust are not impacted by the legislation and any of the temporary increases in the exemption amount and phaseout threshold for an individual. For 2018, the AMT exemption amount for an estate or trust is $24,600 (but $0 for portion of an electing small business trust), and the phaseout threshold is $82,050 for 2018 (Rev. Proc. 2017-58). The corporate AMT is repealed effective for tax years beginning after December 31, 2017 (see ¶310).

In the case of any tax year beginning after 2018, the temporary increases in the AMT exemption amounts and phaseout thresholds are adjusted annually for inflation (Code Sec. 55(d)(4)(B), as added by the 2017 Tax Cuts Act). These adjustments are temporary increases only and no additional adjustment of the temporary increases will apply.

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 12003(b) of the Tax Cuts and Jobs Act.

¶115 Estate, Gift, and Generation-Skipping Transfer Tax Exclusions Increased

NEW LAW EXPLAINED

Estate and gift tax exclusion doubled.— The basic exclusion amount for purposes of federal estate and gift taxes will be doubled from $5 million to $10 million, before adjustment for inflation, for the estates of decedents dying and gifts made after 2017 and before 2026 (Code Sec. 2001(c)(3), as amended by the Tax Cuts and Jobs Act of 2017. Accordingly, the estate and gift tax basic exclusion amount applicable to the estates of decedents dying and gifts made in 2018 will be $11.2 million (based on the inflation-adjusted amount of $5.6 million, as per Rev. Proc. 2017-58). For a married couple using portability, the maximum applicable exclusion amount would be doubled again to $22.4 million.

EXAMPLE 1

Bruce Payne, a wealthy single individual dies in 2018 leaving a taxable estate of $10 million. His estate will owe no federal estate taxes. Instead, if he had died in 2017, the estate tax payable would have been $1,804,000.

EXAMPLE 2

Carol Cologne, a wealthy widow dies in 2018 leaving a taxable estate of $20 million. Her late husband died earlier in 2018 having used only $2 million of his available estate tax exclusion amount. Her estate will owe no federal estate tax. However, if the couple had died under the same circumstances in 2017, the estate tax payable would have been $4,408,000.

COMMENT

Because the doubling of the estate and gift tax exclusion amount will expire for decedents dying and gifts made after December 31, 2025, the next several years present a tremendous opportunity for wealthy individuals and married couples to make large gifts, including those that leverage the amount of the available exclusion, such as those to grantor retained annuity trusts (GRATs).

COMMENT

According to the IRS Statistics of Income tables presenting data on estate tax return data for Filing Year 2016 (*https://www.irs.gov/statistics/soi-tax-stats-estate-tax-filing-year-tables*, see Table 1 showing data from estate tax returns filed in 2016, by tax status and size of gross estate), a total of 5,219 taxable returns were filed contrasted with 7,192 nontaxable returns. Of the taxable returns, 2,402 fell within the $5 to $10 million gross estate range, 1,293 in the $10 to $20 million range. Only 300 returns were filed with gross estates in excess of $50 million. These statistics primarily reflect data from the estates of decedents who died in 2015, when the basic exclusion amount was $5.43 million, but also include some returns for decedents who died in years prior to 2015, as well as a small number of estates with respect to deaths that occurred in 2016. The large increase in the basic exclusion amount after 2017 will no doubt lead to further decreases in the number of taxable estates.

GST tax exemption amount.— Because the exemption from the GST tax is computed by reference to the basic exclusion amount used for estate and gift tax purposes (Code Sec. 2631), the GST exemption

amount for GSTs occurring in 2018 will be $10 million, before adjustment for inflation. Portability does not apply for purposes of the GST tax.

Corresponding adjustments with respect to prior gifts.— In addition to the increase in the basic exclusion amount, the 2017 Tax Cuts Act modifies the computation of gift tax payable and estate tax payable in cases where gifts have been made in prior years. (Code Sec. 2001(g), as amended by the 2017 Tax Cuts Act). With respect to the computation of gift tax payable, the tax rates in effect at the time of the decedent's death are to be used rather than the rates that were in effect at the time the gifts were made (Code Sec. 2001(g)(1), as amended by the 2017 Tax Cuts Act). And, the Secretary of the Treasury is directed to prescribe regulations clarifying the computation of estate tax payable in situations where the basic exclusion amount was different in the year of the decedent's death as opposed to the year when the prior gifts were made (Code Sec. 2001(g)(2), as amended by the 2017 Tax Cuts Act).

Inflation adjustments going forward.— A separate amendment (Act Sec. 11002 of the 2017 Tax Cuts Act (¶125)) requires that future inflation adjustments mandated throughout the Internal Revenue Code be made using the "Chained" Consumer Price Index for All Urban Consumers (C-CPI-U) rather than the CPI adjustment used under current law. This change, effective generally for tax years beginning after December 31, 2017, will tend to slow down inflation adjustments to provisions throughout the Code, including the estate and gift tax exclusion amounts.

> **COMMENT**
>
> Unless Congress takes action before then, for decedents dying and gifts made after 2025, the basic exclusion amount will revert to $5 million, as adjusted for inflation under the C-CPI-U because, unlike many other provisions in the 2017 Tax Cuts a Act, the provision governing the inflation adjustment is not subject to sunset.

Effective date. The amendments made by this section are effective for decedents dying and for gifts and generation-skipping transfers made after December 31, 2017 (Act Sec. 11061(c) of the Tax Cuts and Jobs Act.

¶120 Filing Threshold for 2018; Due Diligence Tax Return Preparer Requirement

NEW LAW EXPLAINED

Filing thresholds increased; paid preparer due diligence requirements.—Generally effective for tax years beginning after December 31, 2017, the elimination of the personal exemption deduction (¶210) and the increase in the standard deduction (¶205) establish new filing thresholds. For 2018, the filing thresholds will be (assuming no recalculation in the amount of the additional standard deduction for taxpayers over age 65 or who are blind due to the use of a new inflation-adjustment factor (¶125)):

Single Individual	$12,000
Single individual, 65 or older or blind	13,600
Single individual, 65 or older and blind	15,200
Married individual, separate return	0
Married couple, joint return	24,000
Married couple, joint return, one spouse 65 or older or blind	25,300
Married couple, joint return, one spouse 65 or older and blind	26,600
Married couple, joint return, both spouses 65 or older or blind	26,600
Married couple, joint return, both spouses 65 or older and blind	29,200
Head of household	18,000
Head of household, 65 or older or blind	19,600
Head of household, 65 or older and blind	21,200
Qualifying widow(er) (surviving spouse)	24,000
Qualifying widow(er) (surviving spouse), 65 or older or blind	25,300
Qualifying widow(er) (surviving spouse), 65 or older and blind	26,600

Tax return preparer due diligence. Effective for tax years beginning after December 31, 2017, the requirement that tax return preparers must satisfy due diligence in ensuring that clients qualify for the child, American Opportunity, lifetime learning, and earned income tax credits is extended to apply to head of household status. Each failure to exercise such due diligence in ensuring that a client meets the requirements of head of household status, and thus qualifies for the filing threshold for head of household status, will result in a $500 penalty (Code Sec. 6695(g), as amended by the Tax Cuts and Jobs Act.

Effective date. The provision applies to tax years beginning after December 31, 2017 (Act Sec. 11001(c) of the Tax Cuts and Jobs Act.

CAPITAL GAINS AND OTHER PROVISIONS

¶125 Chained Consumer Price Index

NEW LAW EXPLAINED

Chained consumer price index to be used in calculating annual inflation adjustments.—For tax years beginning after December 31, 2017 (December 31, 2018, for individual tax brackets and the standard deduction), the calculation of annual inflation adjustments will be made by using the Chained Consumer Price Index for All Urban Consumers (C-CPI-U) (Code Sec. 1(f)(6), as amended by the Tax Cuts and Jobs Act (H.R. 1)). The C-CPI-U is calculated in much the same way as the CPI, but rather than simply accounting for the impact of inflation on the price of goods, it also accounts for consumers' diminished capacity to achieve the same standard of living due to the increase in the price of consumer goods (*BLS Handbook of Methods*, Chapter 17 (6/2015)). The effect is that adjustments for inflation will be smaller.

COMMENT

The difference between the two methods of calculating inflation is not insignificant. Between October 2007 and October 2017, the rate of inflation using CPI has been around 18 percent, while the rate of inflation using C-CPI-U has been around 16 percent. Although this difference may appear small, it can have a much larger impact on higher amounts, such as tax bracket income thresholds or the applicable credit amount (unified credit) for estate and gift taxes and the exemption amount for the generation-skipping transfer tax.

Just as with CPI, the adjustment for a calendar year is based upon the average monthly C-CPI-U for the 12-month period ending on August 31 of the *prior* year. However, because the method of calculating C-CPI-U requires the additional step of making a determination of the impact of inflation on purchasing decisions, the C-CPI-U for any given month is actually the result of an iterative release by the Bureau of Labor Statistics (BLS). An initial value is calculated and announced during the month following the month at issue, which is then reassessed and re-released (with any changes) as an interim amount. Within one year, the interim amount is announced as final. However, for purposes of calculating inflation adjustments, the interim amount is to be used (Code Sec. 1(f)(6), as added by the 2017 Tax Cuts Act).

Many of the changes contained in the 2017 Tax Cuts Act are temporary. For example, the reduced tax rates, increased standard deduction, and elimination of the personal exemption are all temporary, applying to tax years beginning before 2026. However, the replacement of CPI-U with C-CPI-U in calculating annual inflation adjustments is *not* temporary and applies to all amounts that are adjusted for inflation, even if the temporary changes are allowed to expire (Code Sec. 1(f)(2)(A), as amended by the 2017 Tax Cuts Act). This is accomplished by adjusting the CPI-U for the base year by an amount that is adjusted to reset the index using C-CPI-U for that base year (Act Sec. 11002(d) of the 2017 Tax Cuts Act).

CAUTION

The amounts that apply to retirement plans that are annually adjusted using Social Security methodology per Reg. §1.415(d)-1 are not affected by these changes. Unless the regulations are reissued and amended to mandate the use of C-CPI-U or the Social Security methodology is changed to mandate such use, these amounts will continue to be annually adjusted using CPI-U.

COMMENT

Some annual inflation adjustments that use the August 31 CPI amount are required under regulation or IRS administrative guidance (see, for example, annual inflation adjustments made to certain rules under the arbitrage bond rules under Code Sec. 148). Presumably, these items will have to be amended and reissued in order to make the switch over to C-CPI-U.

Effective date. The provision applies to tax years beginning after December 31, 2017 (Act Sec. 11002(e) of the Tax Cuts and Jobs Act (P.L. 115-97)).

¶130 Self-Created Property as Capital Asset

NEW LAW EXPLAINED

Patents, inventions, designs, and secret formulas are not capital assets.—In dispositions after December 31, 2017, a patent, invention, model or design (patented or not), or secret formula or process is not a capital asset in the hands of (1) the taxpayer who personal efforts created the property, or (2) a taxpayer with a substituted or transferred basis from the taxpayer whose personal efforts created the property (Code Sec. 1221(a)(3), as amended by the Tax Cuts and Jobs Act. Thus, gains or losses from the sale or exchange of a patent, invention, model or design, or a secret formula or process that is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property will not be capital gains or losses.

These types of self-created property also do not qualify for the capital gain/ordinary loss rule for dispositions after December 31, 2017 (Code Sec. 1231(b)(1)(C), as amended by the 2017 Tax Cuts Act).

CAUTION

According to the Conference Committee Report, the exclusion of these self-created works from capital assets also applies when the taxpayer's basis is determined by reference to the basis of a person for whom the property was created (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)). However, the amended statutory language apparently still limits this "for whom created" rule to letters, memoranda and similar property.

COMMENT

Although patents will be excluded from the definition of capital asset after 2017, a qualified holder's gain on the disposition of a patent to an unrelated person may still be taxed at the lowest capital gain tax rate. Qualified holders include the creator of the patent and persons who provided financial backing to the creator (Code Sec. 1235).

Effective date. The amendments apply to dispositions after December 31, 2017 (Act Sec. 13314(c) of the Tax Cuts and Jobs Act.

¶135 Sinai Peninsula of Egypt a Qualified Hazardous Duty Area

NEW LAW EXPLAINED

Egypt's Sinai Peninsula a qualified hazardous duty area; treated as combat zone.—The Sinai Peninsula of Egypt is a qualified hazardous duty area and members of the U.S. Armed Forces members serving there are considered to be serving in a combat zone (Sec. 11026(a) of the Tax Cuts and Jobs Act. As a result, such members of the military are entitled to combat zone tax benefits.

A qualified hazardous duty area is treated in the same manner as if it were a combat zone for purposes of the following provisions of the Code:

1. exclusions from income for combat zone compensation (Code Sec. 112);
2. special rule for determining surviving spouse status where the deceased spouse was in missing status as a result of service in a combat zone (Code Sec. 2(a)(3));
3. forgiveness of income taxes of members of the military dying in the combat zone or by reason of combat zone incurred wounds (Code Sec. 692);
4. reduction in estate taxes for members of the military dying in the combat zone or by reason of combat-zone incurred wounds (Code Sec. 2201);
5. exemption from income tax withholding for military pay for any month in which an employee is entitled to the exclusion from income (Code Sec. 3401(a)(1));
6. exemption from the telephone excise tax for toll telephone service that originates in a combat zone (Code Sec. 4253(d));
7. special rule permitting filing of a joint return where a spouse is in missing status as a result of service in a combat zone (Code Sec. 6013(f)(1));
8. suspension of time provisions (Code Sec. 7508) (Sec. 11026(a) of the 2017 Tax Cuts Act).

COMMENT

Although this designation impacts a relatively small number of members of the military (454 troops, as reported by the Multinational Force & Observers website http://mfo.org/en/contingents, visited 12/8/2017), Sen. John Cornyn, R-Texas and Sen. Amy Klobuchar, D-Minn., introduced the measure to provide combat pay and tax benefits in light of the heightened volatility in the area and increased threat to their lives from regional and Islamic State groups (https://homeland.house.gov/press/homeland-security-bipartisan-delegation-examines-spread-islamist-terror-threats-u-s-allies/, visited 12/8/2017).

Members of the military serving in the Sinai Peninsula of Egypt are granted combat zone tax benefits if, as of December 22, 2017, they are entitled to special pay under section 310 of Title 37 of the United States Code (Sec. 11026(b) of the 2017 Tax Cuts Act). Combat zone tax benefits begin June 9, 2015, and apply to every subsequent tax year through December 31, 2025 (Sec. 11026(c) of the 2017 Tax Cuts Act). The Sinai Peninsula of Egypt is considered a qualified hazardous duty zone for the same period (Sec. 11026(b) of the 2017 Tax Cuts Act).

The exemption from income tax withholding under Code Sec. 3401(a)(1) for members of the military serving in the Sinai Peninsula of Egypt is applicable from December 22, 2017, through December 31, 2025.

Effective date. This provision generally applies to members of the U.S. Armed Forces serving in Sinai Peninsula of Egypt beginning on June 9, 2015 (Act Sec. 11026 (d)(1) of the Tax Cuts and Jobs Act (P.L. 115-97)). The provision for wage withholding applies to remuneration paid after December 22, 2017, the date of enactment (Act Sec. 11026 (d)(2) of the 2017 Tax Cuts Act).

¶140 Individual Health Insurance Mandate under Affordable Care Act

NEW LAW EXPLAINED

The amount of the penalty imposed on individuals without health insurance is zero.— For months beginning after December 31, 2018, the amount a taxpayer would otherwise owe for each month they fail to have "minimum essential coverage" for themselves and their dependents is zero (Code Sec. 5000A(c), as amended by the Tax Cuts and Jobs Act (P.L. 115-97). No other Affordable Care Act tax or provision is affected.

COMPLIANCE TIP

Individuals with coverage during the year should receive a reporting form. Marketplace Exchanges are to provide Form 1095-A, Health Insurance Marketplace Statement, if the Marketplace provided coverage. An individual with employer or other health coverage ought to receive Form 1095-B, Health Coverage (indicating coverage provided), or Form 1095-C, Employer-Provided Health Insurance Offer and Coverage (indicating coverage offered or not offered, and coverage provided). These forms can be useful in applying the shared responsibility rules primarily by showing which months (if any) the individual maintained coverage during the year. Presumably, Exchanges will continue to issue Form 1095-A after 2018 since these are necessary for premium tax credit purposes.

COMMENT

Though the tax imposed under Code Sec. 5000A is zeroed out, Code Sec. 5000A(f) and its regulations 1.5000A-2 will still be relevant because they outline the key concept of minimum essential coverage (MEC). Employers that do not offer their employees MEC under an eligible employer sponsored plan may still be liable for large employer shared responsibility payments (Code Sec. 4980H). Individuals who are eligible for MEC for any month do not qualify for the premium tax credit for that month (Code Sec. 36B(c)(2)). Reimbursements under a qualified small employer health reimbursement arrangements are included in an employee's income unless the employee had MEC (Code Sec. 9831(d)(4)(B)(iii)).

Effective date. The amendments made by this provision shall apply to months beginning after December 31, 2018 (Act Sec. 11081(b) of the Tax Cuts and Jobs Act).

¶145 Qualified Opportunity Zones and Treatment of Capital Gain Reinvested in Qualified Opportunity Zones

NEW LAW EXPLAINED

Creation of qualified opportunity zones.—A population census tract that is a low-income community, as defined for purposes of the new markets tax credit under Code Sec. 45D may be designated as a qualified opportunity zone (Code Sec. 1400Z-1(a) and (c)(1), as added by the Tax Cuts and Jobs Act).

The chief executive officer of a state may nominate a low-income community for this designation by notifying the Secretary of Treasury in writing by March 22, 2018 (i.e., the determination period). The Secretary must certify the nomination within 30 days of receiving the nomination (i.e., the consideration period). The chief executive officer may request a 30-day extension of either the determination period or the consideration period, or both (Code Sec. 1400Z-1(b)(2), as added by the 2017 Tax Cuts Act).

For purposes of this provision, a "state" includes any U.S. possession and a "chief executive officer" generally refers to a state's governor, but also includes the mayor of the District of Columbia (Code Sec. 1400Z-1(c)(3), as added by the 2017 Tax Cuts Act; Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Number of designations. The number of population census tracts designated as qualified opportunity zones in a state may not exceed 25 percent of the low-income communities in that state (Code Sec. 1400Z-1(d)(1), as added by the 2017 Tax Cuts Act). However, if there are less than 100 low-income communities in a state, 25 population census tracts may be designated (Code Sec. 1400Z-1(d)(2), as added by the 2017 Tax Cuts Act).

Contiguous tract designation. A population census tract that is not a low-income community may still be designated as qualified opportunity zones if the tract is contiguous to a low-income community that is designated as a qualified opportunity zone and the median family income of the tract does not exceed 125 percent of the contiguous qualified opportunity zone (Code Sec. 1400Z-1(e), as added by the 2017 Tax Cuts Act). This contiguous tract designation is limited to no more than five percent of the qualified opportunity zones in the state (Code Sec. 1400Z-1(e)(2), as added by the 2017 Tax Cuts Act).

Period of designation. The designation as a qualified opportunity zone remains in effect through the end of the 10th calendar year beginning on or after the date of designation (Code Sec. 1400Z-1(f), as added by the 2017 Tax Cuts Act).

Exclusion of gain reinvested in qualified opportunity fund.—A taxpayer may elect to exclude from gross income, gain on the sale or exchange of any property to an unrelated party in the tax year of the sale or exchange if the gain is reinvested in a qualified opportunity zone within 180 days of the sale or exchange (Code Sec. 1400Z-2(a)(1)(A), as added by the 2017 Tax Cuts Act). The amount of gain that can be excluded is equal to the amount of gain invested in the qualified opportunity fund (Code Sec. 1400Z-2(a)(1)(B), as added by the 2017 Tax Cuts Act). Only one election may be made with respect to a sale or exchange (Code Sec. 1400Z-2(a)(2), as added by the 2017 Tax Cuts Act).

CAUTION

No election may be made for any sale or exchange after December 31, 2026.

Deferral of gain. The election allows the taxpayer to defer including the gain in the taxpayer's gross income until the tax year in which:

- the investment is sold or exchanged, or
- December 31, 2026, whichever is earlier (Code Sec. 1400Z-2(b)(1), as added by the 2017 Tax Cuts Act).

If deferred gain is recognized on December 31, 2026 before the fund investment is sold, the recognized gain increases the basis in the fund for purposes of determining any gain that will be recognized on a subsequent sale (Code Sec. 1400Z-2(b)(2)(B)(ii), as added by the 2017 Tax Cuts Act).

CAUTION

The reference in Code Sec. 1400Z-2(b)(2)(B)(ii) to increasing basis by the gain recognized by reason of Code Sec. 1400Z-2(a)(1)(B) was apparently intended to be to Code Sec. 1400Z-2(b)(1)(B), relating to the mandatory December 31, 2026 recognition date.

The amount of gain the taxpayer must include is the excess of:

- the amount of gain excluded or the fair market value of the property on the date of the sale or exchange, whichever is less, over
- the taxpayer's basis in the investment (Code Sec. 1400Z-2(b)(2)(A), as added by the 2017 Tax Cuts Act).

Determination of basis. For purposes of determining the amount of deferred gain that is recognized, the taxpayer's basis in the investment is treated as zero (Code Sec. 1400Z-2(b)(2)(B)(i), as added by the 2017 Tax Cuts Act). However, the longer the taxpayer holds the investment, the more his or her basis in the investment is increased. If an investment is held:

- for at least 5 years, the zero basis is increased by 10 percent of the gain originally deferred (Code Sec. 1400Z-2(b)(2)(B)(iii), as added by the 2017 Tax Cuts Act), and
- for at least 7 years, basis is increased by 5 percent of the gain originally deferred, in addition to the amount of basis increase for investments held for at least 5 years (Code Sec. 1400Z-2(b)(2)(B)(iv), as added by the 2017 Tax Cuts Act).

COMMENT

If the qualified opportunity fund is sold before 5 years, the basis is $0 for purpose of determining the recognized deferred gain and the entire deferred gain is recognized. If the fund is held at least 5 years but less than 7 years, the $0 dollar basis is increased by 10 percent of the deferred gain and 90 percent of the deferred gain is recognized if the fund is sold. If the fund is held at least 7 years but less than 10 years before it is sold the $0 basis is increased by 15 percent of the investment and 85 percent of the deferred gain is recognized. The deferred gain will be recognized as income on December 31, 2026, if the fund has not been sold by that date, determined by increasing the $0 basis by 5 percent if the fund was held at least 5 years but less than 7 years and by 15% if the fund was held at least 7 years.

If the value of the fund investment has decreased on the date it is sold or, if earlier, on the mandatory December 31, 2026 recognition date, a taxpayer determines the amount of deferred gain that is recognized by reference to the fair market value on the date of sale or the earlier December 31, 2026 recognition date (Code Sec. 1400Z-2(b)(2)(A), as added by the 2017 Tax Cuts Act). For this purpose, basis is also considered $0 and is increased as described above if the fund investment has been held at least 5 years.

Finally, if the investment in the qualified opportunity fund is held for at least 10 years a taxpayer may elect to treat the basis on the date of sale as the fair market value of the qualified opportunity fund on the date of its sale or exchange. Consequently, if the value of the fund has increased beyond the initial amount of invested deferred gain and the election is made gain on the appreciation in the fund is not recognized (Code Sec. 1400Z-2(c), as added by the Tax Cuts Act).

EXAMPLE

On January 2, 2018, ABC Corp sells property to an unrelated party and has a resulting gain of $1 million, which ABC Corp then reinvests in InvestFund, a qualified opportunity fund, on March 30, 2018. ABC Corp sells its investment in InvestFund on April 2, 2021 for $1,500,000. Since ABC Corp held its investment in InvestFund for under 5 years, its basis in the investment is $0. In its 2021 tax year, ABC Corp must recognize the deferred gain of $1 million as well as the $500,000 in appreciation.

EXAMPLE

Assume same facts as Example above, except that ABC Corp sells the investment in 2025. Since the investment is held for more than 7 years, ABC Corp's basis increases from $0 to $150,000, thus reducing the amount of deferred gain it must include to $850,000 ($1,000,000 - $150,000). The additional $500,000 in appreciation must also be recognized.

10% of deferred gain --	$100,000
5% of deferred gain --	$50,000
	$150,000

At the election of a taxpayer, a taxpayer's basis in an investment held for at least 10 years is equal to the fair market value of the property on the date of sale or exchange (Code Sec. 1400Z-2(c), as added by the 2017 Tax Cuts Act).

EXAMPLE

ABC invests $1 million of deferred gain in a qualified opportunity fund on January 1, 2025. On December 31, 2026, ABC must recognize the entire $1 million deferred gain ($1 million deferred gain less $0 basis) even though the investment in the fund has not been sold. The $0 basis in the investment is not increased because ABC has not owned the fund for at least 5 years. On January 1, 2037, ABC sells its interest in the fund for $1.5 million. Since ABC has held the investment for 10 or more years, it may elect to treat the basis as $1.5 million and no additional gain is recognized. If ABC does not make the election, its basis is considered to be $1 million (under the provision deferred gain that was previously recognized on December 31, 2026 increases basis) and $500,000 gain is recognized.

EXAMPLE

Assuming the preceding facts except that the value of the fund has decreased to $400,000. Here ABC will not make the fair market value election, and recognizes a $600,000 loss ($400,000 less $1,000,000 previously recognized gain).

Mixed investment. If a taxpayer pays more for a qualified fund than the gain from a sale or exchange that it wishes to defer under this provision, the investment in the qualified opportunity fund is treated as two separate investments. The deferral rules would only apply to the investment with respect to the gain which is deferred (Code Sec. 1400Z-2(e)(1), as added by the Tax Cuts Act).

COMMENT

The creation of qualified opportunity zones is intended to spur investment in low-income communities by allowing taxpayers to defer gain from the sale of any asset by reinvesting that gain in a qualified opportunity fund. To encourage long-term investment, taxpayers may exclude appreciation (post-acquisition gain) in the fund if they retain the investment for at least 10 years. The maximum amount of initially deferred gain (i.e., the original investment in the fund) that can totally escape taxation is 15 percent if the fund is held at least 7 years.

Qualified opportunity fund. A qualified opportunity fund is a corporation or partnership organized for the purpose of investing in qualified opportunity zone property that holds at least 90 percent of its assets in such property (Code Sec. 1400Z-2(d)(1), as added by the 2017 Tax Cuts Act) The determination of the 90-percent requirement is the average of the percentage of qualified zone property held by the fund on the last day of the first 6-month period of the fund's tax year and on the last day of the fund's tax year.

Qualified opportunity zone property is:

- qualified opportunity zone stock,
- qualified opportunity zone partnership interest, or
- qualified opportunity zone business property (Code Sec. 1400Z-2(d)(2), as added by the 2017 Tax Cuts Act).

Qualified opportunity zone stock is original issue stock in a domestic corporation acquired after December 31, 2017, solely in exchange for cash (Code Sec. 1400Z-2(d)(2)(B), as added by the 2017 Tax Cuts Act). The corporation must be a qualified opportunity zone business at the time of issue (or was being organized as such if a new corporation) and for substantially all the fund's holding period. The qualified small business stock redemption rules of Code Sec. 1202(c)(3) apply to qualified opportunity zone stock (Code Sec. 1400Z-2(d)(2)(B)(ii), as added by the 2017 Tax Cuts Act).

A qualified opportunity zone partnership interest is any capital or profits interest in a domestic partnership acquired after December 31, 2017, from the partnership solely in exchange for cash (Code Sec. 1400Z-2(d)(2)(C), as added by the 2017 Tax Cuts Act). The partnership must be a qualified opportunity zone business at the time of acquisition (or was being organized as such if a new partnership) and for substantially all the fund's holding period.

Qualified opportunity zone business property is tangible property used in a trade or business of the qualified opportunity fund, if:

- purchased, as defined in Code Sec. 179(d)(2), by the qualified opportunity find after December 31, 2017,
- originally used or substantially improved by the qualified opportunity find, and
- used in a qualified opportunity zone during substantially all of the qualified opportunity fund's holding period (Code Sec. 1400Z-2(d)(2)(D)(i), as added by the 2017 Tax Cuts Act).

The related party rules of Code Sec. 179(d)(8) apply (Code Sec. 1400Z-2(d)(2)(D)(iii), as added by the 2017 Tax Cuts Act).

CAUTION

The reference in Code Sec. 1400Z-2(d)(2)(D)(iii) to the related party rules applying to qualified opportunity zone stock Code Sec. 1400Z-2(d)(2)(A)(i) was apparently intended to be to Code Sec. 1400Z-2(d)(2)(D)(i)(I), relating to the definition of purchase for the purposes of qualified opportunity zone business property.

Property is considered to be substantially improved if, during the 30-month period beginning after the date of acquisition, additions to basis with respect to the property in the hands of the qualified opportunity fund exceed its adjusted basis at the beginning the 30-month period (Code Sec. 1400Z-2(d)(2)(D)(ii), as added by the 2017 Tax Cuts Act).

CAUTION

The reference in Code Sec. 1400Z-2(d)(2)(D)(ii) to determining substantial improvement for purposes of a qualified opportunity zone partnership interest Code Sec. 1400Z-2(d)(2)(A)(ii) was apparently intended to be to Code Sec. 1400Z-2(d)(2)(D)(i)(II), relating to substantial improvement of the qualified opportunity zone business property by the qualified opportunity fund.

A qualified opportunity zone business is a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property (Code Sec. 1400Z-2(d)(3)(A), as added by the Tax Cuts and Jobs Act of 2017). For this purpose, qualified opportunity zone business property is determined in the same manner as under Code Sec. 1400Z-2(d)(2)(D), except that the term "qualified opportunity business" is substituted for "qualified opportunity fund." The business must also satisfy the requirements as an enterprise zone business under Code Sec. 1397C (2), (4) and (8), but not as a qualified redevelopment bond under Code Sec. 144(c)(6)(B) (Code Sec. 1400Z-2(d)(3)(A)(ii) and (iii), as added by the 2017 Tax Cuts Act).

If tangible property ceases to be qualified opportunity zone business property, it will continue to be treated as such for the lesser of (a) five years after the date it ceases to be qualified opportunity zone business property or (b) the date it is no longer held by a qualified opportunity zone business (Code Sec. 1400Z-2(d)(3)(B), as added by the 2017 Tax Cuts Act).

Failure to maintain 90-percent Investment Standard. A qualified opportunity fund must pay a penalty for each month it fails to hold at least 90 percent of its assets in qualified opportunity zone property (Code Sec. 1400Z-2(f)(1), as added by the 2017 Tax Cuts Act), unless the failure is due to reasonable cause (Code Sec. 1400Z-2(f)(3), as added by the 2017 Tax Cuts Act). The amount of the penalty is the:

- excess of 90 percent of its aggregated assets over the aggregate amount of qualified opportunity property held,
- multiplied by the underpayment rate under Code Sec. 6621(a)(2) for that month.

A qualified opportunity fund that is organized as a partnership must proportionally take the penalty into account as part of each partners' distributive share (Code Sec. 1400Z-2(f)(2), as added by the 2017 Tax Cuts Act).

EXAMPLE

Ninety percent of all assets of BuildFund Partnership, a qualified opportunity zone fund, is qualified opportunity property. The assets cease to be qualified opportunity property as of May 15, 2020. BuildFund must pay a penalty for each month that more than 10 percent of the total amount of its assets are not qualified opportunity fund property. For example, assume BuildFund had total assets worth $1 million, 80% of which were qualified opportunity property for a six-month period before once again meeting the 90 percent threshold. Assuming an underpayment penalty for those months of 4%, BuildFund must pay a penalty of $4,000 ($900,000 - $800,000 x 4%) each month for 6 months.

Applicable rules. For purposes of Code Sec. 1400Z-2, persons are treated as related if they meet the definition under Code Sec. 267(b) or Code Sec. 707(b)(1), except that direct or indirect ownership limitation in the outstanding stock of the corporation or capital interest or profit interest in the partnership is "20 percent" rather than "50 percent" (Code Sec. 1400Z-2(e)(2), as added by the 2017 Tax Cuts Act).

If the taxpayer is a decedent and the inclusion of the deferred gain is not properly included in his or her gross income, the amount is to be included in the gross income of the estate under Code Sec. 691 (Code Sec. 1400Z-2(e)(3), as added by the 2017 Tax Cuts Act).

The IRS is authorized to issue regulations to carry out the purposes of Code Sec. 1400Z-2, including rules:

- for certification of qualified opportunity funds,
- to ensure qualified opportunity funds have reasonable time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and reinvest proceeds from the disposition of qualified opportunity zone property, and
- to prevent abuse (Code Sec. 1400Z-2(e)(4), as added by the 2017 Tax Cuts Act).

COMMENT

The certification process for a qualified opportunity fund will be done by the Community Development Financial Institutions Fund (CDFI Fund) in a similar manner to the process in place for allocating the new markets tax credit (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

COMMENT

Beginning December 22, 2022, the IRS, or its delegate, must submit an annual report to Congress on the opportunity zone incentives. The report is to include: (a) an assessment of investments held by the qualified opportunity fund at both the national and state level; (b) the number of qualified opportunity funds; (c) the amount of assets held by class; (d) the percentage of qualified opportunity zone census tracts designated that received qualified opportunity fund investments; and (e) an assessment of impact of the investments on economic indicators such as job creation, poverty reduction and new businesses (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Effective date. This provision is applicable on December 22, 2017, the date of enactment (Act Sec. 13823(d) of the Tax Cuts and Jobs Act).

CHAPTER 2. DEDUCTIONS, EXCLUSIONS, AND CREDITS FOR INDIVIDUALS

STANDARD DEDUCTION AND PERSONAL

¶205 Increase in Basic Standard Deduction

NEW LAW EXPLAINED

Basic standard deduction temporarily increased.—Effective for tax years beginning after December 31,2017, and before January 1, 2026, the basic standard deduction amounts are increased to: $12,000 for single individuals and married individuals filing separately; $18,000 for heads of household; and $24,000 for married individuals filing jointly (including surviving spouses) (Code Sec. 63(c)(7)(A), as added by the Tax Cuts and Jobs Act). These amounts are adjusted annually for inflation for tax years beginning after 2018 (Code Sec. 63(c)(7)(B), as added by the 2017 Tax Cuts Act).

COMMENT

The additional standard deduction amounts for the aged and/or blind are not affected by the new law.

Effective date. The amendment made by this provision applies to tax years beginning after December 31, 2017 (Act Sec. 11021(b) of the Tax Cuts and Jobs Act (P.L. 115-97)).

¶210 Personal and Dependency Exemptions

NEW LAW EXPLAINED

Suspension of personal exemption deduction.—The deduction for personal and dependency exemptions by an individual taxpayer is temporarily repealed for tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 151(d)(5), as added by the Tax Cuts and Jobs).

Filing threshold. The rules for determining who is required to file a tax return for tax years beginning after December 31, 2017, and before January 1, 2026, are modified (Code Sec. 6012(f), as added by the 2017 Tax Cuts Act). With respect to an individual who is not married (single or head of household), the individual is required to file a tax return if the individual's gross income for the tax year exceeds the applicable standard deduction. Married individuals reach the filing threshold if that individual's gross income, when combined with the individual's spouse's gross income for the tax year, is more than the standard deduction applicable to a joint return, and provided that:

- the individual and his or her spouse, at the close of the tax year, had the same household as their home;
- the individual's spouse does not file a separate return; and
- neither the individual nor his or her spouse is a dependent of another taxpayer who has income (other than earned income) in excess of the amount provided under Code Sec. 63(c)(5)(A) ($1,050 for 2018, as indexed for inflation).

Qualified disability trusts. The annual amount a qualified disability trust is allowed to deduct for tax years beginning after December 31, 2017, and before January 1, 2026, is modified (Code Sec. 642(b)(2)(C)(iii), as added by the 2017 Tax Cuts Act). For those tax years, when the personal exemption is zero, the annual deduction is $4,150, indexed for inflation after 2018.

Withholding requirements. The deduction for personal exemptions, as applied for withholding purposes, is suspended, applicable to tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 3402(a)(2), as amended by the 2017 Tax Cuts Act; Act Sec. 11041(f)(2) of the 2017 Tax Cuts Act). The IRS may administer the withholding rules under Code Sec. 3402 for tax years beginning before January 1, 2019, without regard to the suspension of the personal exemptions (now referred to as "allowances"). In other words, at the IRS's discretion, wage withholding rules might remain the same as under present law for 2018. The 2018 annual personal exemption amount, under prior law, was scheduled to increase to $4,150, and the IRS has stated that it will issue withholding tables to be implemented by February 2018. The withholding provision will apply to tax years beginning before 2019, and its implementation is authorized pursuant to Code Sec. 3402 (Act Sec. 11041(f)(2) of the 2017 Tax Cuts Act).

Levies. The amount exempted from an IRS levy on an individual's wages or salary for personal services for tax years beginning after December 31, 2017, and before January 1, 2026, is altered (Code Sec. 6334(d)(4), as added by the 2017 Tax Cuts Act). For those years, when the personal exemption is zero, the levy exemption is equal to the sum of the standard deduction and the total of $4,150 multiplied by the number of the individual's dependents for the tax year in which the levy occurs, divided by the number of times the taxpayer is paid, except for the first 15 percent. The $4,150 amount is indexed annually for inflation after 2018.

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 11041(f) of the Tax Cuts and Jobs Act).

ITEMIZED DEDUCTIONS

¶215 Deduction of State and Local Taxes by Individuals

NEW LAW EXPLAINED

Limitation of itemized deduction for certain income, property, and sales taxes.— The deduction for taxes paid or accrued by an individual during the tax year that are not directly connected with a trade or business, or with property held for the production of income, is limited for tax years beginning after December 31, 2017, and before January 1, 2026. Specifically, for tax years 2018 through 2025, an individual may claim an itemized deduction on Schedule A of Form 1040 of up to only $10,000 ($5,000 for married taxpayer filing a separate return) for: (1) state and local real property taxes; (2) state and local personal property taxes; and (3) state and local income taxes, as well as state and local sales taxes deducted in lieu of state and local income taxes (Code Sec. 164(b)(6), as added by the Tax Cuts and Jobs Act).

For purposes of applying the dollar limit above, if an individual prepays before 2018 a state or local income tax imposed for a tax year beginning after 2017, the payment is treated as paid on the last day of the tax year for which the tax is imposed (Code Sec. 164(b)(6), as amended by the 2017 Tax Cuts Act). Thus, an individual cannot claim an itemized deduction in 2017 on a prepayment of income tax for a future tax year in order to avoid the dollar limit for tax years tax years 2018 through 2025 (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

COMMENT

The prepayment restriction specifically applies to state or local income taxes, but not to state and local real or personal property taxes.

A taxpayer may still claim a deduction for foreign income taxes subject to the $10,000/$5,000 limit. However, no deduction is available for foreign real property taxes for tax years 2018 through 2025 (Code Sec. 164(b)(6), as amended by the 2017 Tax Cuts Act).

In the case of state and local real property and personal property taxes, a deduction is still allowed with no dollar limit if the taxes are paid or accrued in carrying on a trade or business, or on property held for the production of income. Thus, state and local property taxes may be deducted in computing an individual's Schedule C, Schedule E, or Schedule F of Form 1040. For example, an individual may deduct property taxes if the taxes are imposed on business or income producing assets such as residential rental property.

CAUTION

A deduction is still allowed for state and local income taxes if the taxpayer are paid or accrued in carrying on a trade or business, or on property held for the production of income. However, as written, the language of Code Sec. 164(b)(6) is that state and local income taxes are subject to the $10,000/$5,000 limit regardless of whether or not they are paid or accrued in a business or for the production of income.

COMMENT

The deduction for federal and state generation-skipping transfer (GST) taxes imposed on income distributions is not affected. An individual who received a income distribution from a GST trust and paid GST taxes on the distribution may continue to claim an itemized deduction for the taxes.

Effective date. The amendment made by this provision applies to tax years beginning after December 31, 2016 (Act Sec. 11042(b) of the Tax Cuts and Jobs Act).

¶220 Home Mortgage Interest Deduction

NEW LAW EXPLAINED

Deduction for home equity interest suspended and acquisition debt limits reduced for 2018 through 2025.—The itemized deduction for home mortgage interest (i.e., qualified residence interest) is temporarily limited to interest on acquisition debt for tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 163(h)(3)(F)(i)(I), as added by the Tax Cuts and Jobs). A taxpayer may not claim an itemized deduction for mortgage interest paid or accrued on any home equity debt of any qualified residence of the taxpayer for tax years beginning in 2018 through 2025.

COMMENT

The temporary suspension of the deduction for interest on home equity debt ends after 2025. Thus, a taxpayer may claim the deduction for tax years beginning in 2026.

Limitation on acquisition indebtedness. The maximum amount that may be treated as acquisition debt is also reduced to $750,000 ($375,000 if married filing separately) for tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 163(h)(3)(F)(i)(II), as added by the 2017 Tax Cuts Act). The reduction generally applies to any acquisition debt incurred after December 15, 2017. The maximum amount that may be treated as acquisition debt remains $1 million ($500,000 if married filing separately) for any acquisition debt incurred with respect to the taxpayer's principal residence on or before December 15, 2017 (Code Sec. 163(h)(3)(F)(i)(III), as added by the 2017 Tax Cuts Act). However, the acquisition debt incurred on or before December 15, 2017, reduces the $750,000/$375,000 limit to any acquisition debt incurred after December 15, 2017.

The $1 million ($500,000 if married filing separately) dollar limit will also continue to apply to a taxpayer who enters a binding written contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, so long as the residence is purchased before April 1, 2018 (Code Sec. 163(h)(3)(F)(i)(IV), as added by the 2017 Tax Cuts Act). Similarly, the higher limit continues to apply to any debt incurred after December 15, 2017, to refinance existing acquisition debt on the taxpayer's principal residence to the extent the amount of the debt resulting from the refinancing does not exceed the amount of the refinanced debt (Code Sec. 163(h)(3)(F)(iii), as added by the 2017 Tax Cuts Act). Thus, the maximum dollar amount that may be treated as acquisition debt on the taxpayer's principal residence will not decrease by reason of a refinancing. The exception for refinancing existing acquisition will not apply after: (1) the expiration of the term of the original debt; or (2) the earlier of the expiration of the first refinancing of the debt or 30 years after the date of the first refinancing.

Qualified principal residence debt. The $2 million ($1 million) limit on the exclusion of discharged qualified principal residence debt is not affected by the temporary reduction the limit of acquisition debt for home mortgage interest deduction (Code Sec. 163(h)(3)(F)(iv), as added by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 11043(b) of the Tax Cuts and Jobs Act).

¶225 Medical Expense Itemized Deduction

NEW LAW EXPLAINED

Medical expense deduction AGI threshold temporarily reduced.—The threshold to claim an itemized deduction for unreimbursed expenses paid for the medical care of the taxpayer or the taxpayer's spouse or dependents is reduced to 7.5 percent of adjusted gross income (AG) for all taxpayers for tax years beginning after December 31, 2016 and before January 1, 2019. (Code Sec. 213(f) as amended by the Tax Cuts and Jobs Act). The reduced threshold applies for both regular tax and alternative minimum tax purposes (Code Sec. 56(b)(1)(B) as amended by the Tax Cuts and Jobs Act).

> **PRACTICE POINTER**
>
> Unlike many other provisions of the Tax Cuts and Jobs Act, the reduced AGI threshold for the medical expense deduction is available for expenses incurred in 2017.

Effective date. The amendments made by this section applies to tax years beginning after December 31, 2016 (Act Sec. 11027(c) of the Tax Cuts and Jobs Act).

¶230 Charitable Deduction Modifications

NEW LAW EXPLAINED

Percentage limit for cash charitable contributions by individuals temporarily increased.—The income-based percentage limit is temporarily increased from 50 percent to 60 percent for an individual taxpayer's cash charitable contributions to public charities, private foundations other than nonoperating private foundations, and certain governmental units (i.e., "50% organizations"). The 60-percent contribution base limit applies to qualifying cash contributions made in any tax year beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 170(b)(1)(G)(i), as added by the Tax Cuts and Jobs Act). The individual may carry forward for five years any qualifying cash contributions that exceed the 60-percent ceiling for the tax year of the contribution (Code Sec. 170(b)(1)(G)(ii), as added by the 2017 Tax Cuts Act).

Cash contributions that qualify for the 60-percent limit are not taken into account in determining contributions that are allowed under the 50-percent limit of Code Sec. 170(b)(1)(A) (Code Sec. 170(b)(1)(G)(iii)(I), as added by the 2017 Tax Cuts Act). For each tax year beginning after December 31, 2017, and before January 1, 2026, and for each tax year to which any 60-percent cash contribution is carried over, the aggregate contribution limitation allowed under Code Sec. 170(b)(1)(A) must be reduced (but not below zero) by the total contributions allowed under the 60-percent limit provision. Further, in determining allowable contributions under Code Sec. 170(b)(1)(B) for donations of cash or nonappreciated property to nonoperating private foundations or "for the use of" 50% organizations, any references to the 50-percent limit determination under Code Sec. 170(b)(1)(A) must also include the 60-percent limit determination under Code Sec. 170(b)(1)(G) (Code Sec. 170(b)(1)(G)(iii)(II), as added by the 2017 Tax Cuts Act)

COMMENT

The 60-percent limit for cash contributions to public charities is intended to "encourage taxpayers to provide essential monetary support to front-line charities," because "a robust charitable sector is vital to our economy" and "charitable giving is critical to ensuring that the sector thrives" (Report of the House Ways and Means Committee on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-409, p. 177). However, the Urban-Brookings Tax Policy Center believes that the increased standard deduction amount (see ¶205) and the scaling back of many individual itemized deductions will substantially reduce the number of taxpayers who elect to itemize, and significantly reduce the tax incentive to donate. The Tax Policy Center estimates that individual giving will decline by between $12 billion and $20 billion in 2018 (i.e., between four and five percent), with similar effects in the long run (see "The House Tax Bill Is Not Very Charitable to Nonprofits," at http://www.taxpolicycenter.org/taxvox/house-tax-bill-not-very-charitable-nonprofits).

Charitable deduction for college athletic seating rights payments repealed. A charitable deduction is not allowed for any payment to a college or university in exchange for which the payer receives the right to purchase tickets or seating at an athletic event (Code Sec. 170(l), as amended by the 2017 Tax Cuts Act). Thus, the charitable deduction for amounts paid for college athletic seating rights has been effectively repealed.

COMMENT

This charitable deduction has been eliminated because "taxpayers should only be permitted a charitable deduction commensurate with the value of assets given to charity" (Report of the House Ways and Means Committee on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-409, p. 177).

Substantiation exception for donee-reported contributions repealed. The provision relieving a donor from the requirement to obtain a contemporaneous written acknowledgment for any charitable contribution of $250 or more if the donee organization reports the required information to the IRS has been repealed (Code Sec. 170(f)(8)(D), as stricken by the 2017 Tax Cuts Act). A donor who makes a contribution of $250 or more in the 2017 tax year and later is not allowed a charitable deduction unless the donor substantiates the donation with a contemporaneous written acknowledgment by the donee (Code Sec. 170(f)(8); Reg. §1.170A-13(f)).

Effective date. In general, the amendments apply to contributions made in tax years beginning after December 31, 2017 (Act Secs. 11023(b) and 13704(b) of the Tax Cuts and Jobs Act). The repeal of the exception to the contemporaneous written acknowledgment requirements applies to contributions made in tax years beginning after December 31, 2016 (Act Sec. 13705(b) of the 2017 Tax Cuts Act).

Expiration date. The increase to the income-based percentage limit from 50 percent to 60 percent for charitable contributions of cash by an individual taxpayer to public charities and certain other organizations does not apply to contributions for any tax year beginning after December 31, 2025 (Code Sec. 170(b)(1)(G)(i), as added by the Tax Cuts and Jobs Act).

¶235 Personal Casualty and Theft Loss Deduction

NEW LAW EXPLAINED

Personal casualty and theft loss deduction limited in 2018 through 2025; special rules apply for net disaster losses in 2016 and 2017.—The personal casualty loss deduction is temporarily limited in tax years beginning after December 31, 2017, and before January 1, 2026, to losses attributable to federally declared disasters (Code Sec. 165(h)(5)(A), as added by the Tax Cuts and Jobs Act). A taxpayer may still claim personal casualty losses not attributable federally declared disasters to offset any personal casualty gains during 2018 through 2025. However, any such personal casualty gains used to offset personal casualty losses attributable to a federally declared disaster are not taken into account in determining the taxpayer's 10 percent of AGI limitation (Code Sec. 165(h)(5)(B), as added by the 2017 Tax Cuts Act).

Additional relief for 2016 and 2017 disasters. If an individual has a net disaster loss for tax years beginning in 2016 or 2017, the $100 limitation applicable to each casualty related to the disaster is increased to $500 and the 10 percent AGI limitation is waived (Act Sec. 11028(c) of the 2017 Tax Cuts Act). For this purpose, a net disaster loss is the qualified disaster-related personal casualty losses, over any personal casualty gains. A qualified disaster-related personal loss means a personal casualty loss arising in a disaster area after on or after January 1, 2016, that is attributable to a federally declared disaster. For an individual who does not itemize deductions, his or her standard deduction is increased by the amount of the casualty loss attributable to the disaster.

Effective date. The amendment made by this section limiting personal casualty losses to federal disaster areas declared disaster areas applies to losses incurred in tax years beginning after December 31, 2017 (Act Sec. 11044(b) of the Tax Cuts and Jobs Act). The special rules related to personal casualty losses related to net disaster losses for 2016 and 2017 are effective on December 22, 2017, the date of enactment.

¶240 Gambling Losses

NEW LAW EXPLAINED

"Losses from wagering transactions" clarified.—The term "losses from wagering transactions" is clarified to include any deduction otherwise allowable under Chapter 1 of the Code incurred in carrying on any wagering transaction (Code Sec. 165(d) as amended by the Tax Cuts and Jobs Act). The provision is effective for tax years beginning after December 31, 2017, and before January 1, 2026.

The new law is intended to clarify that the limitation on losses from wagering transactions applies not only to the actual costs of wagers incurred by an individual, but to other expenses incurred by the individual in connection with the conduct of that individual's gambling activities. Thus, for example, expenses incurred in travelling to and from a casino fall within the scope of the gambling loss limitation, and these expenses may only be deducted to the extent of gambling winnings.

Effective date. The provision is effective for tax years beginning after December 31, 2017 (Act Sec. 11050(b) of the Tax Cuts and Jobs Act).

¶245 Miscellaneous Itemized Deductions

NEW LAW EXPLAINED

Suspension of miscellaneous itemized deductions.— All miscellaneous itemized deductions that are subject to the two-percent-of-AGI floor are temporarily repealed for tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 67(g), as added by the Tax Cuts and Jobs Act). Thus, no miscellaneous itemized deduction may be claimed by an individual on Schedule A of Form 1040 for tax years 2018 through 2025.

Effective date. The amendment made by this provision applies to tax years beginning after December 31, 2017 (Act Sec. 11045(b) of the Tax Cuts and Jobs Act).

¶250 Suspension of Overall Limitation on Itemized Deductions

NEW LAW EXPLAINED

Overall limitation on itemized deductions suspended.—The overall limitation on itemized deductions is suspended, applicable to tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 68(f), as added by the Tax Cuts and Jobs Act).

Effective date. The amendments made by this provision apply to tax years beginning after December 31, 2017 (Act Sec. 11046(b) of the Tax Cuts and Jobs Act).

ADJUSTMENTS TO GROSS INCOME

¶255 Alimony and Separate Maintenance Payments

NEW LAW EXPLAINED

Alimony deduction and exclusion repealed for instruments executed or modified after 2018.—The deduction of qualified alimony and separate maintenance payments by a payor, the exclusion of the payments from gross income by a payee, and the special rules for alimony trusts are generally repealed after 2018 (Code Sec. 71, 215, and 682 stricken by the Tax Cuts and Jobs Act). However, the repeal is only effective for any divorce or separation instruments:

- executed after December 31, 2018; and
- • executed before January 1, 2019, and modified after 2018 provided that the modification expressly provides that the repeal of the qualified alimony and separate maintenance rules of the Internal Revenue Code apply (Act Sec. 11051(c) of the 2017 Tax Cuts Act).

COMMENT

A taxpayer may continue to deduct qualified alimony and separate maintenance payments made, or exclude such payments received from gross income after 2018 if his or her divorce or separation instrument is: (1) executed before 2019; or (2) is modified after 2018 so long as it does not expressly provide that the that the repeal of the qualified alimony and separate maintenance rules of the Internal Revenue Code apply. The special rules applicable to alimony trusts will also continue to apply after 2018 under the same conditions as for the deduction and the exclusion.

CAUTION

Since the rules applicable to alimony or separate maintenance payments still apply to certain divorce or separation instruments after 2018, other rules which are amended or repealed by the 2017 Tax Cuts Act will also continue to apply. Examples include rules related to additional withholding allowances, requirements to include taxpayer identification numbers (TIN), and the definition of compensation for the purpose of IRA contributions deductions.

Effective date. The amendments made by this section apply to: (1) any divorce or separation instrument (as defined in Code Sec. (b)(2) as in effect before December 22, 2017, the date of the enactment) and executed after December 31, 2018; (2) any divorce or separation instrument executed on or before December 31, 2018, and modified after that date if the modification expressly provides that the amendments made by this section apply to the modification (Act Sec. 11015(c) of the Tax Cuts and Jobs Act).

¶260 Moving Expense Deduction

NEW LAW EXPLAINED

Moving expense deduction temporarily repealed; special rules for Armed Forces members retained.—The deduction for moving expenses is generally repealed for tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 217(k), as added by the Tax Cuts and Jobs Act). Thus, an employee or self-employed individual may not claim an above-the-line deduction in calculating adjusted gross income for moving expenses in 2018 through 2025.

The special rules applicable to a member of the Armed Forces of the United States will continue to apply after 2017. Thus, the Armed Forces member may still claim a deduction for moving expenses and exclude from income in-kind moving and storage expenses, as well as reimbursement or allowance for those expenses, in 2018 through 2025 if he or she who is on active duty and moves pursuant to a military order and incident to a permanent change of station (Code Sec. 217(g)).

Effective date. The amendment made by this section applies to tax years beginning after December 31, 2017 (Act Sec. 11049(b) of the Tax Cuts and Jobs Act).

EXCLUSIONS FROM GROSS INCOME

¶265 Discharge of Debt Income from Student Loans

NEW LAW EXPLAINED

Student loan debt discharge exclusion expanded before 2025 due to death or disability.—The exclusion of discharge of debt income for student loans is expanded to include discharges because of the student's death or total and permanent disability. The exclusion applies to discharge of debt income due to the discharge of an eligible loan after December 31, 2017, and before January 1, 2026 (Code Sec. 108(f)(5)(A), as added by the Tax Cuts and Jobs Act (P.L. 115-97)). Loans eligible for this exclusion are loans made by:

- the United States (or an instrumentality or agency of the United States);
- a state (or political subdivision of a state);
- certain tax-exempt public benefit corporations that control a state, county, or municipal hospital and whose employees have been deemed to be public employees under state law;
- an educational organization that originally received the funds from which the loan was made from the United States, a state, or a tax-exempt public benefit corporation; or
- private education loans (for this purpose, private education loan is defined in section 140(7) of the Consumer Protection Act) (Code Sec. 108(f)(5)(B), as added by the 2017 Tax Cuts Act).

EXAMPLE

Bridgett becomes totally and permanently disabled in 2018 as the result of an accident. She has an outstanding student loan that was made by the State of New York, which is cancelled by the state due to her disability. Because the discharge is due to Bridgett's total and permanent disability, it does not give rise to discharge of debt income in the tax year.

COMMENT

The legislative text provides a broad catch-all exclusion for discharge of debt income of an eligible loan on account of the death or total and permanent disability of the student. It also provides specific references to provisions in the Higher Education Act of 1965 of loan forgiveness in the case of death and total and permanent disability.

Effective date. The amendment made by this section applies to discharges of debt after December 31, 2017 (Act Sec. 11301(b) of the Tax Cuts and Jobs Act).

¶270 Repeal of the Rollover of Capital Gain from Publicly Traded Securities

NEW LAW EXPLAINED

Rollover of capital gain from publicly traded securities into specialized small business investment companies is repealed.—The election to rollover gain from the sale of publicly traded securities if the sale proceeds are used to purchase common stock or a partnership interest in a specialized small business investment company is repealed (Code Sec. 1044, prior to being stricken by the Tax Cuts and Jobs Act).

Effective date. The amendments made by this section apply to sales after December 31, 2017 (Act Sec. 13313(c) of the Tax Cuts and Jobs Act).

PERSONAL TAX CREDITS

¶280 Child Tax Credit

NEW LAW EXPLAINED

Modification of child tax credit and new credit for qualifying dependents after 2017.—The child tax credit is temporarily expanded effective for tax years beginning after 2017 (Code Sec. 24(h)(1), as added by the Tax Cuts and Jobs Act). Specifically, the following modifications to the credit are effective for tax years beginning after December 31, 2017, and before January 1, 2026:

- The credit amount is increased to $2,000 per qualifying child (Code Sec. 24(h)(2), as added by the Tax Cuts and Jobs Act).
- The threshold amount when the credit begins to phase out is increased to $400,000 if married filing jointly and $200,000 for any other filing status (Code Sec. 24(h)(3), as added by the Tax Cuts and Jobs Act). The credit is reduced by $50 for $1,000 (or fraction thereof) that a taxpayer's modified adjusted gross income (MAGI) exceeds the threshold amount. The threshold amounts are not indexed for inflation.
- A taxpayer may claim a $500 credit for each dependent who is not a qualifying child for purposes of the child tax credit (Code Sec. 24(h)(4), as added by the Tax Cuts and Jobs Act). A dependent for this purpose is a qualifying relative (and not a qualifying child) for purposes of claiming a dependency exemption under Code Sec. 152(b). In addition, the dependent must be a U.S. citizen, national, or resident of the United States. The $500 dollar credit may not be claimed for a dependent who is resident of contiguous country to the United States (i.e., Mexico and Canada).

COMPLIANCE NOTE

A taxpayer must file either Form 1040 or Form 1040A to claim the child tax credit. The child tax credit cannot be claimed by a taxpayer filing Form 1040-EZ.

Refundable child tax credit. A portion of the child tax credit remains refundable after 2017 and before 2026, referred to as the additional child tax credit (ACTC), except that the earned income threshold is temporarily decreased by $500. For tax years beginning in 2018 through 2025, a taxpayer is eligible for a refund equal to 15 percent of his or her earned income in excess of $2,500 (as opposed to $3,000) to the extent the child tax credit exceeds the taxpayer's tax liability (Code Sec. 24(h)(6), as added by the Tax Cuts and Jobs Act).

The refundable amount for 2018 through 2025 is limited to $1,400 per qualifying child regardless that the credit is $2,000 per qualifying child Code Sec. 24(h)(5), as added by the Tax Cuts and Jobs Act). In addition, the $500 credit for each dependent who is not a qualifying child is disregarded in calculating the ACTC (i.e., the refundable portion is only for qualifying children claimed by the taxpayer for the credit). The $1,400 refund limitation per qualifying child for the ACTC is indexed annually for inflation after 2018.

COMPLIANCE NOTE

A taxpayer claiming the ACTC must complete Schedule 8812.

Taxpayer identification number required. A taxpayer must include on his or her return a qualifying child's Social Security number (SSN) to receive either the refundable or nonrefundable portion of the credit with respect to that child (Code Sec. 24(h)(7), as added by the Tax Cuts and Jobs Act). A SSN issued by the Social Security Administration (SSA) to the qualifying child is valid for purpose of the ACTC only if the child is a U.S. citizen or the SSN authorizes the individual to work in the United States under Section 205(c)(2)(B)(i) of the Social Security Act. In addition, the SSN must be issued to the qualifying child on or before the due date of the taxpayer's return.

COMMENT

A Social security card labeled "not valid for employment" merely allows the holder to receive federal benefits (e.g., Medicaid) and it does not give the holder a valid SSN to work in the United States. A Social Security card that reads "Valid for work only with DHS authorization" or "Valid for work only with INS authorization" is valid for work in the United States if the authorization is still valid.

A taxpayer who cannot claim the child credit because a qualifying child does not have a Social Security number may nonetheless qualify for the nonrefundable $500 credit for the child (Code Sec. 24(h)(4)(C), as added by the Tax Cuts and Jobs Act).

COMMENT

A taxpayer can claim the nonrefundable $500 credit for any person claimed as a dependent. In order to claim a dependency exemption for any person, the taxpayer must include a taxpayer identification number (TIN) of the dependent on his or her return (Code Sec. 151(e)). This may be satisfied by including the dependent's SSN, TIN, or adoption taxpayer identification number (ATIN) (Reg. §301.6109-1). Thus, a SSN is only required for a qualifying child in claiming the child tax credit. A SSN is not required to claim the nonrefundable $500 credit for a child or nonchild dependent.

Effective date. The amendment made by this section applies to tax years beginning after December 31, 2017 (Act Sec. 11022(b) of the Tax Cuts and Jobs Act).

CHAPTER 3. CORPORATIONS AND PASS-THROUGH ENTITIES

CORPORATIONS

¶305 21-Percent Corporate Income Tax Rate

NEW LAW EXPLAINED

21-percent flat corporate income tax rate established; normalization requirements provided.—Reduction in corporate tax rate. For tax years beginning after December 31, 2017, the graduated corporate rate structure is eliminated and corporate taxable income is taxed at a 21-percent flat rate (Code Sec. 11(b), as amended by the Tax Cuts and Jobs Act).

COMMENT

The lower corporate tax rate will allow domestic corporations to remain globally competitive and will increase international investments in the United States. Also, it is expected that the lower corporate tax rate will lead to economic growth and jobs creation because U.S. corporations will have more money to invest. In addition, the lower corporate tax rate will provide less incentives for U.S. companies to shift operations and employees abroad and will encourage investment of their foreign earnings into business expansion and employment in the United States.

The alternative tax for net capital gains is repealed (Act Sec. 13001(b)(2) of the 2017 Tax Cuts Act, striking Code Sec. 1201).

COMMENT

The alternative tax is obsolete in light of the new 21-percent corporate tax rate.

Other changes. A definition of undistributed capital gain is provided for purposes of the rules related to the taxation of REITs on net capital gains. Specifically, undistributed capital gain is the excess of the net capital gain over the deduction for dividends paid (as defined in Code Sec. 561) determined with reference to capital gain dividends only (Code Sec. 857(b)(3)(F), as amended by the 2017 Tax Cuts Act).

The new law also clarifies that, for purposes of the capital gain rate differential adjustment in determining the foreign tax credit limitation, there is a capital gain rate differential for any year if Code Sec. 1(h) applies to the tax year. In addition, the rate differential portion of foreign source net capital gain, net capital gain, or the excess of net capital gain from sources within the United States over net capital gain, as the case may be, is the same proportion of such amount as (1) the excess of (i) the highest rate of tax set forth in Code Sec. 1(a), (b), (c), (d), or (e) (whichever applies), over (ii) the alternative rate of tax determined under Code Sec. 1(h), bears to (2) the rate referred to in item (i) (Code Sec. 904(b)(3)(D) and (E), as added by the 2017 Tax Cuts Act).

Moreover, the rules for withholding of tax on dispositions of U.S. real property are modified to replace the 35-percent tax required to be withheld on certain dispositions by domestic partnerships, estates and trusts, and distributions by foreign corporations, REITs, and RICs with the highest rate of tax in effect for the tax year under Code Sec. 11(b) (Code Sec. 1445(e), as amended by the 2017 Tax Cuts Act).

In addition, the provision disallowing the graduated corporate rates or the accumulated earnings credit to transferee corporations upon certain transfers is repealed (Act Sec. 13001(b)(5) of the 2017 Tax Cuts Act, striking Code Sec. 1551).

The new law further modifies the former rules limiting the use of multiple tax benefits of controlled group of corporations to leave only the limitation on the use of the accumulated earnings credit. Specifically, the component members of a controlled group of corporations on a December 31 are limited, for purposes of Subtitle A of the Code, for their tax years which include that December 31, to one $250,000 ($150,000 if any component member is a personal service corporation) accumulated earnings credit under Code Sec. 535(c). This amount must be divided equally among the component members of the group on that

December 31, unless an unequal allocation is allowed by regulations (Code Sec. 1561(a), as amended by the 2017 Tax Cuts Act).

COMMENT

This change reflects the repeal of the corporate alternative minimum tax and the elimination of the graduated corporate rate structure by the 2017 Tax Cuts Act.

If a corporation has a short tax year that does not include a December 31 and is a component member of a controlled group of corporations with respect to that tax year, then for purposes of Subtitle A of the Code, the amount used in computing the accumulated earnings credit of the corporation for that tax year is determined by dividing $250,000 (or $150,000) by the number of corporations that are component members of the group on the last day of that tax year. For this purpose, the definition of component member in Code Sec. 1563(b) is applied as if the last day were substituted for December 31 (Code Sec. 1561(b), as amended by the 2017 Tax Cuts Act).

COMMENT

The effective date provided for the amendment to Code Sec. 1561 is for transfers made after December 31, 2017 (Act Sec. 13001(c)(3) of the 2017 Tax Cuts Act). However, this effective date does not appear to be correct given the subject and application of Code Sec. 1561. More likely, the amendment to Code Sec. 1561 should apply to tax years beginning after December 31, 2017. Also, it is likely that the effective date for transfers made after December 31, 2017, is intended to apply to the repeal of Code Sec. 1551, which concerns transfers to corporations.

Normalization requirements. For taxpayers subject to the normalization method of accounting (e.g., regulated public utilities), the new law provides for the normalization of excess deferred tax reserves resulting from the reduction of corporate income tax rates (with respect to prior depreciation or recovery allowances taken on assets placed in service before the corporate rate reduction takes effect).

Specifically, a taxpayer is not treated as using a normalization method of accounting with respect to any public utility property for purposes of Code Sec. 167 or 168, if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method (Act Sec. 13001(d)(1) of the 2017 Tax Cuts Act).

For this purpose, the excess tax reserve is the excess of:

- the reserve for deferred taxes (described in Code Sec. 168(i)(9)(A)(ii)) as of the day before the corporate rate reductions (provided in the amendments made by Act Sec. 13001 of the 2017 Tax Cuts Act) take effect, over
- the amount which would be the balance in the reserve if the amount of the reserve were determined by assuming that the corporate rate reductions were in effect for all prior periods (Act Sec. 13001(d)(3)(A) of the 2017 Tax Cuts Act).

The average rate assumption method is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in the taxpayer's regulated books of account that gave rise to the reserve for deferred taxes. Under this method, during the time period in which timing differences for the property (i.e., differences between tax depreciation and regulatory depreciation with respect to the property) reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying:

- the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by
- the amount of the timing differences that reverse during that period (Act Sec. 13001(d)(3)(B) of the 2017 Tax Cuts Act).]

COMMENT

In other words, under this method, the excess tax reserve is reduced as the timing differences reverse over the remaining life of the asset. To ensure that the deferred tax reserve, including the excess tax reserve, is reduced to zero at the end of the regulatory life of the asset that generated the reserve, the amount of the timing difference that reverses during a tax year is multiplied by the ratio of (1) the aggregate deferred taxes as of the beginning of the period in question to (2) the aggregate timing differences for the property as of the beginning of the period in question.

COMMENT

The reversal of timing differences generally occurs when the amount of the tax depreciation taken with respect to an asset is less than the amount of the regulatory depreciation taken with respect to the asset.

EXAMPLE

A calendar year regulated utility placed property costing $100 million in service in 2016. For regulatory (book) purposes, the property is depreciated over 10 years on a straight line basis with a full year's allowance in the first year. For tax purposes, the property is depreciated over 5 years using the 200 percent declining balance method and a half-year placed in service convention.

Normalization calculation for corporate rate reduction											
(Millions of dollars)											
Year(s)											
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**Total**
Tax expense	20	32	19.2	11.52	11.52	5.76	0	0	0	0	100
Book depreciation	10	10	10	10	10	10	10	10	10	10	100
Timing difference	10	22	9.2	1.52	1.52	(4.24)	(10)	(10)	(10)	(10)	0
Tax rate	35%	35%	21%	21%	21%	31.1%	31.1%	31.1%	31.1%	31.1%	
Annual adjustment to reserve	3.5	7.7	1.9	0.3	0.3	(1.3)	(3.1)	(3.1)	(3.1)	(3.1)	0
Cumulative deferred tax reserve	3.5	11.2	13.1	13.5	13.8	12.5	9.3	6.2	3.1	(0.0)	0
Annual adjustment at 21%		(0.9)	(2.1)	(2.1)	(2.1)	(2.1)	(9.3)				
Annual adjustment at average rate		(1.3)	(3.1)	(3.1)	(3.1)	(3.1)	(13.8)				
Excess tax reserve						0.4	1.0	1.0	1.0	1.0	4.5

The excess tax reserve as of December 31, 2017, the day before the corporate rate reduction takes effect, is $4.5 million (the cumulative deferred tax reserve as of December 31, 2017 ($11.2 million), minus the cumulative timing difference as of December 31, 2017 ($32 million), multiplied by 21 percent). The taxpayer will begin taking the excess tax reserve into account in the 2021 tax year, which is the first year in which the tax depreciation taken with respect to the property is less than the depreciation reflected in the regulated books of account. The annual adjustment to the deferred tax reserve for the 2021 through 2025 tax years is multiplied by 31.1 percent, which is the ratio of the aggregate deferred taxes as of the beginning of 2021 ($13.8 million) to the aggregate timing differences for the property as of the beginning of 2021 ($44.2 million) (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Alternative method for certain taxpayers. If, as of the first day of the tax year that includes December 22, 2017:

- the taxpayer was required by a regulatory agency to compute depreciation for public utility property on the basis of an average life or composite rate method, and
- the taxpayer's books and underlying records did not contain the vintage account data necessary to apply the average rate assumption method, then
- the taxpayer is treated as using a normalization method of accounting if, with respect to such jurisdiction, the taxpayer uses the alternative method for public utility property that is subject to the regulatory authority of that jurisdiction (Act Sec. 13001(d)(2) of the 2017 Tax Cuts Act).

For this purpose, the alternative method is the method in which the taxpayer:

- computes the excess tax reserve on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and
- reduces the excess tax reserve ratably over the remaining regulatory life of the property (Act Sec. 13001(d)(3)(C) of the 2017 Tax Cuts Act).

Tax increase for normalization violation. If, for any tax year ending after December 22, 2017, the taxpayer does not use a normalization method of accounting for the corporate rate reductions provided in the amendments made by Act Sec. 13001 of the 2017 Tax Cuts Act:

- the taxpayer's tax for the tax year is increased by the amount by which it reduces its excess tax reserve more rapidly than permitted under a normalization method of accounting, and
- the taxpayer is not treated as using a normalization method of accounting for purposes of Code Sec. 168(f)(2) and (i)(9)(C) (Act Sec. 13001(d)(4) of the 2017 Tax Cuts Act).

Effective date. The provision applies generally to tax years beginning after December 31, 2017 (Act Sec. 13001(c) of the Tax Cuts and Jobs Act). The provision relating to the withholding rules on disposition of U.S. real property applies to distributions made after December 31, 2017. The provision relating to the Code Sec. 1561 limitation on the use of the accumulated earnings credit by controlled corporate groups applies to transfers made after December 31, 2017 [applies to tax years beginning after December 31, 2017].

¶310 Alternative Minimum Tax (AMT) for Corporations

NEW LAW EXPLAINED

Corporate AMT repealed; minimum tax credit refundable in 2018 through 2021.—The alternative minimum tax (AMT) is repealed for corporations for tax years beginning after December 31, 2017 (Code Sec. 55(a), as amended by the Tax Cuts and Jobs Act). Thus, the AMT is only applicable to individuals, estates, and trusts after 2017.

> **COMMENT**
>
> The AMT exemption amounts and phaseout thresholds for individuals (but not estates and trusts) are temporarily increased beginning in 2018 (see ¶110). Partnership or S corporations are not subject to AMT, but instead a partner or S corporation shareholder computes AMT liability separately by taking into account their share of partnership or S corporation items.

A corporation's tentative minimum tax is zero ($0) for purposes of the minimum tax credit (AMT credit) beginning in 2018 (Code Sec. 53(d)(2), as amended by the 2017 Tax Cuts Act). As a result, a minimum tax credit claimed by a corporation beginning after 2017 is generally limited to the taxpayer's regular tax liability, reduced by other nonrefundable credits. The minimum tax credit is the corporation's AMT liability from tax years prior to its repeal and carried over to tax years after 2017 (Code Sec. 53(e), as added by the 2017 Tax Cuts Act). Any minimum tax credit carryover from a C corporation tax year may continue to offset the built-in gain tax of an S corporation for tax years beginning after December 31, 2021 (Code Sec. 1374(b)(3)(B), as amended by the 2017 Tax Cuts Act).

Any unused minimum tax credit is refundable for tax years beginning in 2018, 2019, 2020, and 2021 (Code Sec. 53(e), as added by the 2017 Tax Cuts Act). The refundable credit amount is equal to 50 percent (100 percent for tax years beginning in 2021) of the excess of the minimum tax credit for the tax year, over the amount allowable for the year against regular tax liability. Thus, the full amount of the minimum tax credit is allowed in tax years beginning before 2022. If a corporation has a short tax year, then the refundable credit amount for that year is prorated based on the number of days in the short year compared to 365 days.

Election to claim unused AMT credits in lieu of bonus depreciation. The annual election provided to corporations to claim unused minimum tax credits in place of bonus depreciation on property placed in service during the tax year of the election is repealed effective for tax years beginning after December 31, 2017 (Code Sec. 168(k)(4), stricken by the 2017 Tax Cuts Act).

General business credit and effect on other rules. Since corporate AMT is repealed, a corporation's tentative minimum tax is zero ($0) after 2017 for purposes of the tax liability limitation of the general business credit (Code Sec. 38(c)(6)(E), as added by the 2017 Tax Cuts Act). This means that a corporation may claim the credit to the extent it does not exceed 25 percent of its net regular tax liability above $25,000.

> **COMMENT**
>
> Since the corporate AMT is repealed, a corporation may forgo the election to amortize certain expenses to avoid any AMT adjustment or preference with regard to the expenses (circulation expenses, intangible drilling costs, and mineral exploration and development expenses) (Code Sec. 59(e)).

COMMENT

A net operating loss (NOL) deduction of a corporation from tax years beginning after 2017 is determined without regard to any AMT adjustments or preferences due to the repeal of the corporate AMT. Thus, an NOL carried back to determine the corporation's alternative minimum taxable income (AMTI) in tax years before 2018 is calculated the same as for regular tax liability.

Effective date. The amendments made by this section generally apply to tax years beginning after December 31, 2017 (Act Secs. 12001(c) and 12002(d)(1) of the Tax Cuts and Jobs Act). The amendment striking the minimum tax credit carryover of an S corporation arising in a tax year in which the corporation was a C corporation to offset the built-in gains tax of the S corporation applies to tax years beginning after December 31, 2021 (Act. Sec. 12002(d)(2) of the 2017 Tax Cuts Act).

¶315 Reduction of Dividends-Received Deduction

NEW LAW EXPLAINED

Dividends-received deduction reduced.— For tax years beginning after December 31, 2017, the 70-percent dividends-received deduction is reduced to 50 percent and the 80-percent dividends-received deduction is reduced to 65 percent (Code Secs. 243(a)(1) and (c)(1), as amended by the Tax Cuts and Jobs Act).

COMMENT

The dividends-received deduction is reduced to reflect the new lower corporate tax rate of 21 percent.

KEY RATES AND FIGURES

Dividends subject to the new 50-percent dividends-received deduction will be taxed at a maximum rate of 10.5 percent (50 percent of the 21 percent new corporate tax rate). Dividends subject to the new 65-percent dividends-received deduction will be taxed at a maximum rate of 7.35 percent (35 percent of the 21 percent new corporate tax rate).

A 50-percent dividends-received deduction (65 percent in the case of dividends received from a 20-percent-owned corporation) is provided for any dividend received by a U.S. corporation from another corporation that is distributed out of earnings and profits attributable to effectively connected income received or accrued by such other corporation while it was an FSC (Code Sec. 245(c)(1)(B), as amended by the 2017 Tax Cuts Act).

In addition, the aggregate dividends-received deduction under Code Secs. 243 and 245 is limited to 50 percent of the receiving corporation's taxable income if it owns less than 20 percent of the distributing corporation, and to 65 percent of its taxable income if it owns 20 percent or more of the distributing corporation (Code Sec. 246(b)(3), as amended by the 2017 Tax Cuts Act). Also, the 50-percent dividends-received deduction (65 percent in the case of dividends received from a 20-percent owned corporation) is reduced in the case of dividends received with respect to debt-financed portfolio stock by a percentage related to the amount of debt incurred to purchase the stock (Code Sec. 246A(a)(1), as amended by the 2017 Tax Cuts Act).

Finally, for purposes of the foreign tax credit limitation, dividends from a foreign corporation are treated as income from foreign sources to the extent exceeding the amount that is 100/50th (100/65th in the case of a 20-percent owned corporation) of the amount of the deduction allowable under Code Sec. 245 (Code Sec. 861(a)(2), as amended by the 2017 Tax Cuts Act).

Effective date. The provision applies to tax years beginning after December 31, 2017 (Act Sec. 13002(f) of the Tax Cuts and Jobs Act).

¶320 Modification to Definition of Contribution to Capital

NEW LAW EXPLAINED

Contribution to capital definition modified.— For purposes of applying the general rule under Code Sec. 118(a) that excludes from a corporation's gross income any contributions to capital, contribution to capital does not include:

- 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 (other than a contribution made by a shareholder as such) (Code Sec. 118(b), as added by the Tax Cuts and Jobs Act).

COMMENT

The new law eliminates the special rules for contributions to water and sewage disposal utilities and the extended statute of limitations period for the assessment of deficiencies attributable to such contributions.

The IRS is authorized to issue regulations or other guidance as may be necessary or appropriate to carry out this provision, including regulations or other guidance for determining whether any contribution constitutes a contribution in aid of construction (Code Sec. 118(c), as added by the 2017 Tax Cuts Act).

Effective date. The provision generally applies to contributions made after December 22, 2017, the date of the enactment (Act Sec. 13312(b)(1) of the Tax Cuts and Jobs Act). The provision will not apply to any contributions made after December 22, 2017, the date of enactment, by a governmental entity, which is made pursuant to a master development pan that has been approved prior to such date by a governmental entity (Act Sec. 13312(b)(2) of the Tax Cuts Act).

¶325 Alaska Native Settlement Trusts

NEW LAW EXPLAINED

Tax treatment of payments made to Alaska Native Corporations and Alaska Native Settlement Trusts clarified.—The tax treatment of transactions between Alaska Native Corporations (Native Corporations) and Alaska Native Settlement Trusts (Settlement Trusts) is clarified by the following new provisions::

- Native Corporations are not required to recognize income for certain payments assigned to Settlement Trusts (Code Sec. 139G, as added by the Tax Cuts and Jobs Act), and
- Native Corporations can deduct contributions to Settlement Trusts (other than those made pursuant to Code Sec. 139G) (Code Sec. 247, as added by the 2017 Tax Cuts Act).

Settlement Trusts may elect to defer recognition of income for payments received from Native Corporations (Code Sec. 247(g), as added by the 2017 Tax Cuts Act).

Additionally, information reporting is required for deductible contributions made by Native Corporations to Settlement Trusts (Code Sec. 6039H(e), as added by the 2017 Tax Cuts Act).

Native Corporations assignment of payments under ANCSA to Settlement Trusts. The value of payments received by any one of the 13 Native Corporations under the Alaska Native Claims Settlement Act (ANCSA), (43 U.S.C. 1601 et seq.) will not be included in the gross income of the Native Corporation provided that the payments:

- • are assigned in writing to a Settlement Trust, and
- • were not received by the Native Corporation before it made the assignment to the Settlement Trust (Code Sec. 139G(a), as added by the 2017 Tax Cuts Act).

This nonrecognition rule also applies to payments that would otherwise have been made to a Village Corporation pursuant to 7(j) of the ANSCA (43 U.S.C. 1606(j)) (Code Sec. 139G(a), as added by the 2017 Tax Cuts Act).

A Settlement Trust that receives assigned payments from a Native Corporation must include the payments in its gross income when the payments are received pursuant to assignment. The assigned payments will have the same character as if they were received by the Native Corporation. The amount of any assignment made by a Native Corporation to a Settlement Trust must be described with reasonable particularity. It may either be described as a percentage of one or more payments, or as a fixed dollar amount (Code Sec. 139G(b) and (c), as added by the 2017 Tax Cuts Act).

An assignment to a Settlement Trust must specify whether it is made in perpetuity or for a period of time, and whether the assignment may be revoked (Code Sec. 139G(d), as added by the 20017 Tax Cuts Act).

Despite the rules for deductible contributions made by Native Corporations to Settlement Trusts underCode Sec. 247 (discussed below), a Native Corporation cannot take a deduction for any amounts received under the ANCSA that were excluded from income under Code Sec. 139G(a) (Code Sec. 139G(e), as added by the 2017 Tax Cuts Act).

COMMENT

Because amounts received by Native Corporations with respect to the settlement agreement with the U.S. government, as compensation for relinquishment of the Alaskan native tribes' territorial claims under ANSCA, are made nontaxable under Code Sec. 139G(a), deduction for such amounts is unavailable. However, amounts that a Native Corporation receives that are unrelated to the ANSCA settlement that are contributed to a Settlement Trust may be deductible under Code Sec. 247.

The terms “Native Corporation” and “Settlement Trust” are defined under Code Sec. 646(h) (Code Sec. 139G(f), as added by the 2017 Tax Cuts Act).

Deductions for contributions by Native Corporations. A Native Corporation may elect annually to deduct contributions made to a Settlement Trust (Code Sec. 247(a)(1), (e), as added by the 2017 Tax Cuts Act).

> **COMMENT**
>
> No deduction will be allowed to a Native Corporation for amounts that were made nontaxable under new Code Sec. 139G.

If otherwise allowable, the Native Corporation’s deduction will be available regardless of whether or not it has made an election under Code Sec. 646 (Code Sec. 247(a), as added by the 2017 Tax Cuts Act).

The deduction will be equal to the amount of payment in the case of cash contributions, regardless of the method of payment (including currency, coins, money order, or check). In the case of all other forms of payment, the deduction will be equal to *the lesser of* the Native Corporation’s adjusted basis in the property contributed, or the fair market value of the property contributed (Code Sec. 247(b), as added by the 2017 Tax Cuts Act).

A Native Corporation’s deduction under Code Sec. 247(a) cannot exceed its taxable income (as determined without regard to such deduction), for the tax year in which the contribution was made. If the aggregate amount of the contributions exceeds the Native Corporation’s taxable income for the tax year, the amount of the excess may be carried over in each of the 15 succeeding years (Code Sec. 247(c), as added by the 2017 Tax Cuts Act).

The terms “Native Corporation” and “Settlement Trust” are defined under Code Sec. 646(h) (Code Sec. 247(d), as added by the 2017 Tax Cuts Act).

Election to claim deductions. A Native Corporation may elect to claim deductions under Code Sec. 247 on its income tax return, amendment or supplement. Each election will only be effective for the tax year. The Native Corporation’s election may be revoked by a timely filed amendment or supplement to its income tax return (Code Sec. 247(e), as added by the 2017 Tax Cuts Act).

If a Native Corporation claims a deduction under Code Sec. 247, the earnings and profits of the Native Corporation for the tax year will be reduced by the amount of the deduction. This rule is contrary to the rule in Code Sec. 646(d)(2), which precludes such reductions. No gain or loss will be recognized by a Native Corporation with respect to deductible contributions (Code Sec. 247(f)(1), (f)(2), as added by the 2017 Tax Cuts Act).

Unless a Settlement Trust elects to defer income under Code Sec. 247(g) (discussed below), it must include in income the amount of any deduction allowed with respect to a contribution received, in the tax year in which the contribution was received (Code Sec. 247(f)(3), as added by the 2017 Tax Cuts Act).

Holding period and basis rules. The holding period under Code Sec. 1223 of a Settlement Trust will include the period that the property was held by the transferring Native Corporation. A Settlement Trust’s basis in contributed property for which the Native Corporation claimed a deduction is the lesser of:

- the adjusted basis that the Native Corporation has in the property immediately before the contribution, or
- the fair market value of the property immediately before its contribution (Code Sec. 247(f)(5), as added by the 2017 Tax Cuts Act).

Prohibited transfers. No deduction under Code Sec. 247 is allowed with respect to any contribution to a Settlement Trust of subsurface property rights (estates) or timber resources (43 U.S.C. 1629(e)(a)(2) and 1629(e)(c)(2)) (Code Sec. 247(f)(6), as added by the 2017 Tax Cuts Act).

Deferral of income recognition by Settlement Trusts. Except for cash contributions received, a Settlement Trust may elect to defer recognition of income for properties (on a property-by-property basis, if desired) until the sale or exchange of a property (Code Sec. 247(g)(1), as added by the 2017 Tax Cuts

Act). In the case of such a property, income or gain realized on the sale or exchange of the property will be treated as:

- ordinary income if the income or gain realized on the sale or exchange of the property is an amount that is less than or equal to the amount of income that would be included in income at the time of contribution under Code Sec. 247(g)(2)(A), but for the Settlement Trust's election to defer gain, and
- having the same tax character as if the deferral election did not apply if the amounts of income or gain are in excess of the amount of income that would be included at the time of contribution under Code Sec. 247(g)(2)(B), but for the Settlement Trust's election to defer gain.

Election procedure. A Settlement Trust may make an yearly election to defer gain on any property (other than cash) that it received as a contribution during the tax year. Any property for which this election is made must be identified and described with reasonable particularity on the Settlement Trust's income tax return or amendment or supplement to the return. The election will be effective only for that tax year. Such an election can be revoked on a timely filed amendment or supplement to the Settlement Trust's income tax return (Code Sec. 267(g)(3)(A) and (B)).

If a Settlement Trust disposes of a property for which an income deferral election was made, within the first tax year after the property was contributed to the Settlement Trust:

- the deferral election would be treated as if it had not been made;
- any income or gain that would have been included in the year of contribution under Code Sec. 247(f)(3) but for the Settlement Trust's income deferral election, is include in income for the tax year of the contribution; and
- the Settlement Trust must pay any increase in tax relating to the inclusion, plus applicable interest, as well as an additional 10 percent on the increase amount, plus interest (Code Sec. 247(g)(3)(C)(i), as added by the 2017 Tax Cuts Act).

The increase in tax applicable with respect to a disposition of property within the first tax year after contribution to a Settlement Trust may be assessed, or a court proceeding may be initiated without assessment, within four years after the date on which the return making the election for such property was filed, despite the three-year limitations period on assessment and collection in Code Sec. 6501(a)(Code Sec. 247(g)(3)(C)(ii), as added by the 2017 Tax Cuts Act).

Information reporting of Native Corporation's deductible contributions to Settlement Trusts. A Native Corporation that makes an election to deduct a contribution to a Settlement Trust under Code Sec. 247(e) must provide the Settlement Trust with a statement regarding the election no later than the January 31 of the calendar year after the calendar year in which the contribution was made. This statement must include:

- the total contributions to which the election under Code Sec. 247(e) applies;
- for each contribution, whether it was in cash;
- for each contribution that was not in cash, the date that the Native Corporation acquired the property, and the adjusted basis and fair market value of the property on the date it was contributed to the Settlement Trust;
- the date on which each contribution was made to the Settlement Trust; and
- such additional information that the IRS determines is needed or appropriate for identifying each contribution and to the Settlement Trust's accurate inclusion of the income relating to such contributions (Code Sec. 6039H(e), as added by the 2017 Tax Cuts Act).

Effective date. The provisions of new Code Sec. 139G, which provides for assignments to Alaska Native Settlement Trusts, is effective for tax years beginning after December 31, 2016 (Act Sec. 13821(a)(3) of the Tax Cuts and Jobs Act). The provisions of new Code Sec. 247, which provides a deduction for

contributions to Settlement Trusts, applies to tax years for which the period of limitation on refund or credit under Code Sec. 6511 has not expired (Act Sec. 13821(b)(3)(A) of the 2017 Tax Cuts Act). If the period of limitation on a credit or refund from the deduction expires before the end of the one-year period beginning on December 22, 2017, the date of enactment, the refund or credit of the overpayment may be allowed if the claim is filed before the close of the one-year period (Act Sec. 13821(b)(3)(B) of the 2017 Tax Cuts Act). New Code Sec. 6039H(e), which provides for information reporting, applies to tax years beginning after December 31, 2016 (Act Sec. 13821(c)(3) of the 2017 Tax Cuts Act).

COMMENT

It is worth noting that Act Sec. 13821(b) provides two major elections under Code Sec. 247. The first gives Native Corporations that made contributions to a Settlement Trust the option of claiming a deduction for such contributions (Code Sec. 247(a), (e), as added by the 2017 Tax Cuts Act). The second gives a Settlement Trust the option of deferring income recognition of non-cash contributions received from a Native Corporation (Code Sec. 247(g), as added by the 2017 Tax Cuts Act).

PASS-THROUGH ENTITIES

¶330 Qualified Business Income Deduction (Passthrough Deduction)

NEW LAW EXPLAINED

New deduction provided for portion of passthrough business income.— An individual taxpayer may deduct up to 20 percent of certain domestic qualified business income from a partnership, S corporation, or sole proprietorship for a tax year (Code Sec. 199A, as added by the Tax Cuts and Jobs Act (P.L. 115-97)). The deduction is generally limited to the greater of (1) 50 percent of W-2 wages paid by the business, or (2) the sum of 25 percent of the W-2 wages paid plus 2.5 percent of the unadjusted basis of certain property the business uses to produce qualified business income. This limit may be phased-in or eliminated if the taxpayer's taxable income meets certain threshold requirements (Code Sec. 199A(b)(2) and (3), as added by the 2017 Tax Cuts Act). The deduction is generally not allowed for certain service trades or businesses, but this disallowance is phased-in for taxpayers whose taxable income meets certain threshold requirements (Code Sec. 199A(d), as added by the 2017 Tax Cuts Act).

For individual taxpayers, the Code Sec. 199A deduction is not allowed in determining adjusted gross income (Code Sec. 62(a), as amended by the 2017 Tax Cuts Act). Further, it is not an itemized deduction, but it is available to individuals who itemize deductions and to those who claim the standard deduction (Code Sec. 63(b) and (d), as amended by the 2017 Tax Cuts Act; Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 39).

A similar 20-percent deduction is available for agricultural or horticultural cooperatives (Code Sec. 199A(g), as added by the 2017 Tax Cuts Act).

The Code Sec. 199A deduction applies to tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 199A(i), as added by the 2017 Tax Cuts Act; Act Sec. 11011(e) of the 2017 Tax Cuts Act).

Deduction amount. A noncorporate taxpayer can claim a Code Sec. 199A deduction for a tax year for the sum of—

1) the *lesser* of—
   - (a) the taxpayer's "combined qualified business income amount"; or
   - (b) 20 percent of the excess of the taxpayer's taxable income over the sum of (i) the taxpayer's net capital gain under Code Sec. 1(h) and (ii) the taxpayer's aggregate qualified cooperative dividends; *plus*

2) the *lesser* of—
   - (a) 20 percent of the taxpayer's aggregate qualified cooperative dividends; or
   - (b) the taxpayer's taxable income minus the taxpayer's net capital gain (Code Sec. 199A(a), as added by the 2017 Tax Cuts Act).

The Code Sec. 199A deduction cannot be more than the taxpayer's taxable income (reduced by net capital gain) for the tax year (Code Sec. 199A(a), as added by the 2017 Tax Cuts Act). Further, in determining the deduction amount, the taxpayer's taxable income is computed without regard to the Code Sec. 199A deduction (Code Sec. 199A(e)(1), as added by the 2017 Tax Cuts Act).

COMMENT

The Code Sec. 199A deduction is similar to the domestic production activities deduction under Code Sec. 199, which the 2017 Tax Cuts Act has repealed (see ¶530). Both deductions allow taxpayers to deduct a portion of their "taxable income" if it is less than a portion of their relevant business income. Neither deduction can be claimed if the taxpayer has no relevant business income. It is anticipated that the IRS will provide a new

worksheet or form for calculating the Code Sec. 199A deduction, similar to Form 8903, Domestic Production Activities Deduction.

Combined qualified business income amount. A taxpayer's combined qualified business income amount for a tax year equals—

1) the sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer; plus
2) 20 percent of the taxpayer's aggregate qualified REIT dividends and qualified publicly traded partnership income (Code Sec. 199A(b)(1), as added by the 2017 Tax Cuts Act).

A qualified trade or business's "deductible amount" is generally the *lesser* of—

1) 20 percent of the taxpayer's qualified business income from the trade or business; or
2) a "W-2 wages/qualified property limit," which is the *greater* of—
    a) 50 percent of the W-2 wages of the trade or business; or
    b) (b) the sum of 25 percent of the W-2 wages of the trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property of the trade or business (Code Sec. 199A(b)(2), as added by the 2017 Tax Cuts Act).

COMMENT

The qualified property component means that a taxpayer might be able to claim the Code Sec. 199A deduction if the taxpayer carries on a qualified trade or business that has few or no employees but generates income using its depreciable tangible assets.

EXAMPLE 1

Thomas operates a sole proprietorship that makes personalized protective covers for smartphones. The business buys a machine for $100,000 that can quickly produce the covers, and places the machine in service in 2020. In that year, the business has no employees. The W-2 wages/qualified property limit on the business's deductible amount for 2020 is $2,500, which is the greater of (1) 50% of W-2 wages ($0 × 50% = $0), or (2) the sum of 25% of W-2 wages ($0) plus 2.5% of the unadjusted basis of the machine immediately after its acquisition ($100,000 × 0.025 = $2,500).

The Treasury is instructed to provide guidance on how the combined qualified business income amount rules apply when the taxpayer has a short tax year, or acquires or disposes of the major portion of a trade or business or a separate unit of a trade or business (Code Sec. 199A(b)(5), as added by the 2017 Tax Cuts Act).

COMMENT

The Conference Committee Report states that if a taxpayer has a short tax year that does not contain a calendar year ending during the short year, only wages paid, elective deferrals made under Code Sec. 402(g)(3), and compensation actually deferred under Code Sec. 457 during the short tax year should be treated as the taxpayer's W-2 wages for the short year. The Report further states that amounts treated as W-2 wages for a tax year should not be treated as W-2 wages for any other tax year (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 32, fn 51).

Modifications to W-2 wages/qualified property limit. The W-2 wages/qualified property limit described above does not apply if the taxpayer's taxable income for the tax year is equal to or less than a $157,500 threshold amount ($315,000 for taxpayers filing a joint return) (Code Sec. 199A(b)(3)(A) and (e)(2)(A), as added by the 2017 Tax Cuts Act).

For other taxpayers, the W-2 wages/qualified property limit may be phased in. If the taxpayer's taxable income for the tax year is more than the $157,500 threshold amount ($315,000 for a joint return) but not

more than $207,500 ($415,000 for a joint return), and if the W-2 wages/qualified property limit amount for the qualified trade or business is less than 20 percent of the taxpayer's qualified business income for that trade or business, then—

1) the W-2 wages/qualified property limit does not apply for the qualified trade or business; and
2) the amount that is 20 percent of the taxpayer's qualified business income from the qualified trade or business is reduced by a reduction amount (Code Sec. 199A(b)(3)(B)(i) and (e)(2)(A), as added by the 2017 Tax Cuts Act).

The reduction amount is calculated by—

1) subtracting the qualified trade or business's W-2 wages/qualified property limit amount from the amount that is 20 percent of the taxpayer's qualified business income from the trade or business; then
2) multiplying the difference determined in (1) above by a fraction: the numerator is the amount by which the taxpayer's taxable income for the tax year exceeds the $157,500 threshold amount ($315,000 for a joint return), and the denominator is $50,000 ($100,000 for a joint return) (Code Sec. 199A(b)(3)(B)(ii) and (iii), as added by the 2017 Tax Cuts Act).

EXAMPLE 2

Hans and Wendy are married. Wendy has a qualified business that is not a specified service business. For the 2018 tax year, they file a joint return reporting taxable income of $345,000. In that tax year, 20% of the qualified business income from Wendy's business is $15,000. Wendy's share of wages paid by the business in the tax year is $20,000, so 50% of the W-2 wages from the business is $10,000. (For purposes of this example, assume that no qualified property factors into the calculation.) The $15,000 amount is reduced by 30% (($345,000 taxable income - $315,000 threshold amount) / $100,000) of $5,000 ($15,000 - $10,000), which equals $1,500 (0.3 × $5,000). Hans and Wendy take a Code Sec. 199A deduction of $13,500 ($15,000 - $1,500).

COMMENT

The threshold amounts are adjusted for inflation for tax years beginning after 2018 (Code Sec. 199A(e)(2)(B), as added by the 2017 Tax Cuts Act).

Qualified trade or business. A taxpayer can claim the Code Sec. 199A deduction for income from many types of trades or businesses carried on by the taxpayer, but not for certain specified service trades or businesses (with exceptions). Also, performing services as an employee is not a qualified trade or business (Code Sec. 199A(d)(1), as added by the 2017 Tax Cuts Act).

A specified service trade or business is any trade or business—

- that involves the performance of services in the fields of accounting, actuarial science, athletics, brokerage services, consulting, financial services, health, law, or the performing arts; or
- that involves the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities; or
- whose principal asset is the reputation or skill of one or more of its employees or owners (Code Sec. 199A(d)(2), as added by the 2017 Tax Cuts Act).

COMMENT

Note that architecture and engineering are *not* specified service trades or businesses, and so can be qualified trades or businesses for Code Sec. 199A purposes if they otherwise qualify. Further, for guidance on the types of activities that qualify as services in the fields of health, the performing arts, and consulting, the Conference Committee referred to

guidance in the rules for determining whether a qualified personal service corporation may use the cash method of accounting (see Temporary Reg. §1.448-1T(e)(4); Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), pp. 30-31, fns. 44-46).

A taxpayer carrying on a specified service trade or business can claim a modified qualified business deduction, however, if his or her taxable income for the tax year is less than—

- $415,000 for taxpayers filing a joint return ($315,000 threshold amount + $100,000); or
- $207,500 for all other taxpayers ($157,500 threshold amount + $50,000) (Code Sec. 199A(d)(3)(A) and (e)(2), as added by the 2017 Tax Cuts Act).

If this income requirement is met, the taxpayer takes into account only a percentage of his or her qualified items of income, gain, deduction, or loss, and W-2 wages and unadjusted basis of qualified property, that are allocable to the specified service in computing qualified business income, W-2 wages, and unadjusted basis of qualified property for the tax year (Code Sec. 199A(d)(3)(A)(ii), as added by the 2017 Tax Cuts Act). The applicable percentage equals 100 percent reduced (not below zero) by the ratio of (1) the taxpayer's taxable income for the tax year in excess of the $157,500 threshold amount ($315,000 for a joint return), over (2) $50,000 ($100,000 in the case of a joint return) (Code Sec. 199A(d)(3)(B), as added by the 2017 Tax Cuts Act).

EXAMPLE 3

Theo has taxable income of $187,500, of which $134,000 is attributable to an accounting sole proprietorship (i.e., a specified service business) after paying wages of $67,000 to employees. Because his taxable income is less than the $207,500 threshold for specified service businesses, Theo can claim the Code Sec. 199A deduction, but only for an applicable percentage of his qualified items of income, gain, deduction, or loss, and the W-2 wages, from the accounting business. (For purposes of this example, assume that no qualified property factors into the calculation.) Theo has a 40% applicable percentage (1 - ($187,500 - $157,500)/$50,000 = 1 - 30,000/50,000 = 1 - 0.6 = 0.4). In determining includible qualified business income, Theo takes into account 40% of $134,000, or $53,600. In determining the includible W-2 wages, Theo takes into account 40% of $67,000, or $26,800. Theo calculates the deduction by taking the lesser of: 20% of $53,600 ($10,720), or 50% of $26,800 ($13,400). Theo can take a Code Sec. 199A deduction for $10,720.

EXAMPLE 4

Harold and Winona are married. They file a joint return on which they report taxable income of $345,000 (determined without regard to the Code Sec. 199A deduction). Harold is a partner in the XYZ Partnership, a qualified trade or business that is not a specified service business. Winona operates Winnie's Web Consulting, a sole proprietorship qualified trade or business that is a specified service business. They also received $10,000 in qualified REIT dividends during the tax year. Harold and Winona determine their Code Sec. 199A deduction for the tax year as follows (for purposes of this example, assume that no qualified property factors into the calculation):

Harold's allocable share of qualified business income from the XYZ Partnership is $300,000, so 20% of the qualified business income from XYZ is $60,000 ($300,000 × 0.20). Harold's allocable share of wages paid by XYZ is $100,000, so 50% of the W-2 wages from the business is $50,000 ($100,000 × 0.5). Harold and Winona's taxable income is above the $315,000 threshold amount for a joint return, so the wage limit for XYZ is phased in. Accordingly, the $60,000 amount is reduced by 30% (($345,000 - $315,000)/$100,000) of the difference between $60,000 and $50,000, or $3,000 (($60,000 - $50,000) × 0.3). Harold's deductible amount for the XYZ Partnership is $57,000 ($60,000 - $3,000).

Winona's qualified business income and W-2 wages from Winnie's Web Consulting are $325,000 and $150,000, respectively. Because their taxable income is less than the $415,000 joint-return threshold for specified service businesses, Harold and Winona can claim the Code Sec. 199A deduction for Winona's consulting business, but only for an applicable percentage of the qualified items of income, gain, deduction, or loss, and the W-2 wages from that business. Further, because their taxable income is above the $315,000 threshold amount for a joint return, the exclusion of qualified business income and W-2 wages from Winona's consulting business are phased in.

Winona has an applicable percentage of 70% (1 - ($345,000 - $315,000)/$100,000 = 1 - $30,000/$100,000 = 1 - 0.3 = 0.7). In determining includible qualified business income, Winona takes into account $227,500 ($325,000 × 0.7). In determining includible W-2 wages, Winona takes into account $105,000 ($150,000 × 0.7). Winona calculates the deductible amount for her consulting business by taking the lesser of 20% of her $227,500 of includible qualified business income ($45,500) or 50% of her $105,000 of includible W-2 wages ($52,500). Although Harold and Winona's taxable income is above the threshold amount for a joint return, the wage limit is not binding because the 20% of includible qualified business income of the consulting business ($45,500) is less than 50% of its includible W-2 wages ($52,500). Winona's deductible amount for Winnie's Web Consulting is $45,500.

Harold and Winona's combined qualified business income amount of $104,500, which consists of the $57,000 deductible amount for the XYZ Partnership, plus the $45,500 deductible amount for Winnie's Web Consulting, plus 20% of the $10,000 qualified REIT dividends ($2,000). However, their Code Sec. 199A deduction for the tax year is limited to $69,000, which is 20% of their $345,000 taxable income, because that amount is less than their qualified business income amount for the year.

Qualified business income. The qualified business income of a qualified trade or business carried on by a taxpayer for a tax year is the net amount of the business's qualified items of income, gain, deduction, and loss (Code Sec. 199A(c)(1), as added by the 2017 Tax Cuts Act). Items of income, gain, deduction, and loss are qualified to the extent they are effectively connected with the conduct of a trade or business within the United States, and are included or allowed in determining taxable income for the tax year (Code Sec. 199A(c)(3)(A), as added by the 2017 Tax Cuts Act).

EXAMPLE 5

ABC Company is a qualified business for Code Sec. 199A purposes. For the tax year, ABC has $100,000 of ordinary income from inventory sales, and makes a $25,000 expenditure that must be capitalized and amortized over five years under applicable tax rules. ABC's net business income is $95,000 ($100,000 minus the $5,000 current-year ordinary amortization deduction). ABC's qualified business income is not reduced by the entire amount of the capital expenditure, only by the amount deductible in determining taxable income for the year.

Code Sec. 864(c) applies to determine if items of income, deduction, etc., are "effectively connected," but by substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or "a foreign corporation" (Code Sec. 199A(c)(3)(A)(i), as added by the 2017 Tax Cuts Act).

A taxpayer includes his or her qualified business income from sources within Puerto Rico if all such income is taxable under Code Sec. 1 for the tax year (Code Sec. 199A(f)(1)(C)(i), as added by the 2017 Tax Cuts Act).

If the net amount of qualified income, gain, deduction, and loss is less than zero, the loss is carried over to the next tax year (Code Sec. 199A(c)(2), as added by the 2017 Tax Cuts Act). Any deduction allowed

in the next tax year is reduced (but not below zero) by 20 percent of any carryover qualified business loss (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 29).

EXAMPLE 6

Richard carries on two qualified businesses, Business A and Business B. In 2018, Richard has qualified business income of $20,000 from Business A and a qualified business loss of $50,000 from Business B. Richard cannot claim the Code Sec. 199A deduction for 2018, but has a carryover qualified business loss of $30,000 to 2019. In 2019, Richard has qualified business income of $20,000 from Business A and $50,000 from Business B. To determine his Code Sec. 199A deduction for 2019, Richard reduces the 20% deductible amount determined for the $70,000 qualified business income from Businesses A and B by 20% of the $30,000 carryover qualified business loss.

EXAMPLE 7

Herbert and Whitney are married. They file a joint return for the tax year, on which they report taxable income of $200,000 (determined without regard to the Code Sec. 199A deduction). Herbert has a sole proprietorship qualified trade or business, and Whitney is a partner in the LMO Partnership, a qualified trade or business. Neither qualified business is a specified service business. They have a carryover qualified business loss of $50,000. Herbert and Whitney determine their Code Sec. 199A deduction for the tax year as follows (for purposes of this example, assume that no qualified property factors into the calculation):

Herbert's qualified business income from his business is $150,000, so 20% of the qualified business income is $30,000. Herbert and Whitney's taxable income is below the $315,000 threshold amount for a joint return, so the wage limit does not apply to Herbert's business. Herbert's deductible amount for his business is $30,000.

Whitney's allocable share of qualified business loss from the LMO Partnership is $40,000, so 20% of the qualified business loss is $8,000. Because their taxable income is below the $315,000 threshold amount for a joint return, the wage limit does not apply to Whitney's partnership. Whitney's deductible amount for the LMO Partnership is an $8,000 reduction to the deduction amount.

Herbert and Whitney's combined qualified business income amount is $12,000, which consists of the $30,000 deductible amount for Herbert's business, the $8,000 reduction for the LMO Partnership, and a $10,000 reduction attributable to the carryover qualified business loss (20% × $50,000). Their deduction is limited to 20% of their $200,000 taxable income, or $40,000. Since their combined qualified business income amount is less than 20% of their taxable income, Herbert and Whitney's Code Sec. 199A deduction amount for the tax year is $12,000.

Qualified items of income, gain, deduction, or loss do not include—

1) items of short-term capital gain or loss, or long-term capital gain or loss;
2) dividends, income equivalent to a dividend, or payments in lieu of dividends;
3) interest income which is not properly allocable to a trade or business;
4) the excess of gain over loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business;

5) the excess of foreign currency gains over foreign currency losses from Code Sec. 988 transactions, other than transactions directly related to the business needs of the business activity;

6) net income from notional principal contracts, other than clearly identified hedging transactions that are treated as ordinary (i.e., not treated as capital assets);

7) amounts from an annuity not received in connection with the trade or business; or

8) items of deduction or loss properly allocable to an amount described in (1)-(7) (Code Sec. 199A(c)(3)(B), as added by the 2017 Tax Cuts Act).

Qualified business income does not include—

- reasonable compensation paid to the taxpayer by the business for services rendered;
- guaranteed payments to a partner for services rendered;
- payments described in Code Sec. 707(a) to a partner for services rendered (to the extent provided in regulations);
- qualified REIT dividends;
- qualified cooperative dividends; or
- qualified publicly traded partnership income (Code Sec. 199A(c)(1) and (4), as added by the 2017 Tax Cuts Act).

In determining alternative minimum taxable income under Code Sec. 55, qualified business income is determined without regard to the minimum tax preferences and adjustments under Code Secs. 56–59 (Code Sec. 199A(f)(2), as added by the 2017 Tax Cuts Act).

W-2 wages. W-2 wages are wages that the taxpayer's qualified trade or business paid to its employees during the calendar year that ends in the business's tax year. They also include annual deferrals under Code Sec. 401(k) plans, simplified employee pensions, Code Sec. 403(b) annuities, amounts deferred under Code Sec. 457 deferred compensation plans, and designated Roth contributions (Code Sec. 199A(b)(4)(A), as added by the 2017 Tax Cuts Act).

For Code Sec. 199A deduction purposes, W-2 wages must be properly allocable to qualified business income (Code Sec. 199A(b)(4)(B), as added by the 2017 Tax Cuts Act). They also must be properly included in a return—e.g., Form W-2, Wage and Tax Statement—filed with the Social Security Administration on or before the 60th day after the filing due date (including extensions) (Code Sec. 199A(b)(4)(C), as added by the 2017 Tax Cuts Act).

If a taxpayer has qualified business income from sources within Puerto Rico, all of which is subject to federal income tax under Code Sec. 1 for the tax year, the taxpayer's W-2 wages for the qualified trade or business conducted there are determined without regard to the withholding exclusion under Code Sec. 3401(a)(8) for wages paid to certain U.S. citizens for services in Puerto Rico (Code Sec. 199A(f)(1)(C)(ii), as added by the 2017 Tax Cuts Act).

Qualified property. Qualified property is depreciable tangible property held by and available for use in the qualified trade or business at the close of the tax year, and is used to produce qualified business income. To be qualified, the property's depreciable period cannot end before the close of the tax year (Code Sec. 199A(b)(6)(A), as added by the 2017 Tax Cuts Act). The depreciable period begins on the date the taxpayer first places the property in service. The period ends on the later of (1) the date 10 years after the placed-in-service date, or (2) the last day of the last full year in the applicable recovery period that would apply under Modified Accelerated Cost Recovery System (MACRS) depreciation without regard to the alternative depreciation system (ADS) (Code Sec. 199A(b)(6)(B), as added by the 2017 Tax Cuts Act).

Property that is sold is no longer available for use in the trade or business, and is not taken into account in determining the qualified property limitation (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 38).

The Treasury is instructed to provide guidance for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions. Further, the Treasury must apply anti-abuse rules similar to those under Code Sec. 179(d)(2) to prevent taxpayers from manipulating the depreciable period of qualified property by using related party transactions (Code Sec. 199A(h), as added by the 2017 Tax Cuts Act).

Partnerships and S corporations. For partnerships and S corporations, the Code Sec. 199A deduction is applied at the partner or shareholder level. Each partner must take into account his or her allocable share, and each shareholder must take into account his or her pro rata share, of each qualified item of income, gain, deduction, and loss. Further, each partner or shareholder is treated as having W-2 wages and unadjusted basis immediately after acquisition of qualified property for the tax year, in an amount equal to his or her allocable or pro rata share of the partnership's or S corporation's W-2 wages and unadjusted basis for the tax year as determined in the regulations. The share of W-2 wages is determined in the same manner as the partner's or shareholder's share of wage expenses. The share of the unadjusted basis of qualified property is determined in the same manner as the partner's or shareholder's allocable share of depreciation (Code Sec. 199A(f)(1)(A), as added by the 2017 Tax Cuts Act).

> **EXAMPLE 8**
>
> Pete is a partner in the PDQ Partnership. If Pete is allocated a deductible amount of 10% of wages paid by the partnership to employees for the tax year, he must be allocated 10% of the W-2 wages of the partnership for purposes of calculating the wage limit for the Code Sec. 199A deduction.

Trusts and estates. Trusts and estates are eligible for the Code Sec. 199A deduction (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 40). Rules similar to those under Code Sec. 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the domestic production activities deduction apply for apportioning any W-2 wages and unadjusted basis of qualified property between fiduciaries and beneficiaries (Code Sec. 199A(f)(1)(B), as added by the 2017 Tax Cuts Act).

Agricultural or horticultural cooperatives. A specified agricultural or horticultural cooperative may claim a Code Sec. 199A deduction for a tax year, equal to the *lesser* of—

1) 20 percent of the excess of the cooperative's gross income over any qualified cooperative dividends paid during the tax year for the tax year; or
2) a "W-2 wages/qualified property limit," which is the *greater* of—
    a) 50 percent of the cooperative's W-2 wages from its trade or business; or
    b) the sum of 25 percent of the cooperative's W-2 wages from its trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all of the cooperative's qualified property (Code Sec. 199A(g)(1), as added by the 2017 Tax Cuts Act).

The deduction amount cannot be more than the cooperative's taxable income for the tax year (Code Sec. 199A(g)(2), as added by the 2017 Tax Cuts Act).

A specified agricultural or horticultural cooperative is an organization subject to the cooperative income tax rules at Code Secs. 1381-1383, and engaged in—

1) manufacturing, producing, growing, or extracting an agricultural or horticultural product;
2) marketing agricultural or horticultural products that the cooperative's patrons manufactured, produced, grew, or extracted; or

3) providing supplies, equipment, or services to farmers or to organizations engaged in the activities described in (1) or (2) (Code Sec. 199A(g)(3), as added by the 2017 Tax Cuts Act).

Other definitions. A qualified REIT dividend is a dividend received from a real estate investment trust that is not a capital gain dividend under Code Sec. 857(b)(3) or a qualified dividend income under Code Sec. 1(h)(11) (Code Sec. 199A(e)(3), as added by the 2017 Tax Cuts Act).

A qualified cooperative dividend is a patronage dividend under Code Sec. 1388(a), a per-unit retain allocation under Code Sec. 1388(f), a qualified written notice of allocation under Code Sec. 1388(c), or similar amounts that are includible in gross income and received from certain local benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, cooperative organizations, or an organization governed by the federal tax rules that applied to cooperatives and their patrons before enactment of Code Secs. 1381–1388 (Code Sec. 199A(e)(4), as added by the 2017 Tax Cuts Act).

Qualified publicly traded partnership income is the sum of (1) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss from a publicly traded partnership under Code Sec. 7704(a) that is not treated as a corporation under Code Sec. 7704(c) (without regard to reasonable compensation, guaranteed payments, or other payments to the taxpayer or partner for services rendered); plus (2) any gain recognized by the taxpayer from disposing his or her partnership interest, to the extent the gain is treated as realized from the sale or exchange of property other than a capital asset under Code Sec. 751(a) (Code Sec. 199A(e)(5), as added by the 2017 Tax Cuts Act).

Substantial understatement penalty. A taxpayer who claims the Code Sec. 199A deduction may be subject to the 20-percent accuracy-related penalty for a substantial understatement of income tax if the understatement is more than the greater of five percent (not 10 percent) of the tax required to be shown on the return for the tax year, or $5,000 (Code Sec. 6662(d)(1)(C), as added by the 2017 Tax Cuts Act).

Additional Treasury guidance. The Treasury must prescribe regulations to carry out the purposes of Code Sec. 199A, including rules on appropriate reporting requirements, allocating items and wages, and applying the Code Sec. 199A deduction to tiered entities (Code Sec. 199A(f)(4), as added by the 2017 Tax Cuts Act).

Effective date. The provisions apply to tax years beginning after December 31, 2017 (Act Sec. 11011(e) of the Tax Cuts and Jobs Act).

Expiration date. The Code Sec. 199A deduction will not apply to tax years beginning after December 31, 2025 (Code Sec. 199A(i), as added by the 2017 Tax Cuts Act).

¶335 Extended Holding Period for Capital Gain Passed Through to Partners with Carried Interests

NEW LAW EXPLAINED

Holding period increased for long-term capital gains from "carried interest" in investment partnership.—A three-year holding period applies to certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer. This rule applies notwithstanding Code Sec. 83 and any Code Sec. 83(b) election in effect (Code Sec. 1061(a), as added by the Tax Cuts and Jobs Act).

If a taxpayer holds an applicable partnership interest at any time during the tax year, this rule treats as short-term capital gain—taxed at ordinary income rates—the amount of the taxpayer's net long-term capital gain from the applicable interest that exceeds the amount of such gain calculated as if a three-year holding period applies instead of a one-year period. In making this calculation, long-term capital losses also are taken into account as if a three-year holding period applies (Code Sec. 1061(a), as added by the 2017 Tax Cuts Act).

An "applicable partnership interest" is any interest in a partnership that is transferred to or held by the taxpayer in connection with the performance of services by the taxpayer or a related person in any applicable trade of business, even if the taxpayer made contributions to the partnership (Code Sec. 1061(c)(1), as added by the 2017 Tax Cuts Act). An applicable partnership interest does not include (1) any interest in a partnership held by a corporation, or (2) any capital interest in the partnership that provides the taxpayer with a right to share in partnership capital based on the amount of capital contributed or on the value of the interest subject to tax under Code Sec. 83 when the interest is received or vested (Code Sec. 1061(c)(4), as added by the 2017 Tax Cuts Act).

The three-year holding period applies notwithstanding the rules of Code Sec. 83 or a Code Sec. 83(b) election. As a result, the fact that an individual may have included an amount in income upon acquiring the applicable partnership interest, or may have made a Code Sec. 83(b) election with respect to the applicable partnership interest, does not change the required three-year holding period for long-term capital gain treatment (Joint Explanatory Statement of the Conference Committee, Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 269).

An "applicable trade or business" is one whose regular business activity consists of (1) raising or returning capital, and (2) either investing in or disposing of specified assets, or developing specified assets (Code Sec. 1061(c)(2), as added by the 2017 Tax Cuts Act). "Specified assets" are securities, commodities, real estate held for rental or investment, cash or cash equivalents, or options or derivative contracts with respect to these assets. An interest in a partnership to the extent of the partnership's proportionate interest in these assets is also a specified asset (Code Sec. 1061(c)(3), as added by the 2017 Tax Cuts Act).

If a taxpayer transfers an applicable partnership interest to a related person, the taxpayer must include in gross income as short-term capital gain so much of the taxpayer's net long-term capital gain attributable to the sale or exchange of an asset held for not more than three years as is allocable to the interest. The amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the tax year under Code Sec. 1061(a) (Code Sec. 1061(d)(1), as added by the 2017 Tax Cuts Act). A "related person" is a family member under the Code Sec. 318(a)(1) attribution rules, or a colleague who performed a service within the current calendar year or the preceding three calendar years in an applicable trade or business in which or for which the taxpayer performed a service (Code Sec. 1061(d)(2), as added by the 2017 Tax Cuts Act).

The short-term capital gain treatment for carried interest gain under Code Sec. 1061(a) applies only to income or gain attributable to an asset held for portfolio investment on behalf of third party investors (Code Sec. 1061(b) and (c)(5), as added by the 2017 Tax Cuts Act).

Effective date. The provision applies to tax years beginning after December 31, 2017 (Act Sec. 13309(c) of the Tax Cuts and Jobs Act).

¶340 Scope of Basis Limitation on Partner Losses

NEW LAW EXPLAINED

Basis limitation on partner losses takes into account charitable contributions and foreign taxes.— The basis limitation on partner losses is modified to take into account a partner's distributive share of (1) partnership charitable contributions, and (2) taxes paid or accrued to foreign countries and U.S. possessions. For a charitable contribution by the partnership, the amount of the basis limitation on partner losses is decreased by the partner's distributive share of the adjusted basis of the contributed property. A special rule provides that if the partnership makes a charitable contribution of property whose fair market value is greater than its adjusted basis, the basis limitation on partner losses does not account for the partner's distributive share of the excess (Code Sec. 704(d), as amended by the Tax Cuts and Jobs Act).

Effective date. The provision applies to partnership tax years beginning after December 31, 2017 (Act Sec. 13503(b) of the Tax Cuts and Jobs Act).

¶345 Definition of Substantial Built-In Loss Upon Transfer of Partnership Interest

NEW LAW EXPLAINED

Test for substantial built-in loss also applies at transferee partner level.—The definition of a "substantial built-in loss" is modified so that a substantial built-in loss also exists *if the transferee would be allocated* a net loss in excess of $250,000 upon a hypothetical disposition at fair market value by the partnership of all partnership assets immediately after the transfer of the partnership interest (Code Sec. 743(d)(1), as amended by the Tax Cuts and Jobs Act). In other words, even if the partnership itself does not have an overall built-in loss, depending on allocations of gain under the partnership agreement, a basis adjustment may be mandated with respect to a transferee.

EXAMPLE

Partnership ABC has not made a Code Sec. 754 election. The partnership has two assets, X and Y. Asset X has a built-in gain of $1 million; Asset Y has a built-in loss of $900,000. Under the partnership agreement, any gain on the sale of Asset X is specially allocated to Partner A. Partners A, B and C share equally in all other partnership items, including the built-in loss in Asset Y. Each of Partner B and C has a net built-in loss of $300,000 (one third of $900,000) allocable to her partnership interest. But the partnership itself does not have an overall built-in loss. Rather, it has a net built-in gain of $100,000 ($1 million minus $900,000). Partner C sells her partnership interest to D for $33,333. The test for a substantial built-in loss applies both at the partnership level and at the transferee partner level. If the partnership were to sell all of its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of $300,000 (one third of the built-in loss of $900,000 in Asset Y). A substantial built-in loss exists under the partner-level test, and the partnership adjusts the basis of its assets accordingly with respect to D (Joint Committee on Taxation, Description of the Chairman's Mark of the "Tax Cuts and Jobs Act" (JCX-51-17), November 9, 2017).

Effective date. The provision applies to transfers of partnership interests after December 31, 2017 (Act Sec. 13502(b) of the Tax Cuts and Jobs Act).

¶350 Treatment of Sale or Exchange of Partnership Interests by Foreign Persons

NEW LAW EXPLAINED

Foreign person's gain or loss on sale of partnership interest treated as effectively connected.— Gain or loss from any sale, exchange, or other disposition of a partnership interest is effectively connected with a U.S. trade or business, to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. Any gain or loss from the hypothetical asset sale must be allocated to interests in the partnership in the same manner as nonseparately stated income and loss (Code Sec. 864(c)(8), as added by the Tax Cuts and Jobs Act).

Gain or loss treated as effectively connected income under this provision is reduced by the amount treated as effectively connected income under Code Sec. 897, which relates to gain or loss of a nonresident alien or foreign corporation from the disposition of a U.S. real property interest (Code Sec. 864(c)(8)(C), as added by the 2017 Tax Cuts Act).

In addition, the transferee of a partnership interest must withhold 10 percent of the amount realized on the sale or exchange, unless the transferor certifies that it is not a nonresident alien or foreign corporation. The amount withheld may be reduced, at the transferor's or transferee's request, if the IRS determines that the reduced amount will not jeopardize income tax collection on the gain realized. If the transferee fails to withhold the correct amount, the partnership must deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold (Code Sec. 1446(f), as added by the 2017 Tax Cuts Act).

The Treasury is instructed to prescribe regulations and other appropriate guidance to apply these provisions and carry out the withholding requirements (Code Secs. 864(c)(8)(E) and 1446(f)(6), as added by the 2017 Tax Cuts Act). It is anticipated that the Treasury will provide regulations allowing a broker, as agent of the transferee, to fulfill the obligation to deduct and withhold (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 369).

Effective date. The provision treating gain or loss on the sale or exchange of a partnership interest as effectively connected applies to sales, exchanges, and dispositions on or after November 27, 2017. The provision requiring withholding on sales or exchanges of partnership interests applies to sales, exchanges, and dispositions after December 31, 2017 (Act Sec. 13501(c) of the Tax Cuts and Jobs Act).

¶355 Repeal of Technical Termination of Partnerships

NEW LAW EXPLAINED

Technical termination of partnerships repealed.—The rule providing for the technical termination of partnerships is repealed (Code Sec. 708(b), as amended by the Tax Cuts and Jobs Act).

Effective date. The amendment made by this section applies to partnership tax years beginning after December 31, 2017 (Act Sec. 13504(c) of the Tax Cuts and Jobs Act).

¶360 Qualified Beneficiary of Electing Small Business Trust (ESBT)

NEW LAW EXPLAINED

Expansion of qualifying beneficiaries of electing small business trust (ESBT) to include nonresident aliens.— A nonresident alien individual may be a potential current beneficiary of an electing small business trust (ESBT) without causing the loss of the S corporation election (Code Sec. 1361(c)(2)(B)(v), as amended by the Tax Cuts and Jobs Act). Thus, an ESBT's nonresident alien potential current beneficiaries would not be considered to be disqualifying shareholders under Code Sec. 1361(b)(1)(C). Accordingly, the ESBT's share of S corporation income is taxed to the ESBT (whether or not distributed) , not to its nonresident alien potential current beneficiaries.

> **COMMENT**
>
> Although the new law permits a nonresidential alien individual to be a potential current beneficiary of an ESBT, it does not allow a nonresidential alien to be an S corporation shareholder.

Effective date. The amendment made by this provision is effective on January 1, 2018 (Act Sec. 13541 of the Tax Cuts and Jobs Act).

¶365 Charitable Contribution Deduction for Electing Small Business Trust (ESBT)

NEW LAW EXPLAINED

Charitable deduction of ESBT determined by rules for individuals.— The charitable contribution deduction of an electing small business trust is not determined by the rules generally applicable to trusts under Code Sec. 642(c)Code Sec. 641(c)(2)(E)(i), as added by the Tax Cuts and Jobs Act). The deduction, instead is determined by rules applicable to individuals (Code Sec. 641(c)(2)(E)(ii), as added by the 2017 Tax Cuts Act. Thus, the percentage limitations and carryforward provisions applicable to individuals apply charitable contributions made by the portion of an ESBT holding S corporation stock.

Specifically for purposes of the contribution base for percentage limitations under Code Sec. 170(b)(1)(G), adjusted gross income is computed in the same manner as in the case of an individual. However, the deductions for costs which are paid or incurred in connection with the administration of the trust and which would not have been incurred if the property were not held in such trust are to be treated as allowable in arriving at adjusted gross income (Code Sec. 641(c)(2)(E)(ii), as added by the 2017 Tax Cuts Act).

Effective date. The amendment made by this provision is effective for tax years beginning after December 31, 2017 (Act Sec. 13542 of the Tax Cuts and Jobs Act).

¶370 Modification of Treatment of S Corporation Conversions to C corporations

NEW LAW EXPLAINED

Period relating to adjustments attributable to S corporation conversions to C corporation extended.—Any Code Sec. 481(a) adjustment resulting from an accounting method change that is attributable to an eligible S corporation's revocation of its S corporation election during the two-year period beginning on December 22, 2017, will be taken into account ratably over a six-year period beginning with the year of change (Code Sec. 481(d), as added by the Tax Cuts and Jobs). An eligible terminated S corporation is any C corporation:

- which was an S corporation on the day before December 22, 2017;
- which during the two-year period beginning on December 22, 2017, makes a revocation of its election under Code Sec. 1362(a); and
- the owners of the stock of which, determined on the date such revocation is made, are the same owners (and in identical proportions) as on December 22, 2017 (Code Sec. 481(d)(2), as added by the 2017 Tax Cuts Act).

If an eligible terminated S corporation distributes money after the post-termination transition period, the accumulated adjustments account will be allocated to such distribution. Further, the distribution will be chargeable to accumulated earnings and profits in the same ratio as the amount of such accumulated adjustments account bears to the amount of such earnings and profits (Code Sec. 1371(f), as added by the 2017 Tax Cuts Act).

Effective date. No specific effective date is provided by the Act. The provision is, therefore, considered effective on December 22, 2017, the date of enactment.

CHAPTER 4. DEPRECIATION AND EXPENSE DEDUCTIONS

¶405 Section 179 Expensing of Depreciable Assets

NEW LAW EXPLAINED

Code Sec. 179 deduction limitations increased, qualified real property expensing expanded, lodging facility property made eligible, $25,000 limit on SUVs inflation-adjusted— The overall Code Sec. 179 expensing dollar limitation is increased from $500,000 (inflation-adjusted to $510,000 for 2017) to $1 million, and the investment limitation is increased from $2 million (inflation-adjusted to $2,030,000 in 2017) to $2.5 million, effective for property placed in service in tax years beginning after December 31, 2017 (Code Sec. 179(b)(1) and (2), as amended by the Tax Cuts and Jobs Act (P.L. 115-97)).

These increases are permanent and will be inflation-adjusted for tax years beginning after 2018 (Code Sec. 179(b)(6), as amended by the 2017 Tax Cuts Act). The amount of the inflation adjustment is based on the cost-of-living adjustment determined under Code Sec. 1(f)(3) for the calendar year in which the tax year begins, by substituting calendar year 2017 for calendar year 1992. When adjusting the dollar limitation or the investment limitation for inflation, the resulting amount must be rounded to the nearest multiple of $10,000.

Qualified real property definition expanded. The definition of qualified real property that taxpayers may elect to treat as section 179 is significantly expanded. Effective for tax years beginning after 2017, qualified real property is defined as (Code Sec. 179(f), as amended by the 2017 Tax Cuts Act):

1) Qualified improvement property; and
2) Any of the following improvements to nonresidential real property that are placed in service after the nonresidential real property is placed in service:
   - roofs;
   - heating, ventilation, and air-conditioning property;
   - fire protection and alarm systems; and
   - security systems

COMMENT

As under prior law, a taxpayer must elect to treat qualified real property as section 179 property (Code Sec. 179(d)(1)(B)(ii), as amended by the 2017 Tax Cuts Act). If the election is made and the total cost of all section 179 property, including qualified real property, exceeds the investment limitation ($2.5 million in 2018) the dollar limitation ($1 million in 2018) is subject to reduction.

Qualified improvement property is an improvement to *an interior portion* of a building that is nonresidential real property provided the improvement is placed in service after the date that the building is placed in service. However, improvements related to the enlargement of the building, an elevator or escalator, or the internal structural framework of the building are not qualified improvement property (Code Sec. 168(e), as amended by the 2017 Tax Cuts Act.

COMMENT

Previously, qualified real property eligible for expensing consisted of qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant improvements and buildings that are eligible for an MACRS 15-year recovery period. Qualified leasehold improvement property is any improvement to the interior portion of a building that is not residential rental property and is made under or pursuant to the terms of a lease by the lessor or lessee. Qualified retail improvement property is any improvement to the interior portion of a building that is not residential rental property, which is open to the general public, and is used in the retail trade or business of selling

tangible personal property to the general public. The improvement to leasehold or retail improvement property must be placed in service more than 3 years after the date the building is first placed in service by any person and improvements related to the enlargement of the building, any elevator or escalator, any structural component benefitting a common area, or the internal structural framework of the building do not qualify. Qualified restaurant property is any improvement to a restaurant building or any restaurant building. No additional restrictions apply to restaurant property.

COMMENT

Qualified improvement property became a category of property eligible for bonus depreciation for property placed in service after 2015 (Code Sec. 168(k)(3), as added by Division Q of P.L. 114-113 (PATH Act), December 18, 2015). The new law does not change the definition of qualified improvement property but now includes it as a category of property eligible for expensing under section 179 as "qualified real property." Under the new law, qualified real property also includes roofs, HVAC property, fire protection or alarm systems, and security systems placed in service in or on a commercial building after the building is placed in service. Under prior law, qualified real property included only 15-year leasehold improvement property, 15-year retail improvement, and 15-year restaurant improvements and buildings.

COMMENT

A separate provision eliminates the 15-year recovery period for 15-year leasehold improvement property, 15-year retail improvement, and 15-year restaurant improvements and buildings effective for property placed in service after 2017 (Code Sec. 168(e)(3)(E), as amended by the 2017 Tax Cuts Act). In its place, Congress intended to assign a 15-year recovery period for qualified improvement property (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)). However, the final bill text, while eliminating the 15-year classifications for leasehold improvement property, etc., inadvertently failed to assign a 15-year recovery period to qualified improvement property. A technical correction may be necessary unless a correction is made to the enrolled bill text before it is signed by the President. See ¶425 for details..

COMMENT

The new section 179 provision is unfavorable to restaurant owners. Previously, restaurant buildings, and improvements to the exterior as well as the interior of a restaurant building qualified for expensing. Under the new law, a restaurant improvement (or improvement to any other type of building) must meet the definition of "qualified improvement property." This means that only internal improvements to a restaurant building (and also roofs, HVAC property, fire protection and alarm systems, and security systems) will qualify for expensing. Furthermore, restaurant buildings are not "qualified improvement property" and, accordingly, can no longer be expensed.

Exclusion for property used in connection with lodging repealed. Effective for property placed in service in tax years beginning after December 31, 2017, property that is used predominantly to furnish lodging or in connection with the furnishing of lodging qualifies for expensing under section 179 (Code Sec. 179(d)(1), as amended by the 2017 Tax Cuts Act).

COMMENT

The primary impact is to allow expensing of section 1245 property purchased for use in connection with a residential rental building. See "*Background*" section above for examples of types of property are used in connection with the furnishing of lodging and are now eligible for expensing.

$25,000 limit on certain vehicles adjusted for inflation. The $25,000 maximum Code Sec. 179 deduction that may be claimed on specified vehicles that are exempt from the luxury car caps will be adjusted for inflation in tax years beginning after 2018 (Code Sec. 179(b)(6), as amended by the 2017 Tax Cuts Act).

> **COMMENT**
>
> The $25,000 limit applies to a sport utility vehicle, a truck with an interior cargo bed length less than six feet, or a van that seats fewer than 10 persons behind the driver's seat if the vehicle is exempt from the Code Sec. 280F annual depreciation caps because it has a gross vehicle weight rating in excess of 6,000 pounds or is otherwise exempt (Code Sec. 179(b)(5)).

The amount of the inflation adjustment is based on the cost-of-living adjustment determined under Code Sec. 1(f)(3) for the calendar year in which the tax year begins, but substituting calendar year 2017 for calendar year 1992. When adjusting the dollar limitation or the investment limitation for inflation, the resulting amount must be rounded to the nearest multiple of $100.

Effective date. The provisions apply to property placed in service in tax years beginning after December 31, 2017 (Act Sec. 13101(d) of the Tax Cuts and Jobs Act).

¶410 Additional Depreciation Allowance (Bonus Depreciation)

NEW LAW EXPLAINED

Bonus depreciation extended and increased to 100 percent; additional modifications made.—For qualified property acquired after September 27, 2017, the 50 percent bonus depreciation rate is increased to 100 percent and phased-out as follows:

1) 100 percent for property placed in service after September 27, 2017 and before January 1, 2023
2) 80 percent for property placed in service after December 31, 2022 and before January 1, 2024
3) 60 percent for property placed in service after December 31, 2023 and before January 1, 2025
4) 40 percent for property placed in service after December 31, 2024 and before January 1, 2026
5) 20 percent for property placed in service after December 31, 2025 and before January 1, 2027
6) 0 percent (bonus expires) for property placed in service after December 31, 2026 (Code Sec. 168(k)(6)(A), as amended by Tax Cuts and Jobs Act).

Property acquired before September 28, 2017. Property acquired before September 28, 2017 is subject to the 50 percent rate if placed in service in 2017, a 40 percent rate if placed in service in 2018, and a 30 percent rate if placed in service in 2019. Property acquired before September 28, 2017 and placed in service after 2019 is not eligible for bonus depreciation. In the case of longer production property (LPP) and non-commercial aircraft (NCA) these placed-in-service dates are extended one year (Code Sec. 168(k)(8), as added by the 2017 Tax Cuts Act). These are the rules that applied before enactment of the 2017 Tax Cuts Act. They continue to apply to property acquired before the September 28, 2017 cut-off date set by Congress.

If a written binding contract for the acquisition of property is in effect prior to September 28, 2017, the property is not considered acquired after the date the contract is entered into (Act Sec. 13201(h)(1) of the 2017 Tax Cuts Act). Consequently, property subject to a binding written contract entered into before September 28, 2017 is not eligible for the 100 percent rate and is subject to a 40 percent rate if placed in service in 2018 and a 30 percent rate if placed in service in 2019. The 50 percent rate applies if such property is placed in service in 2017.

COMMENT

Prior to the enactment of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) on December 18, 2015, property acquired before January 1, 2008 (or pursuant to a written binding contract entered into before January 1, 2008) was not eligible for bonus depreciation and property acquired before September 8, 2010 (or pursuant to a written binding contract entered into before September 8, 2010) was not eligible for the 100 percent bonus depreciation rate that applied to property placed in service after September 7, 2010 and before January 1, 2012 (before January 1, 2013 for LLP and NCA). With the passage of time, the acquisition date and binding contract requirements became irrelevant and were stricken by the PATH Act, effective for property placed in service after December 31, 2015. Now that an acquisition date requirement is reinstated for purposes of determining whether a 50 percent or 100 percent rate will apply, various issues revolving around the definition of an “acquisition” are back in play. The acquisition date requirements in the context of the 100 percent bonus depreciation rate for property acquired after September 7, 2010 were specifically addressed in Rev. Proc. 2011-26. The IRS will presumably issue similar guidance in the future for purposes of determining whether property is considered acquired after September 27, 2017 and eligible for the 100 percent rate. See also Reg. §1.168(k)-1(b)(4) for rules regarding the determination of acquisition dates.

Specified plants. The applicable rates above also apply to specified plants acquired after September 27, 2017, except that the date the specified plant was planted or grafted replaces the placed in service date (Code Sec. 168(k)(6)(C), as amended by the 2017 Tax Cuts Act). In general, a specified plant is any tree or vine which bears fruits or nuts, and any other plant which will have more than one yield of fruits or nuts and which generally has a pre-productive period of more than 2 years from the time of planting or grafting to the time at which such plant begins bearing fruits or nuts (Code Sec. 168(k)(5)).

Property with longer production period and non-commercial aircraft. In the case of property with a longer production period (LPP) and non-commercial aircraft (NCA), the placed-in-service deadlines for property acquired after September 27, 2017 are extended for one year as follows:

1) 100 percent for property placed in service after September 27, 2017 and before January 1, 2024
2) 80 percent for property placed in service after December 31, 2023 and before January 1, 2025
3) 60 percent for property placed in service after December 31, 2024 and before January 1, 2026
4) 40 percent for property placed in service after December 31, 2025 and before January 1, 2027
5) 20 percent for property placed in service after December 31, 2026 and before January 1, 2028
6) 0 percent (bonus expires) for property placed in service after December 31, 2027 (Code Sec. 168(k)(6)(B), as amended by the 2017 Tax Cuts Act).

2027 production expenditures for LPP do not qualify for bonus depreciation (Code Sec. 168(k)(2)(B)(ii), as amended by the 2017 Tax Cuts Act). This rule does not apply to non-commercial aircraft (NCA).

Election to apply 50 percent rate. A taxpayer may elect to apply the 50 percent rate instead of the 100 percent rate for property placed in service during the taxpayer's first tax year ending after September 27, 2017. The time and manner of making the election will be provided by the IRS (Code Sec. 168(k)(8), as added by the 2017 Tax Cuts Act). For example, a calendar year taxpayer making this election can apply the 50 percent rate to all qualified property placed in service in 2017 and ignore the 100 percent rate that would otherwise apply to qualified property acquired and placed in service after September 27, 2017 and before January 1, 2018.

COMMENT

When Congress last increased the bonus rate from 50 percent to 100 percent, the IRS provided a similar election to use the 50 percent rate on a property class basis (Rev. Proc. 2011-26). For example, the election could be made to apply to all 5-year property only. Presumably, the IRS will again provide a similar rule

CAUTION

The explanation below for qualified improvement property assumes that qualified improvement property placed in service after December 31, 2017 will have a 15-year recovery period as intended by Congress.

The original Senate bill would have provided a 10-year recovery period for qualified improvement property. The House bill contained no provision. The final bill, according to the Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466) sets a 15-year recovery period for qualified improvement property. However, the text of the final bill omits the provision which would have given a 15-year recovery period for qualified improvement property. A technical correction will be needed to create a 15-year recovery period for qualified improvement property and all such property in the absence of such a correction will be treated as 39-year nonresidential real property, effective for property placed in service after December 31, 2017 (no acquisition date requirement applies). See ¶425 for a detailed discussion of qualified improvement property.

An unintended consequence of failing to provide a 15-year recovery period for qualified improvement property placed in service after December 31, 2017, is that such property

will not qualify for bonus depreciation if placed in service after that date. As explained below, qualified improvement property was removed as a specific category of bonus depreciation property, effective for property placed in service after December 31, 2017 (Code Sec. 168(k)(3), as stricken by the 2017 Tax Cuts Act) on the assumption that all qualified improvement property would have a 15-year recovery period and, therefore, qualify for bonus depreciation under the general rule that allows MACRS property with a recovery period of 20 years or less qualify for bonus depreciation.

Qualified improvement property. Qualified improvement property is removed as a specifically named category of property eligible for bonus depreciation, effective for property placed in service after December 31, 2017 (this provision applies without regard to the acquisition date) (Code Sec. 168(k)(2)(A)(IV) and Code Sec. 168(k)(3), stricken by the 2017 Tax Cuts and Jobs Act). However, all qualified improvement property remains eligible for bonus depreciation (assuming the correction described in the "Caution" note above is made)..

It was previously necessary to list qualified improvement property as a separate category of property eligible for bonus depreciation because some types of improvements which met the definition of qualified improvement property had a recovery period of 39 years. Therefore, this 39-year qualified improvement property would not have been eligible for bonus depreciation without the separate category for qualified improvement property because bonus depreciation generally otherwise only applies to property with an MACRS recovery period of 20 years or less (Code Sec. 168(k)(2)(A)(i))). The 2017 Tax Cuts and Jobs Act, however, provides a standard 15-year recovery period for all qualified improvement property (assuming the correction discussed above is made) placed in service December 31, 2017. This means qualified improvement will qualify for bonus depreciation because it has a recovery period of 20 years or less.

COMMENT

The new law does not change the definition of qualified improvement property. It simply assigns a 15-year recovery period and straight-line method to such property (assuming the correction discussion above is made). Qualified improvement property is defined as an improvement to the interior of nonresidential real property but does not include improvements for expenditures attributable to the enlargement of a building, elevator or escalator, or the internal structural framework of a building (Code Sec. 168(e)(6), as added by the 2017 Tax Cuts and Jobs Act). The new law eliminates the categories of 15-year qualified leasehold improvement property, 15-year qualified retail improvement property, and 15-year restaurant property, effective for property placed in service after December 31, 2017. A 15-year recovery period (and bonus depreciation) will apply to this type of property when placed in service after December 31, 2017 only if the definitional requirements of 15-year qualified improvement property are satisfied. See ¶425 for a detailed discussion.

EXAMPLE

A calendar-year taxpayer makes an improvement to the interior of an office building in June 2016. Assume the improvement is depreciable over 39 years as non-residential real property because it does not satisfy the definition of 15-year qualified leasehold improvement, 15-year retail improvement, or 15-year restaurant property. Even though the improvement has a 39-year recovery period is may qualify for bonus depreciation because for property placed in service in 2017 qualified improvement property is listed as a separate category of property eligible for bonus depreciation. If the same improvement is made in 2018, the recovery period of the improvement is 15 years and the improvement may qualify as bonus depreciation under the bonus depreciation category for MACRS property with a recovery period of 20 years or less.

Exclusion for property of rate-regulated utility. Under a new provision, rate-regulated utilities are preventing from claiming bonus depreciation, effective for property acquired and placed in service after September 27, 2017 (Code Secs. 168(k)(d)(9) and 163(j)(7)(A)(iv), as added by the 2017 Tax Cuts Act). Specifically, property does not qualify for bonus depreciation if it is primarily used in a trade or business of furnishing or selling for regulated rates:

- electrical energy or water,
- sewage disposal services,
- gas or steam through a local distribution system, or
- transportation of gas or steam by pipeline.

Rates are regulated if established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

Exclusion for property used by certain motor vehicle, boat, farm machinery businesses that used floor financing indebtedness. Property used in a trade or business that has had floor plan financing indebtedness does not qualify for bonus depreciation if the floor plan financing interest on the indebtedness was taken into account under the new rules that limit the business interest deduction to 30 percent of adjusted taxable income plus floor plan financing interest and interest income (Code Sec. 168(k)(9)(B) and Code Sec. 163(j), as added by the 2017 Tax Cuts Act). Floor plan financing indebtedness means indebtedness:

- used to finance the acquisition of motor vehicles held for sale or lease; and
- secured by the inventory acquired (Code Sec. 168(j)(3)(9), as added by the 2017 Tax Cuts Act).

A motor vehicle means:

- Any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road;
- A boat; or
- Farm machinery or equipment.

COMMENT

The interest deduction limitation does not apply in any tax year that a taxpayer meets the gross receipts test of Code Sec. 448(c) by having average annual gross receipts for the three-taxable year period ending with the prior tax year that do not exceed $25 million (Code Sec. 163(j)(3), as added by the 2017 Tax Cuts Act). However, if a taxpayer has floor financing interest in any tax year that it is not exempt from the 30 percent deduction limitation by reason of the gross receipts test or otherwise, the exclusion from bonus depreciation continues to apply in tax years that it is exempt.

The 30 percent of taxable business limitation on deductible interest is discussed at ¶510.

Used property qualifies for bonus depreciation. Effective for property acquired and placed in service after September 27, 2017, property previously used by an unrelated taxpayer may qualify for bonus depreciation if it meets “acquisition requirements” (Code Sec. 168(k)(2)(A)(ii)). The acquisition requirements are met if (Code Sec. 168(k)(2)(E)(ii), as amended by the 2017 Tax Cuts Act):

- the taxpayer did not use the property at any time before acquiring it; and
- the taxpayer acquired the property by “purchase” within the meaning of Code Sec. 179(d)(2) (Code Sec. 168(k)(2)(E)(ii), as amended by the 2017 Tax Cuts Act).

Under Code Sec. 179(d)(2), any acquisition is considered a purchase unless the property:

- is acquired from a person whose relationship to the taxpayer would bar recognition of a loss in any transaction between them under Code Sec. 267 (with the taxpayer's family limited to spouse, ancestors and lineal descendants) or Code Sec. 707(b);
- is acquired by one member of a controlled group of corporations from another member (substituting 50 percent for the 80 percent that would otherwise apply with respect to stock ownership requirements);
- has a basis in the hands of the acquiring taxpayer determined in whole or in part by reference to the adjusted basis of the person from who the property was acquired (e.g., a gift or section 1022 basis property); or
- has a basis determined under Code Sec. 1014(a) relating to inherited or bequeathed property (Reg. §1.179-4(c)).

Used property received in carryover basis transactions. The acquisition is also subject to the requirements of Code Sec. 179(d)(3) (Code Sec. 168(k)(2)(E)(ii)(II), as added by the 2017 Tax Cuts Act). Code Sec. 179(d)(3) (see also Reg. §1.179-4(d)), provides that the cost of property eligible for section 179 expensing does not include basis of property that is determined by reference to the basis of other property held at any time by the person acquiring the property (e.g., the carryover basis in a like-kind exchange does not qualify for expensing but any additional cash paid does) (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466).

COMMENT

According to the Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), the reference to Code Sec. 179(d)(3) means that in the case of trade-ins, like-kind exchanges, or involuntary conversions, bonus depreciation only applies to any money paid in addition to the trade-in property or in excess of the adjusted basis of the replaced property. This limitation should only apply when the replacement property is used property. Bonus depreciation regulations currently in effect provide that bonus depreciation may be claimed on the carryover and excess basis of property acquired in a like-kind exchange if the property received in the exchange meets all other qualification requirements, including the original use requirement (Reg. §1.168(k)-1(f)(5)).

Rule for sale-leasebacks eliminated. Since the original use requirement is now supplemented with the rule above allowing used property to qualify for bonus depreciation, a special rule for sale-leasebacks in Code Sec. 168(k)(2)(E)(ii), prior to amendment by the 2017 Tax Cuts Act, is stricken.

COMMENT

The eliminated rule provides an exception to the requirement that original use must begin with the taxpayer in a sale-leaseback. The rule applies to new property that was originally placed in service after December 31, 2007 by a person who sells it to the taxpayer and then leases it from the taxpayer within three months after the date that the property was originally placed in service. In this situation, the property is treated as originally placed in service by the taxpayer-lessor and the taxpayer-lessor's placed-in-service date is deemed to occur no earlier than the date that the property is used by the lessee under the leaseback.

Bonus allowed for film and television productions and live theatrical productions. Bonus depreciation is allowed for a qualified film, television show, or theatrical production placed in service after September 27, 2017 if it would have qualified for the Code Sec. 181 expense election without regard to the $15 million expensing limit or the December 31, 2016 expiration date (Code Sec. 168(k)(2)(A)(i), as amended by the 2017 Tax Cuts Act). A qualified film or television production is placed in service at the time of its initial release or broadcast. A qualified live theatrical production is placed in service at the time of its initial live-staged performance (Code Sec. 168(k)(2)(H), as added by the 2017 Tax Cuts Act).

COMMENT

Property acquired before September 28, 2017 does not qualify for bonus depreciation at the 100 percent rate (Act Sec. 13201(h)(1) of the 2017 Tax Cuts Act). If a film, television show, or theatrical production is deemed acquired before that date, bonus depreciation may not be claimed since it would not be qualified property. A 50 percent rate, however, would apply to other types of qualified property acquired before September 28, 2017. The IRS may need to provide guidance on how the acquisition requirement applies to films, television shows, and theatrical productions. One possibility is that the acquisition date for this purpose may be deemed to occur, at least in the case of a film or television show, when the production "commences," as defined below. Another possibility is to adapt the generally applicable rule for tangible property produced by or for a taxpayer that treats acquisition as occurring when physical work of a significant nature begins (Reg. §1.168(k)-1(b)(4)(iii)(B)).

COMMENT

The Code Sec. 181 deduction expired effective for productions commencing after December 31, 2016 (Code Sec. 181(g)) and was not extended by the new law. In the case of a film or television show a production commences on the date of first principal photography. A theatrical production commences on the date of the first public performance before a paying audience. If a section 181 election is made production costs are expensed in the tax year paid or incurred. If the production does not commence until after the December 31, 2016 expiration date, costs expensed under section 181 are subject to recapture. Under the bonus depreciation rule, production costs will now be expensed in the tax year the production is placed in service and without regard to the $15 million limit.

COMMENT

A taxpayer generally makes an election under Code Sec. 181 on the income tax return for the tax year in which production costs are first paid or incurred (Reg. §1.181-2(b)) and not at the later time when the production is placed in service, as defined above for bonus depreciation purposes. A taxpayer that made a Code Sec. 181 election at the time a production commenced is prohibited from claiming bonus depreciation on the same production if it is placed in service after September 27, 2017 unless the IRS grants permission to revoke the section 181 election (Code Sec. 181(b) and (c)). Automatic consent, however, will be granted without filing a letter ruling request if the taxpayer recaptures previously claimed deductions under section 181 (Reg. §181-2(d)(2)).

Coordination with passenger automobile depreciation caps. The first-year depreciation cap on a passenger vehicle that is subject to the annual depreciation limitations of Code Sec. 280F because its gross vehicle rate rating does not exceed 6,000 pounds is increased by $8,000 if 100 bonus depreciation is claimed. This is the same increase that applies when bonus depreciation is claimed at a 50 percent rate. The scheduled decrease in the $8,000 bump-up to $6,400 in 2018 and $4,800 in 2019 to reflect the formerly scheduled decreases in the bonus rate from 50 percent to 40 percent in 2018 and to 30 percent in 2019 will only apply to vehicles acquired before September 28, 2017 and placed in service after September 27, 2017 (Code Sec. 168(k)(2)(F)(iii), stricken by the 2017 Tax Cuts Act).

COMMENT

The annual depreciation caps are substantially increased by the new law (Code Sec. 280F(a), as amended by the 2017 Tax Cuts Act). In addition, for taxpayers that claims 100 percent bonus on a vehicle subject to the caps, the IRS will likely need to issue a safe harbor similar to one that was previously issued when a 100 percent bonus rate applied, that will allow such taxpayers to claim depreciation deductions after the first-year a vehicle is placed in service. See ¶415.

Long-term accounting method relief. In determining the percentage of completion under Code Sec. 460(b)(1)(A) for purposes of the long-term contract method of accounting, the cost of property with a MACRS recovery period of 7 years or less that qualifies for bonus depreciation is taken into account as a cost allocated to the contract as if the bonus depreciation had not been enacted. The provision applies only to property placed in service (1) after December 31, 2009 and before January 1, 2011 (before January 1, 2012 in the case of property with a longer production period) and (2) after December 31, 2012, and before January 1, 2027 (before January 1, 2028, in the case of long production property) (Code Sec. 460(c)(6)(B), as amended by the 2017 Tax Cuts Act).

COMMENT

With the exception of transportation property, property with a longer production period must have a recovery period of 10 years or greater. Thus, longer production property that is not transportation property does not qualify for the special treatment provided by this provision. Transportation property is tangible personal property used in the trade or business of transporting persons or property, such as an airliner, and is not subject to the rule that requires a MACRS depreciation period of 10 years or greater in order to constitute long-production property (Code Sec. 168(k)(2)(B)(iii)).

Corporate election to claim unused AMT credits in lieu of bonus depreciation. The annual election provided to corporations to claim unused alternative minimum tax (AMT) credits in place of bonus depreciation on property placed in service during the tax year of the election is stricken effective for tax years beginning after December 31, 2017 (Code Sec. 168(k)(4), stricken by the 2017 Tax Cuts Act).

COMMENT

The corporate AMT is repealed, effective for tax years beginning after December 31, 2017. See ¶310.

Effective date. The amendments made by this section generally apply to property which is acquired after September 27, 2017, and is placed in service after September 27, 2017 (Act Sec. 13201(h)(1) of the Tax Cuts and Jobs Act). For this purpose, if a written binding contract for the acquisition of property is in effect prior to September 28, 2017, the property is not considered acquired after the date the contract is entered into. The amendments related to specified plants apply to specified plants planted or grated after September 27, 2017 (Act. Sec. 13201(h)(2) of the 2017 Tax Cuts Act).

¶415 Depreciation Caps on Luxury Cars

NEW LAW EXPLAINED

Depreciation caps for passenger automobiles increased.—The annual depreciation caps are increased, effective for vehicles placed in service after December 31, 2017. The increased caps that apply to vehicles placed in service in 2018 are (Code Sec. 280AF(a)(1), as amended by the Tax Cuts and Jobs Act):

- Tax Year 1.....$10,000 ($18,000 if bonus depreciation claimed)
- Tax Year 2.....$16,000
- Tax Year 3.....$9,600
- Tax Years 4 -6.....$5,760

Any unrecovered basis remaining at the end of the regular recovery period of a vehicle is recovered at the rate of $5,760 per tax year.

> **COMMENT**
>
> The recovery period of a vehicle is 5 years. However, the 5-year recovery period covers 6 tax years because under the MACRS half-year or mid-quarter convention a full year's depreciation is not allowed in the tax year that the vehicle is placed in service.

These caps are adjusted annually for inflation effective for vehicles placed in service after 2018 (Code Sec. 280F(d), as amended by the 2017 Tax Cuts Act). The $8,000 bump-up to the first-year cap if bonus depreciation is claimed is not adjusted for inflation.

> **COMMENT**
>
> For vehicles placed in service in 2018, the preceding caps will apply to all types of vehicles. However, the IRS figures inflation adjustments differently for (1) trucks (including SUVs treated as trucks) and vans and (2) regular passenger cars. Thus, beginning in 2019 when these figures are first adjusted for inflation, separate inflation adjusted caps will be provided for (1) trucks (including SUVs) and vans and for (2) regular passenger cars.

$8,000 increase in first-year cap if bonus depreciation claimed. The first-year depreciation cap on a passenger vehicle that is subject to the annual depreciation limitations of Code Sec. 280F is increased by $8,000 if 100 bonus depreciation is claimed. This is the same increase that applies when bonus depreciation is claimed at a 50 percent rate. However, the scheduled decrease in the $8,000 bump-up to $6,400 in 2018 and $4,800 in 2019 is eliminated (Code Sec. 168(k)(2)(F)(iii), stricken by the 2017 Tax Cuts Act). Thus, the $8,000 increase will continue to apply.

No depreciation deductions after first recovery year if 100 percent bonus claimed unless IRS provides safe harbor. When Congress last enacted a 100 percent bonus rate for property acquired after September 8, 2010 and placed in service before January 1, 2012 in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010), an unforeseen consequence was that taxpayers claiming the 100 percent bonus deduction on a vehicle were limited to a deduction equal to the first-year cap amount and could not claim any further depreciation deductions until after the end of the vehicle's regular recovery period. This is because (1) the basis of qualified property is reduced by the full amount of depreciation, including the bonus and section 179 allowance, without regard to the caps and (2) depreciation deductions that are disallowed by the depreciation caps (including bonus depreciation) are effectively deferred until after the end of the vehicle's recovery period (Code Sec. 280F(a)(1)(B)).

The IRS, however, provided a safe harbor method that allowed a taxpayer to compute depreciation as if a 50 percent bonus rate applied so that depreciation deductions could be claimed during the entire recovery period of the vehicle (Rev. Proc. 2011-21, 2011-12 I.R.B. 560).

COMMENT

According to the General Explanation of Tax Legislation Enacted in the 111th Congress (JCS-2-11) (the "Blue Book" explanation) Congress intended that a 50 percent bonus depreciation rate apply to vehicles placed in service after September 8, 2010 that were eligible for the 100 percent rate and subject to the Code Sec. 280F depreciation limitations. The report further states that a technical correction might be necessary to accomplish this result (Footnote 1597 of JCS-2-11). The IRS safe harbor in effect accomplished this result and no technical correction was enacted.

The following example illustrates why the safe harbor will once again be needed.

EXAMPLE

A car (5-year MACRS property) costing $35,000 that is subject to the luxury car limitations is placed in service in November 2017 by a calendar-year taxpayer and the taxpayer claims 100 percent bonus depreciation on its 5-year property, including the vehicle. However, because the first-year depreciation cap for the vehicle is $11,160, the bonus deduction that may be deducted is limited to $11,160. If the IRS does not reinstate the safe harbor method of accounting, the $23,840 excess ($35,000 - $11,160) may only be recovered at the rate of $1,875 per year beginning in 2023, which is the first year after the end of the vehicle's recovery period. No regular depreciation deductions are allowed after the first year of the vehicle's regular recovery period because the vehicle's basis for computing depreciation deductions is reduced to $0 by the entire amount of the bonus depreciation allowable without regard to the first-year depreciation cap. The table percentages when applied to a depreciable basis of $0 are equal to $0 in each year of the vehicle’s regular 5-year recovery period. The same problem applies to vehicles placed in service in 2018 and later years in which 100 percent bonus depreciation applies.

Year	***Regular Deduction***	***Luxury Car Cap***	***Allowable Depreciation***	
2017	$35,000		$11,160	$11,160
2018	$0		$5,100	$0
2019	$0		$3,050	$0
2020	$0		$1,875	$0
2021	$0		$1,875	$0
2022	$0		$1,875	$0
			TOTAL	$11,160

COMMENT

A taxpayer may elect to apply the 50 percent rate instead of the 100 percent rate for property placed in service during the taxpayer’s first tax year ending after September 27, 2017 (Code Sec. 168(k)(8), as added by the 2017 Tax Cuts Act). See ¶410. Thus, for the 2017 tax year only, the taxpayer in the preceding example could avoid the adverse result by electing the 50 percent rate. The election, however, would apply to all 5-year property placed in service during the 2017 tax year and not just vehicles with a 5-year recovery period.

$25,000 limit on certain vehicles adjusted for inflation. The $25,000 maximum Code Sec. 179 deduction that may be claimed on specified vehicles that are exempt from the luxury car caps will be adjusted for inflation in tax years beginning after 2018 (Code Sec. 179(b)(6), as amended by the 2017 Tax Cuts Act).

> **COMMENT**
>
> The $25,000 limit applies to a sport utility vehicle, truck with an interior cargo bed length less than six feet, and a van that seats fewer than 10 persons behind the driver's seat if the vehicle is exempt from the annual depreciation caps because it has a gross vehicle weight rating in excess of 6,000 pounds, or if it is otherwise exempt (Code Sec. 179(b)(5)).

The amount of the inflation adjustment is based on the cost-of-living adjustment determined under Code Sec. 1(f)(3) for the calendar year in which the tax year begins, by substituting calendar year 2017 for calendar year 1992. When adjusting the dollar limitation or the investment limitation for inflation, the resulting amount must be rounded to the nearest multiple of $100.

Effective date. The amendments apply to property placed in service after December 31, 2017 (Act Sec. 13202(c) of the Tax Cuts and Jobs Act).

¶420 Computers as Listed Property

NEW LAW EXPLAINED

Computers and peripheral equipment removed from listed property treatment.—Effective for property placed in service after December 31, 2017, computers and peripheral equipment are removed as a category of listed property (Code Sec. 280F(d)(4)(A), as amended by the Tax Cuts and Jobs Act). As a result, the cost of computers and peripheral equipment can be deducted or depreciated like other business property and are no longer subject to the strict substantiation requirements of Code Sec. 274(d).

> **COMMENT**
>
> The removal of computers from listed property status will allow more employees to depreciate or expense the cost of computers since the convenience of the employer and condition of employment requirements of Code Sec. 280F(d)(3) will no longer apply.

A conforming amendment strikes a provision which excludes a computer or peripheral equipment from the definition of listed property if it is used exclusively at a regular business establishment and owned or leased by the person operating the establishment (Code Sec. 280F(d)(4)(B), stricken by the Tax Cuts Act of 2017).

Impact on depreciation. The declassification of computers as listed property means that a computer used 50 percent or less for business purposes in the year that it is placed in service is no longer required to be depreciated under the MACRS alternative depreciation system (ADS) using the straight-line method and a five-year ADS recovery period. Instead, the five-year recovery period and the 200 percent declining balance method under the MACRS general depreciation system (GDS) will apply. Furthermore, if the computer is placed in service after 2017, bonus depreciation may be claimed even if business use is 50 percent or less, because the rule under Code Sec. 168(k)(2)(D)(i)(II) that bonus depreciation may not be claimed on a listed property used 50 percent or less for business in the year it is placed in service will no longer apply.

Removal of computers from listed property status also means that if business use drops to 50 percent or less in a tax year after the computer is placed in service, the listed property recapture rules will not apply. Consequently, regular depreciation deductions (including any bonus deduction) will not be recaptured upon such a business use decline. However, as explained below, section 179 recapture is still required.

Impact on section 179 expensing. Under current law, property may not be expensed under Code Sec. 179 if it is not used more than 50 percent for trade or business purposes in the tax year that it is placed in service (Code Sec. 179(d)(10); Reg. §1.179-1(d)(1)). This rule applies to listed and nonlisted property (Temporary Reg. §1.280F-3T(c)(1)). Thus, although computers are no longer considered listed property if placed in service after December 31, 2017, the failure to use the computer more than 50 percent in a trade or business in the tax year that the computer is placed in service will continue to prevent a taxpayer from expensing the portion of the cost of the computer that is not attributable to business use.

The amount expensed under Code Sec. 179 is recaptured if business use falls to 50 percent or less during any year of the expensed asset's recovery period (Code Sec. 179(d)(10); Reg. §1.179-1(e)). However, if the section 179 deduction is claimed on a listed property, the amount recaptured is determined by applying the listed property recapture rules when business use drops to 50 percent or less (Code Sec. 280F(d)(1)). That is, the listed property recapture rules take precedence in determining the recapture amount. As the result of the removal of computers from listed property classification, the section 179 recapture rules will now be used to determine the amount of section 179 allowance that is recaptured. The recapture amount included in ordinary income under the Code Sec. 179 recapture rules is the difference between the Code Sec. 179 expense allowance claimed and the depreciation (including bonus depreciation, if applicable) that would have been allowed on the amount expensed for prior tax years and the tax year of recapture (Reg. §1.179-1(e)(1)).

CAUTION

Since the provision declassifying computers as listed property applies to property placed in service after December 31, 2017, the listed property recapture rules continue to apply to computers placed in service before January 1, 2018.

Impact on fringe benefits. The declassification of computers as listed property means that employees must not longer meet the substantiation requirements under Code Sec. 274(d) in order to exclude the value of the availability of the computer from income as a working condition fringe benefit (Temporary Reg. §1.274-5T(e)). The new law does not affect Treasury's authority to determine the appropriate characterization of computers as a working condition fringe benefit under Code Sec. 132(d), or that the personal use of computers that are provided primarily for business purposes may constitute a de minimis fringe benefit under Code Sec. 132(e), the value of which is so small as to make accounting for it administratively impracticable.

Effective date. The provision is effective for property placed in service after December 31, 2017 (Act Sec. 13202(c) of the Tax Cuts and Jobs Act of 2017).

¶425 Recovery Periods for MACRS Real Property

NEW LAW EXPLAINED

Depreciation of real property.—The Tax Cuts and Jobs Act makes the following changes related to MACRS recovery periods for real property, effective for property placed in service after December 31, 2017:

- qualified improvement property is assigned a 15-year recovery period (however, see "Caution Note" below);
- the property classes for 15-year leasehold improvement property, retail improvement property, and restaurant improvements and buildings are eliminated'
- the MACRS alternative depreciation system (ADS) must be used by an electing real property trade or business to depreciate residential rental property, nonresidential real property, and qualified improvement property (effective for tax years beginning after December 31, 2017).

CAUTION

The explanations in this section assume that qualified improvement property placed in service after December 31, 2017 will have a 15-year recovery period as intended by Congress.

The Senate bill would have provided a 10-year recovery period for qualified improvement property (Act Sec. 13204(b)(1), adding Code Sec. 168(e)(3)(v)). The House bill contained no provision. The final bill, according to the Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466) sets a 15-year recovery period for qualified improvement property effective for property placed in service after December 31, 2017. However, the text of the final bill inadvertently omits the provision which would have given a 15-year recovery period for qualified improvement property. A technical correction will be needed to create a 15-year recovery period for qualified improvement property and all such property in the absence of such a correction will be treated as 39-year nonresidential real property, effective for property placed in service after December 31, 2017.

An unintended consequence of failing to provide a 15-year recovery period for qualified improvement property placed in service after December 31, 2017, is that such property will not qualify for bonus depreciation. As explained at ¶410, qualified improvement property was removed as a specific category of bonus depreciation property, effective for property placed in service after December 31, 2017 (Code Sec. 168(k)(3), as stricken by the 2017 Tax Cuts Act) on the assumption that all qualified improvement property would have a 15-year recovery period and, therefore, qualify for bonus depreciation under the general rule that allows MACRS property with a recovery period of 20 years or less to qualify for bonus depreciation.

Qualified improvement property assigned 15-year recovery period. Qualified improvement property is assigned a recovery period of 15 years, effective for property placed in service after December 31, 2017, assuming a technical correction is made. Qualified improvement property is depreciated using the straight-line method and half-year convention or, if applicable, the mid-quarter convention (Code Sec. 168(b)(3)(G), as added by the 2017 Tax Cuts and Jobs Act)). The alternative depreciation system (ADS) recovery period for qualified improvement property is 20 years (Code Sec. 168(g)(3)(B), as amended by the 2017 Tax Cuts Act).

COMMENT

The amended table in Code Sec. 168(g)(3)(B), makes an erroneous reference to subparagraph (D)(iv) of Code Sec. 168(e)(3) in establishing the intended 20-year ADS period for qualified improvement property. In the original Senate Bill, subparagraph (D)(iv) of Code Sec. 168(e)(3) added qualified improvement property to the list of property with a 10-year recovery period. Subparagraph (D)(iv) was not included in the text of the final bill because the final bill intended to change the recovery period of qualified improvement property to 15-years instead. See "*Caution*" note above.

The definition of qualified improvement property for purposes of the new 15-year recovery period is the same as the definition that has applied for bonus depreciation purposes. Specifically, qualified improvement property is defined as any improvement to an interior portion of a building which is nonresidential real property if the improvement is placed in service after the date the building was first placed in service by any taxpayer (Code Sec. 168(e)(6)(A), as added by the 2017 Tax Cuts Act. However, qualified improvement property does not include expenditures attributable to:

- the enlargement of a building
- any elevator or escalator
- the internal structural framework of a building (Code Sec. 168(e)(6)(B), as added by the 2017 Tax Cuts Act):

COMMENT

Qualified improvement property has been a category of property eligible for bonus depreciation since the enactment of the Protecting Americans from Tax Hikes Act of 2015 (December 18, 2015) (P.L. 114-113) (PATH Act), effective for property placed in service after December 31, 2015. However, the depreciation period for property which met the definition of qualified improvement property for bonus depreciation purposes was 15 years if the improvement also met the definition of a qualified leasehold improvement, a qualified retail improvement, or a qualified restaurant improvement. If the 15-year recovery period did not apply, then the qualified improvement property was depreciated over 39 years as MACRS nonresidential real property. Under the new law, all qualified improvement property is assigned a 15-year recovery period. The 15-year recovery periods previously provided for a qualified leasehold, retail, and restaurant improvements are repealed.

COMMENT

The definition of qualified improvement property for bonus depreciation purposes was formerly located in Code Sec. 168(k)(3), relating to bonus depreciation. The new law moves the definition of qualified improvement property to Code Sec. 168(e)(6)(B) and assigns a 15-year recovery period (assuming a correction is made (see "*Caution*" note above). Qualified improvement property, however, still remains eligible for bonus depreciation even though it has been removed as a separate category of bonus depreciation property. Now that all qualified improvement property is assigned a 15-year recovery period it will qualify for bonus depreciation under the generally applicable rule requiring that bonus depreciation property must have a recovery period of 20 years of less. Previously, some qualified improvement property had a 39-year recovery period and could not have qualified for bonus depreciation unless qualified improvement property was treated as a separate category of bonus depreciation property without regard to its recovery period. This special treatment is no longer necessary.

15-year qualified leasehold, retail, and restaurant improvement property classes eliminated. The property classifications for 15-year qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant property are removed (Code Sec. 168(e)(3)(E), as amended by the 2017 Tax Cuts Act; Code Secs. 168(e)(6), (7), and (8), stricken by the 2017 Tax Cuts Act). See "*Background*" section above for the definition of these categories of property. All improvements which previously qualified for a 15-year recovery period as qualified leasehold improvement property or qualified retail improvement property fall within the definition of qualified improvement property and have a 15-year recovery period, effective for property placed in service after December 31, 2017 (assuming a correction is made (see "*Caution*" note above). Improvements to a restaurant will only qualify for the 15-year recovery period for qualified improvement property if the improvement to is to the interior of the restaurant and does not relate to an enlargement or internal structural framework of the building or an elevator or escalator. External improvements to a restaurant and restaurant buildings which currently qualify as 15-year qualified restaurant property do not meet the definitional requirements of qualified improvement property and are not eligible for the 15-year recovery period. Such property will be depreciated over 39 years, effective for property placed in service after December 31, 2017.

COMMENT

If any property meets the definition of 15-year qualified leasehold improvement property or 15-year qualified retail property it will necessarily meet the definitional requirements of qualified improvement property and be eligible for the new 15-year recovery period that applies to such property. Consequently, the elimination of these two property classifications has no negative impact. Not all 15-year restaurant property, however, will meet the definitional requirements of qualified improvement property. Most significantly, 15-year qualified restaurant property is defined to include restaurant buildings. Qualified improvement property only includes internal improvements to a building. This means that a restaurant building will not qualify for a 15-year recovery period as qualified improvement property. Instead, effective for restaurants placed in service after December 31, 2017, restaurant buildings will once again be treated as nonresidential real property and the 39-year recovery period for nonresidential real property applies. 15-year restaurant property is also defined to include external as well as internal improvements. Since external improvements to a building are excluded from the definition of qualified improvement property, external improvements to a restaurant will also be treated as 39 year nonresidential real property, effective for improvements placed in service after December 31, 2017. Again, this comment assumes that a technical correction will be enacted.

Real property trade or business electing out of interest deduction limits must use ADS for residential rental property, nonresidential real property, and qualified improvement property. An electing real property trade or business must use the MACRS alternative depreciation system (ADS) to depreciate any nonresidential real property, residential rental property, or qualified improvement property it holds (Code Sec. 168(g)(1), as amended by the 2017 Tax Cuts Act). The provision is effective for tax years beginning after December 31, 2017 (Act Sec. 13204(b)(2), of 2017 Tax Cuts Act).

An electing real property trade or business is a real property trade or business that elects out of new rules which disallow deduction for net interest expense in excess of 30 percent of a business' adjusted taxable income (Code Sec. 163(j)(7)(B), as added by the 2017 Tax Cuts Act). "Real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (Code Sec. 469(c)(7)(C)). See ¶510 for a discussion of the net interest deduction limitation and the election out for a real property trade or business.

COMMENT

The ADS period for nonresidential real property is 40 years. The ADS period for residential rental property is reduced from 40 years to 30 years, effective for property placed in service after December 31, 2017, although it is not clear whether Congress intended to make this change (Code Sec. 168(g)(2)(C), as amended by the 2017 Tax Cuts Act). See discussion below. The ADS period for qualified improvement property is intended to be 20 years, although a technical correction is necessary to create the intended 15-year regular depreciation period for such property. See, "*Caution*" above.

COMMENT

Since this provision applies to tax years beginning after December 31, 2017, and not to *property placed in service* in tax years beginning after December 31, 2017, it appears that an electing real property trade or businesses will also be required to depreciate nonresidential rental, nonresidential real property, and qualified improvement property placed in service in tax years before the election year using the ADS method beginning in year of election.

Regular and ADS recovery periods for MACRS residential rental and MACRS nonresidential real property. A provision in the original Senate bill would have reduced the recovery period for MACRS residential rental property from 27.5 years to 25 years and the recovery period for nonresidential real property is decreased from 39 years to 25 years, effective for property placed in service after December 31, 2017. This provision was dropped from the final bill. Consequently, the recovery period for residential rental property remains 27.5 years and the recovery period for nonresidential real property remains 39 years.

COMMENT

The original Senate bill also reduced the MACRS alternative depreciation system (ADS) recovery period for residential rental property from 40 years to 30 years. This provision was retained, perhaps inadvertently, in the final bill (Code Sec. 168(g)(2)(C), as amended by the 2017 Tax Cuts Act).

Effective date. The amendments in this section apply to property placed in service after December 31, 2017 (Act Sec. 13204(b)(1) of the Tax Cuts and Jobs Act). The amendment requiring an electing real property trade or business to use ADS to depreciate its real property is effective for tax years beginning after December 31, 2017 (Act Sec. 13204(b)(2) of the 2017 Tax Cuts Act).

¶435 Depreciation of Farm Property

NEW LAW EXPLAINED

Farming machinery depreciated over five years; 200 percent DB method allowed; ADS required if farming business elects out of interest deduction limits.— Modifications to the treatment of certain farm equipment include:

- a decrease in the 7-year recovery period for new farming machinery and equipment to 5 years, and
- elimination of the rule requiring use of the 150-percent-declining balance method on property used in a farming business.

Five-year recovery period for new farming machinery and equipment. Effective for property placed in service after December 31, 2017, a 5-year recovery period applies to any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business if the original use commences with the taxpayer after December 31, 2017 (Code Sec. 168(e)(3)(B)(vii), as amended by the Tax Cuts and Jobs Act). Generally, a seven-year recovery period previously applied to this property (Rev. Proc. 87-56, Asset Class 01.1).

CAUTION

The provision only applies to new machinery and equipment used in a farming business. A 7-year recovery period continues to apply to used farming machinery and equipment.

200-percent declining method allowed for farming property. The provision that requires MACRS 3-, 5-, 7-, and 10-year property placed in service after 1988 and used in a farming business to be depreciated using the 150-percent declining balance (DB) method in place of the normally applicable 200 percent DB method is repealed, effective for property placed in service after December 31, 2017 (Code Sec. 168(b)(2)(B), as stricken by the 2017 Tax Cuts Act).

COMMENT

A taxpayer may now elect to depreciate any class of 3-, 5-, 7-, or 10-year farming property using the 150-percent declining balance method, the straight-line method, or the alternative depreciation system (ADS) (Code Sec. 168(b)(2)(D)). The election was not previously available because such property had to be depreciated using the 150-percent declining balance method.

Farming business defined. As defined in Code Sec. 263A(e)(4) and Reg. §1.263A-4(a)(4), the term "farming business" means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity (e.g., the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals). A farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products. A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer.

Farming business electing out of interest deduction limitation must use ADS for property with recovery period of 10 years or greater. Any property with a recovery period of 10 years or greater which is held by an "electing farming business" that makes an election out of the new rules which disallow the deduction for net interest expense in excess of 30 percent of the business' adjusted taxable income must be depreciated using the MACRS alternative depreciation system (ADS) (Code Sec. 168(g)(1)(G), as added by the 2017 Tax Cuts Act). See ¶510 for discussion of 30 percent limitation on business interest expense deductions.

COMMENT

Under ADS, the straight-line method applies using a recovery period that is usually longer than the regular recovery period. The ADS recovery period is the asset's class life, usually as shown in Rev. Proc. 86-56.

An electing farming business is a farming business as defined above that elects out of the interest deduction limitation or any trade or business of a "specified agricultural or horticultural cooperative" (as defined in new Code Sec. 199A(g)(2)) with respect to which the cooperative makes an election out of the interest deduction limitation (Code Sec. 167(j)(7), as added by the 2017 Tax Cuts and Jobs Act).

A specified agricultural or horticultural cooperative is an organization to which part I of subchapter T applies, and which is engaged in—

1) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product;

2) the marketing of agricultural or horticultural products which its patrons have so manufactured, produced, grown, or extracted; or

3) the provision of supplies, equipment, or services to farmers or to organizations in items (1) or (2) (Code Sec. 199A(g), as added by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section reducing the recovery period of farm machinery and allowing use of the 200-percent declining method apply to property placed in service after December 31, 2017 (Act Sec. 13203(c) of the Tax Cuts and Jobs Act). The amendment requiring an electing farming business to use ADS to depreciate property with a recovery period of 10 years or greater applies to tax years beginning after December 31, 2017 (Act Sec. 13205(b) of the 2017 Tax Cuts Act).

¶440 Expensing of Certain Costs of Replanting Citrus Plants Lost by Reason of Casualty

NEW LAW EXPLAINED

Certain costs of replanting citrus plants lost by reason of casualty may be deducted by a person other than the taxpayer.—Costs incurred by persons other than the taxpayer in connection with replanting citrus plants following loss or damage due to freezing temperatures, disease, drought, pests, or casualty may be deducted by that person if:

- for the entire tax year that the replanting costs were paid or incurred, the taxpayer has an equity interest of at least 50 percent in the replanted citrus plants, and the person who incurred the costs holds any part of the remaining equity interest (Code Sec. 263A(d)(2)(C)(i)(I), as added by the Tax Cuts and Jobs Act); or

- the person who incurred the costs of replacing the lost or damaged citrus plants acquires all of the taxpayer's equity interest in the land on which such citrus plants were located at the time of the loss or damage, and the replanting is on the same land (Code Sec. 263A(d)(2)(C)(i)(II), as added by the 2017 Tax Cuts Act).

This new rule expires ten years after December 22, 2017 (Code Sec. 263A(d)(2)(C)(ii), as added by the Tax Cuts and Jobs Act.

Effective date. The amendment made by this section apply to costs paid or incurred after December 22, 2017, the date of enactment (Act Sec. 13207(b) of the Tax Cuts and Jobs Act).

CHAPTER 5. BUSINESS INCOME, DEDUCTIONS AND CREDITS

INCOME, EXCLUSIONS, ETC

¶505 Like-Kind Exchanges of Real Property

Like-kind exchanges limited to real property.—Like-kind exchanges are allowed only for real property after 2017. Thus, as under current law, no gain or loss is recognized on the exchange of real property held for productive use in a trade or business or for investment if that real property is exchanged solely for real property of like kind that will be held either for productive use in a trade or business or for investment. However, like-kind exchanges are not allowed for depreciable tangible personal property, and intangible and nondepreciable personal property (Code Sec. 1031(a)(1), as amended by the Tax Cuts and Jobs Act of 2017).

> **COMMENT**
>
> Although most real property is like-kind to other real property, disputes as to whether properties are genuinely like-kind are still likely to arise when an exchange involves limited or partial property interests, such as life estates, remainder interests, and tenancies-in-common.

As under current law, (1) real property is not eligible for a like-kind exchange if it is held primarily for sale (Code Sec. 1031(a)(2), as amended by the 2017 Tax Cuts Act); (2) real property in the United States and foreign real property are not like-kind (Code Sec. 1031(h), as amended by the 2017 Tax Cuts Act); and (3) an interest in a partnership that has elected out of subchapter K is treated as an interest in each of the partnership's assets, rather than a partnership interest (Code Sec. 1031(e), as amended by the 2017 Tax Cuts Act).

> **CAUTION**
>
> The statute no longer expressly provides that stock in a mutual ditch, reservoir or irrigation company described in Code Sec. 501(c)(12)(A) is eligible for a like-kind exchange if it is treated as real property under applicable state law (Code Sec. 1031(i), as stricken by the 2017 Tax Cuts Act).
>
> The Report by the House Ways and Means Committee notes that real property eligible for like-kind exchange treatment under present law should continue to be eligible for like-kind exchange treatment. Specifically, stock in a mutual ditch, reservoir, or irrigation company should still be eligible for a like-kind exchange if the shares are treated as real property or as an interest in real property under applicable state law at the time of the exchange (Report of the Committee on Ways and Means on H.R. 1, Rep. 115-409, note 476). However, the Conference Committee Report does not contain similar language.

Transition rule. The restriction of like-kind exchanges to real property does not apply to an exchange if the relinquished property is disposed of or the replacement property is received on or before December 31, 2017 (Act Sec. 13303(c)(2) of the 2017 Tax Cuts Act).

> **COMMENT**
>
> This transition rule allows taxpayers to complete a deferred or reverse-Starker exchange that involves depreciable tangible personal property or intangible and nondepreciable personal property. However, the 45-day identification deadline and the 180-day exchange deadline still apply.

Effective date. The amendments made by this section generally applies to exchanges completed after December 31, 2017 (Act Sec. 13303(c) of the Tax Cuts and Jobs Act). However, the amendments do not apply to an exchange if (1) the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017; or (2) the property received by the taxpayer in the exchange is received on or before December 31, 2017.

BUSINESS DEDUCTIONS

¶510 Limitation on Deduction of Business Interest

NEW LAW EXPLAINED

Limitation on deduction of business interest for all taxpayers.—The deduction of interest paid or accrued on a debt incurred in a trade or business is limited regardless of the form the taxpayer's business is organized (i.e., corporation, partnership, sole proprietorship, etc.) effective for tax years beginning after December 31, 2017 (Code Sec. 163(j), as amended by the Tax Cuts and Jobs Act). An exception to the limitation is provided for a small business with average gross receipts of $25 million or less. Any interest not deductible generally may be carried forward indefinitely to succeeding tax years, subject to certain restrictions for partnerships and S corporations.

COMMENT

The limitation on the deduction of business interest, along with the reduction of income tax rates for corporation (¶305) and the business income deduction for passthrough entities (¶330), helps to reduce the differences in marginal tax rates based on different sources of financing and in the choice of business entities.

Limitation on business interest. The deduction for business interest for any taxpayer is limited in any tax year to the sum of:

- business interest income of the taxpayer for the tax year;
- 30 percent of the taxpayer's adjusted taxable income for the year, including any increases in adjusted taxable income as a result of a distributive share in a partnership or S corporation (discussed below), but not below zero; and
- floor plan financing interest of the taxpayer for the tax year (Code Sec. 163(j)(1), as added by the 2017 Tax Cuts Act).

COMMENT

The practical effect of the rule is to limit the deduction of net interest expenses to 30 percent of the taxpayer's adjusted taxable income. The deduction for business interest and floor plan financing interest is permitted to full extent of business interest income and floor plan financing interest. If the taxpayer has any interest expenses that exceed these amounts, then the deduction is limited to 30 percent of adjusted taxable income.

Business interest. Business interest for purposes of the limitation means any interest paid or accrued on debt properly allocable to a trade or business of the taxpayer (Code Sec. 163(j)(5), as added by the 2017 Tax Cuts Act). It does not include any investment interest. Business interest income is the amount of interest includible in the taxpayer's gross income for the tax year that is properly allocable to a trade or business (Code Sec. 163(j)(6), as added by the 2017 Tax Cuts Act). It does not include any investment income. Investment interest and investment income in this context has the same meaning as for the limitation on the deduction of interest by taxpayers other than corporations.

COMMENT

Investment interest is interest allocable to property that produces interest, dividends, annuities, royalties, gains, or losses not derived in the ordinary course of a trade or business. It also includes interest in a trade or business activity that is not a passive activity and in which the taxpayer does not materially participate. Investment income is the gross income derived from property held for investment purposes or from its disposition (Code Sec. 163(d)).

Adjusted taxable income. The adjusted taxable income of a taxpayer for purposes of the limitation is the taxpayer's regular taxable income computed without regard to:

- any item of income, gain, deduction, or loss that is not properly allocable to a trade or business;
- any business interest or business interest income;
- the amount of any net operating loss (NOL) deduction;
- the 23-percent deduction for qualified business income of a passthrough entity under Code Sec. 199A (see ¶330); and
- in tax years beginning before January 1, 2022, and allowable deduction for depreciation, amortization, or depletion (Code Sec. 163(j)(8), as added by the 2017 Tax Cuts Act).

COMMENT

The IRS is authorized to provide other adjustments to the computation of adjusted taxable income as it deems necessary.

Floor plan financing indebtedness. Floor plan financing interest is interest paid or accrued on debt use to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory (Code Sec. 163(j)(9), as added by the 2017 Tax Cuts Act). A motor vehicle for this purpose includes any self-propelled vehicle designed for transporting people or property on a public street, highway, or road, as well as a boat, and farm machinery or equipment

COMMENT

Any property used in a trade or business that has had floor plan financing indebtedness is not qualified property (¶410) eligible for the additional first-year depreciation deduction (bonus depreciation) if the floor plan financing interest to the debt is taken into account for purposes of the business interest deduction limitation (Code Sec. 168(k)(9), as added by the 2017 Tax Cuts Act).

Trade or business. A trade or business for purposes of calculating the business interest deduction limitation does not include the performance of services as an employee (Code Sec. 163(j)(7)(A)(i), as added by the 2017 Tax Cuts Act). Thus, wages of an employee are not included as part of the taxpayer's adjusted taxable income.

A taxpayer may also elect to exclude from the limitation any real property trade or business as defined under the passive activity rules (Code Sec. 163(j)(7)(A)(ii) and (B), as added by the 2017 Tax Cuts Act). An electing real property trade or business is any real estate development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Thus, interest expenses paid or accrued in the electing real property trade or business is not business interest subject to the limitation. The election is made at a time and manner as provided by the IRS. Once made, the election is irrevocable.

COMMENT

Under the passive activity rules, the way in which a taxpayer otherwise groups activities does not control the determination of the taxpayer's real property trades or businesses (Reg. §1.469-9(d)).

COMMENT

If a taxpayer elects to exclude a real property trade or business from the business interest limitation, then the business must use the alternative depreciation system (ADS) for certain property (Code Secs. 163(j)(10)(A) and 168(g)(1)(F), as added by the 2017 Tax Cuts Act). This includes any nonresidential real property, residential rental property, and qualified improvement property (¶405) held by the electing real property trade or business (Code Sec. 168(g)(8), as added by the 2017 Tax Cuts Act).

Similarly, a taxpayer may elect to exclude from the limitation any farming business as defined under the uniform capitalization rules, as well as any trade or business of a specified agricultural or horticultural cooperative that makes the election (Code Sec. 163(j)(7)(A)(iii) and (C), as added by the 2017 Tax Cuts Act). An electing farming business is any trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. It also includes a trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (an evergreen tree that is more than six years old at the time it is severed from the roots is not an ornamental tree). Interest expenses paid or accrued in a an electing farming business is not business interest subject to the limitation. The election is made at a time and manner as provided by the IRS. Once made, the election is irrevocable.

COMMENT

If a taxpayer elects to exclude a farming business from the business interest limitation, then the business must use the alternative depreciation system (ADS) for any property with a recovery period of 10 years or more (Code Secs. 163(j)(10)(B) and 168(g)(1)(G), as added by the 2017 Tax Cuts Act).

A trade or business for purposes of the limitation does not include the furnishing or sale of a public utility if the rates for the utility are established or approved by a State, political subdivision of a State, agency or instrumentality of the United States, public service or public utility commission, or governing or ratemaking body of an elective cooperative (Code Sec. 163(j)(7)(A)(iv), as added by the 2017 Tax Cuts Act). A regulated public utility includes the trade or business of furnishing or sale of: (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline.

COMMENT

Any property primarily used the trade or business of a regulated utility and electric cooperative as described above is not qualified property (¶410) eligible for the additional first-year depreciation deduction (bonus depreciation) (Code Sec. 168(k)(9), as added the 2017 Tax Cuts Act).

COMMENT

The limitation on the deduction of business interest is intended to apply after the application of other limitations on interest. For example, the Code Sec. 163(j) limitation applies to interest that is required to be deferred if paid on an original issue discount (OID) high-yield obligation. The business interest limitation also applies after application of the capitalization rules (House Committee Report for the Tax Cuts and Jobs Act (P.L. 115-97) (H.R. Rep. No. 115-409).

Small business exception. The limitation on the deduction of business interest does not apply to any taxpayer that meets the $25 million gross receipts test for a corporation or partnership under Code Sec. 448(c) to use the cash method of accounting after 2017 (Code Sec. 163(j)(3), as added by the 2017 Tax Cuts Act). A taxpayer meets the small business test for the tax year if its average annual gross receipts for the three tax years ending with the prior tax year do not exceed $25 million, adjusted for inflation after 2018 (¶570). In the case of a taxpayer that is not a corporation or partnership, the gross receipts test is applied in the same manner as if the taxpayer were a corporation or partner. The small business exception is not available to tax shelter.

Carryforward of disallowed business interest. Any business interest not allowed as a deduction for the tax year under these rules may be carried forward and treated as business interest paid or accrued in the succeeding tax year (Code Sec. 163(j)(2), as added by the 2017 Tax Cuts Act). The interest may be carried forward indefinitely, subject to certain restrictions for partnerships and S corporations (discussed below).

In the case of a nontaxable acquisition or liquidation of a corporation under Code Sec. 381, the acquiring corporation generally succeeds to any carryover of disallowed business interest to tax years ending after the date of distribution or transfer (Code Sec. 381(c)(20), as added by the 2017 Tax Cuts Act). Similarly, the amount of any pre-change loss of a loss corporation (i.e., target corporation) that may be used to offset post-change taxable income of an acquiring corporation includes the carryover of disallowed business interest to the tax year ending with the ownership change or in which the change date occurs (Code Sec. 382(d)(3), as added by the 2017 Tax Cuts Act). A loss corporation for this purpose includes any corporation with carryforwards of disallowed business interest deductions (Code Sec. 382(k)(1), as amended by the 2017 Tax Cuts Act).

Application to partnerships and S corporations. In the case of a partnership or S corporation, the limitation on the deduction of business interest is applied at the entity level. Any deduction for business interest is taken into account in determining the non-separately stated taxable income or loss of the partnership or S corporation (Code Sec. 163(j)(4)(A)(i) and (D), as added by the 2017 Tax Cuts Act). While any business interest not deductible generally may be carried forward indefinitely to succeeding tax years, restrictions apply for partnerships and S corporations (discussed below).

The adjusted taxable income of each partner or shareholder is determined without regard to the partner's or shareholder's distributive share of any item of income, gain, deduction, or loss of the partnership or S corporation (Code Sec. 163(j)(4)(A)(ii)(I) and (D), as added by the 2017 Tax Cuts Act). This prevents doubled counting of the same dollars used in the adjusted taxable income of the entity generating addition interest deductions passed through to the partners or shareholders.

> **EXAMPLE 1**
>
> The ABC partnership is owned equally by XYZ, Inc. and an individual. ABC generates $200 of noninterest during the tax year, but its only expense is $60 of business interest. Its deduction for business interest is limited to $60 (30 percent of its adjusted taxable income of $200). ABC deducts $60 of business interest and reports ordinary business income of $140.
>
> XYZ's distributive share of ordinary business income of ABC is $70. It has no taxable income from its other operations and $25 of business interest expenses. XYZ's adjusted taxable income for the year is computed without regard to the $70 distributive share of the non-separately stated income of ABC. As a result, XYZ has adjusted taxable income of $0 and its deduction for business interest is limited to $0 (30 percent of adjusted taxable income of $0). The $25 of business interest expenses may not be deducted for the tax year, but may be carried forward for up to five years.
>
> In the absence of the double counting rule, XYZ's adjusted taxable income for the year would include the $70 distributive share of the non-separately stated income of ABC. Its deduction for business interest would be limited to $21 (30 percent of adjusted taxable income of $70), resulting in a disallowance of only $4. Thus, XYZ's share of ABC's adjusted taxable income ($100) would generate $51 of interest deduction ($21 deduction for XYZ, plus $30 from distributive share of ABCs' deduction). If XYZ were a passthrough entity rather than a C corporation, additional deductions could be available at each tier.

If a partnership or S corporation has an excess taxable income for purposes of the deduction limit, then the excess is passed through to the partners or shareholders. Specifically, the adjusted taxable income of each partner or shareholder is increased by the partner's or shareholder's distributive share of the entity's excess taxable income (Code Sec. 163(j)(4)(A)(ii)(II) and (D), as added by the 2017 Tax Cuts Act). A partner's or shareholder's distributive share of partnership excess taxable income is determined in the same manner as the partner's or shareholder's distributive share of non-separately stated taxable income or loss of the entity.

The excess taxable income of a partnership or S corporation is a percentage of the entity's adjusted taxable income for the year (Code Sec. 163(j)(4)(C) and (D), as added by the 2017 Tax Cuts Act). The percentage is:

- 30 percent of the entity's adjusted taxable income, over its net excess business interest (the excess of business interest of the entity, reduced by floor plan financing interest, over business interest income; over
- 30 percent of the entity's adjusted taxable income.

This addition to a partner's or shareholder's adjusted taxable income, allows them to deduct more interest than they may have paid or incurred during the year, to the extent the entity could have deducted more business interest.

EXAMPLE 2

Assume the same facts as in Example 1 above, except that the ABC partnership has only $40 of business interest for the tax year. Its limit on its interest deduction is $60 for the year. Thus, the excess amount for ABC is $20 ($60 - $40). The excess taxable income for ABC is $66.67 (($20/$60) × $200) and XYZ's distributive share is $33.33. XYZ's deduction for business interest is limited to 30 percent of the sum of its adjusted taxable income plus its distributive share of the excess taxable income from ABC partnership is $10 (30 percent × ($0 + $33.33). As a result of the rule, XYZ may deduct $10 of business interest and has an interest deduction disallowance of $15.

Carryforwards for partnerships and S corporations. Unlike other taxpayers, any disallowed interest of a partnership or S corporation is not carried forward to the succeeding tax year. Instead, the disallowed interest of the entity is treated as excess business interest that is allocated to each partner or shareholder in the same manner as any non-separately state taxable income or loss (Code Sec. 163(j)(4)(B)(i) and (D), as added by the 2017 Tax Cuts Act).

The allocated excess business interest for the current tax year is treated by the partner or shareholder as business interest paid or accrued by the partner or shareholder in the next succeeding year. In other words, the allocated excess business interest is carried forward to next succeeding tax year by the partner or shareholder but only to the extent the partner or shareholder is allocated excess taxable income from the entity in the succeeding year (Code Sec. 163(j)(4)(B)(ii)(I) and (D), as added by the 2017 Tax Cuts Act). Excess taxable income allocated to a partner or shareholder for any tax year must be used against excess business interest from the entity from all tax years before it may be used against any other business interest.

If the partner or shareholder does not have enough excess taxable income from the entity to offset the carried forward excess business interest, then the interest must continue to be carried forward to succeeding tax years (Code Sec. 163(j)(4)(B)(ii)(II) and (D), as added by the 2017 Tax Cuts Act). In all subsequent tax years, the excess business interest carried forward by the partner or shareholder is treated as paid or accrued in the next subsequent tax year that may only be used against excess taxable income allocated by the entity to the partner or shareholder for that tax year.

The adjusted basis of a partner's or shareholder's interest in the entity is reduced (but not below zero) by the amount of excess business interest allocated by the entity to the partner or shareholder (Code Sec. 163(4)(B)(iii)(I) and (D), as added by the 2017 Tax Cuts Act). However, if the partner or shareholder sells or otherwise disposes of the interest in the partnership or S corporation, then their adjusted basis is increased immediately before the disposition by the excess (if any) of:

- the amount of the basis reduction due to the excess business interest allocated by the entity to the partner or shareholder, over

- any portion of the excess business interest allocated to the partner or shareholder which has previously been treated as interest paid or accrued by the partner (Code Sec. 163(4)(B)(iii)(I) and (D), as added by the 2017 Tax Cuts Act).

A disposition for purposes of an increase in the adjusted basis of a partnership or S corporation interest includes any transactions in which gain is not recognized in whole or part (including the death of the partner of shareholder). Also, no deduction is allowed to the transferor or transferee for any excess business interest that increases the adjusted basis in the entity.

Effective date. The amendments made by this section generally apply to tax years beginning after December 31, 2017 (Act Sec. 13301(c) of the Tax Cuts and Jobs Act).

¶515 Net Operating Losses

NEW LAW EXPLAINED

Net operating loss carryback eliminated and unlimited carryforwward period provided; 80 percent taxable income limit.— Net operating loss deductions in carryback and carryforward years are limited to 80 percent of taxable income. The generally applicable two-year carryback period, as well as the longer carryback periods for special types of losses, are eliminated. NOLs, however, may be carried forward indefinitely. Exceptions described below apply to farming losses and losses of casualty and property insurance companies.

Net operating loss deduction limited to 80 percent of taxable income. Effective for net operating losses that arise in tax years beginning after December 31, 2017, the net operating loss deduction for a tax year is limited to the lesser of:

1) the aggregate of net operating loss carryovers (i.e., carryforwards) to the tax year, plus net operating loss carrybacks to the tax year, or
2) 80 percent of taxable income computed for the tax year without regard to the net operating loss deduction allowed for the tax year (Code Sec. 172(a), as amended by the Tax Cuts and Jobs Act of 2017)

COMMENT

Since the 80 percent taxable income limit applies to losses arising in tax year beginning after December 31, 2017, net operating loss carrybacks and carryforwards attributable to losses that arose in tax years beginning before January 1, 2018, are not subject to the 80 percent limitation (Act Sec. 13302(e)(1) of the 2017 Tax Cuts Act).

In determining the amount of a net operating loss that remains available for carryback or carryforward, the taxable income for any prior tax year to which the net operating loss was carried is not treated as exceeding 80 percent (Code Sec. 172(b)(2), as amended by the 2017 Tax Cuts Act).

Taxable income of REIT. In the case of a real estate investment trust, the 80 percent taxable income limitation is determined by reference to “real estate investment trust taxable income” as defined in Code Sec. 857(b)(2) but without regard to the dividends paid deduction (Code Sec. 172(d)(6), as amended by 2017 Tax Cuts Act).

Most net operating loss carrybacks eliminated and carryforwards allowed indefinitely. The new law eliminates the carryback of all NOLs except for NOLs attributable to farm losses and certain insurance companies, as described below. However, the 20-year limitation on carryforwards is also eliminated (Code Sec. 172(b)(1)(A), as amended by 2017 Tax Cuts Act). This provision is effective for net operating losses arising in tax years ending after December 31, 2017 (Act Sec. 13302(c)(2) of the 2017 Tax Cuts Act).

A conforming amendment strikes special carryback rules that apply to:

- Real estate investment trusts (Code Sec. 179(b)(1)(B), stricken by the 2017 Tax Cuts Act)
- Specified liability losses (Code Sec. 179(b)(1)(C), stricken by the 2017 Tax Cuts Act)
- Excess interest loss in a corporate equity reduction transaction (CERT) (Code Sec. 179(b)(1)(D), stricken by the 2017 Tax Cuts Act)
- Casualty losses (Code Sec. 179(b)(1)(E), stricken by the 2017 Tax Cuts Act)
- Farming losses (Code Sec. 179(b)(1)(F), stricken by the 2017 Tax Cuts Act)

Two-year carryback for farming losses. The five-year carryback period for farming losses is replaced with a two-year carryback period (Code Sec. 172(b)(1)(B), as added by the 2017 Tax Cuts Act). This provision is effective for net operating losses arising in tax years ending after December 31, 2017 (Act Sec. 13302(e)(2) of the 2017 Tax Cuts Act).

COMMENT

The definition of a farming loss remains unchanged and taxpayers may continue to waive the carryback period (Code Sec. 172(b)(1)(B)(ii) and (iv), as added by the 2017 Tax Cuts Act). Also, as under prior law, where a NOL for a tax year consists of both a farming loss and a non-farming loss, the two losses are treated separately and the farming loss is taken into account in carryback and carryforward years after the non-farming loss (Code Sec. 172(b)(1)(B)(iii), as added by the 2017 Tax Cuts Act). This rule was previously provided by a cross-reference to a similar rule for specified liability losses (Code Sec. 172(f)(5), stricken by the 2017 Tax Cuts Act).

Two-year carryback and 20-year carryforward for casualty and property insurance company losses. The net operating loss of an insurance company other than a life insurance company (e.g., a property and casualty insurance company) may continue to be carried back two years and forward twenty years (Code Sec. 172(b)(1)(C), as added by the 2017 Tax Cuts Act).

In addition, the 80 percent taxable income limitation does not apply to a non-life insurance company. Accordingly, the deductible amount of a non-life insurance company's net operating loss for a tax year is the sum of the net operating loss carryovers to the tax year plus the net operating loss carrybacks to the tax year (Code Sec. 172(f), as added by the 2017 Tax Cuts Act).

COMMENT

The two-carryback and 20-year carryforward period are retained for insurance companies other than life insurance companies. In addition, the 80 percent of taxable income limitation does not apply to these companies. The operations loss deduction for life insurance companies is repealed and life insurance companies will claim NOLs in a manner similar to other corporations under Code Sec. 172 (i.e., no carryback, indefinite carryforward, and 80 percent taxable income limitation on deduction). The NOL deduction of a life insurance company is determined by treating the NOL for any tax year generally as the excess of the life insurance deductions for such taxable year, over the life insurance gross income for such taxable year. See ¶905 for the treatment of life insurance companies.

Determination of remaining carryback or carryforward. In determining the portion of a net operating loss that remains for carryback or carryforward, the new 80 percent taxable income limitation applies. Consequently, the portion of a net operating loss that remains available for carryback or carryforward to another tax year is the excess, if any, of the amount of the loss over the sum of 80 percent of the taxable income (computed with certain of the modifications described in Code Sec. 172(d)) for each of the tax years to which the loss was previously carried (Code Sec. 172(b)(2), as amended by 2017 Tax Cuts Act).

Modifications to taxable income in computing NOL for loss year. The Code Sec. 199 manufacturing deduction is removed from the list of deductions that may not be claimed in computing the net operating loss for a loss year (Code Sec. 172(d)(7), stricken by the 2017 Tax Cuts Act).

COMMENT

This amendment is made because the Act repeals the manufacturing deduction (Act Sec. 13305(a) of the 2017 Tax Cuts Act).

The new deduction for foreign-derived intangible income (Code Sec. 250) is added to the list of deductions that may not be claimed in computing the net operating loss for the loss year (Code Secs. 172(d)(9) , as added by the 2017 Tax Cuts Act).

The qualified business income deduction allowed by new Code Sec. 199A for noncorporate taxpayers is also added to the list of deductions that may not be claimed (Code Sec. 172(d)(8), as added by the 2017 Tax Cuts Act) (see ¶330).

These modifications apply to tax years beginning after December 31, 2017 (Act Secs. 11011(e), 13305(c), 14202c) of the 2017 Tax Cuts Act).

Effective date. The amendments made by this section limiting net operating losses (NOLs) to 80 percent of taxable income, determining the amount of remaining carryback or carryforward, and exempting life insurance companies from the 80 percent of taxable income limitation apply to losses arising in tax years beginning after December 31, 2017 (Act Sec. 13302(e)(1) of the Tax Cuts and Jobs Act). The amendments eliminating the carryback periods, making the carryforward period indefinite, reducing the farming loss carryback period from five years to two years, and allowing a two-year carryback and twenty-year carryforward for the net operating loss of an insurance company apply to net operating losses arising in tax years ending after December 31, 2017 (Act Sec. 13302(e)(2) of the 2017 Tax Cuts Act).

¶520 Limit on Excess Business Losses for Noncorporate Taxpayers

NEW LAW EXPLAINED

Excess business losses of noncorporate taxpayers disallowed.—Excess business losses of noncorporate taxpayers are not allowed for tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 461(l)(1)(B), as added by the Tax Cuts and Jobs Act). Any excess business loss that is disallowed is treated as a net operating loss (NOL) carryover to the following tax year (Code Sec. 461(l)(2), as added by the 2017 Tax Cuts Act). Noncorporate taxpayers must apply this rule for excess business losses after applying the passive activity loss rules (Code Sec. 461(l)(6), as added by the 2017 Tax Cuts Act; Code Sec. 469).

COMMENT

For losses arising in tax years beginning after December 31, 2017, an NOL may only reduce 80 percent of taxable income in a carryback or carryforward tax year. See ¶515 for further details on the modified NOL rules.

An "excess business loss" is the excess, if any, of:

1) the taxpayer's aggregate deductions for the tax year from the taxpayer's trades or businesses, determined without regard to whether or not such deductions are disallowed for such tax year under the excess business loss limitation (Code Sec. 461(l)(1), as added by the 2017 Tax Cuts Act); over

2) the sum of:

   a) the taxpayer's aggregate gross income or gain for the tax year from such trades or businesses, plus

   b) $250,000, adjusted for inflation (200 percent of the $250,000 amount in the case of a joint return) (Code Sec. 461(l)(3), as added by the 2017 Tax Cuts Act).

The $250,000 amount in (b), above, is adjusted for inflation for tax years beginning after December 31, 2018. The $250,000 amount will be increased by $250,000 multiplied by the cost-of-living-adjustment determined under Code Sec. 1(f)(3) (as amended by the 2017 Tax Cuts Act) for the calendar year in which the tax year begins. If the increase is not a multiple of $1,000, then the increase is rounded to the nearest multiple of $1,000 (Code Sec. 461(l)(3)(B), as added by the 2017 Tax Cuts Act).

EXAMPLE

For 2018, Ned Brown has $1,000,000 of gross income and $1,400,000 of deductions from a retail business that is not a passive activity. His excess business loss is $150,000 ($1,400,000 − ($1,000,000 + $250,000)). Brown must treat his excess business loss of $150,000 as an NOL carryover to 2019.

COMMENT

During the period that excess business losses are disallowed (tax years beginning after December 31, 2017, and before January 1, 2026), the similar limit on excess farm losses of noncorporate taxpayers will not apply (Code Sec. 461(l)(1)(A), as added by the 2017 Tax Cuts Act).

Partnerships and S corporations. For partnerships and S corporations, the limit on excess business losses is applied at the partner or shareholder level. Each partner's distributive share or each S corporation shareholder's pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation is taken into account by the partner or shareholder in applying the excess business loss rules to the partner's or shareholder's tax year with or within which the partnership's or S corporation's tax

year ends (Code Sec. 461(l)(4), as added by the 2017 Tax Cuts Act; Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Reporting requirements. The IRS is authorized to issue additional reporting requirements that it determines are necessary to carry out the purposes of the excess business loss rules (Code Sec. 461(l)(5), as added by the 2017 Tax Cuts Act)).

Effective date. The amendments made by this provision apply to tax years beginning after December 31, 2017 (Act Sec. 11012(b) of the Tax Cuts and Jobs Act).

¶525 Research and Experimental Expenditures

NEW LAW EXPLAINED

Five-year amortization of research expenditures.—In tax years beginning after December 31, 2021, amounts paid or incurred for most research expenditures are amortized ratably over 5 years (Code Sec. 174, as amended by Tax Cuts and Jobs Act). The amortization period begins at the mid-point of the tax year in which the expenditures are paid or incurred (Code Sec. 174(a)(2), as amended by the 2017 Tax Cuts Act).

COMMENT

The prior rule which allowed taxpayers to currently deduct research and experimental expenditures is eliminated. Furthermore, taxpayers may no longer elect an amortization period 60 months or greater beginning when benefits are first realized. The rule in Code Sec. 59(e) which allows a taxpayer to elect 10-year amortization of research and experimental expenditures beginning in the year the expenditures are paid or incurred remains available. However, the specific reference to Code Sec. 59(e) in Code Sec. 174(f) has been removed as part of the rewriting of the entire Code Sec. 174.

PLANNING NOTE

Taxpayers with significant losses have often elected 10-year amortization to reduce amounts that could be subject to expiration under the 20-year net operating loss carryfoward limitation even if they had no alternative minimum tax liability. Under the new law, NOLs may now be carried forward indefinitely. Consequently, taxpayers are less likely to elect 10-year amortization.

Five-year amortization applies to “specified research or experimental expenditures.” This term is simply defined as research or experimental expenditures paid or incurred by the tax payer during a tax year in connection with the taxpayer’s trade or business (Code Sec. 174(b), as amended by the 2017 Tax Cuts Act. Certain exclusions described below are provided.

COMMENT

Research and experimental expenditures are defined in Reg. §1.174-2.

Software development expenditures. Any amount paid or incurred in connection with the development of any software is treated as a research or experimental expenditure for purposes of this amortization provision (Code Sec. 174(c)(3), as added by the 2017 Tax Cuts Act).

COMMENT

Under current law, the IRS allows a taxpayer to treat all software development expenses as currently deductible even if such expenses do not otherwise meet the requirements of Code Sec. 174 (Rev. Proc. 2000-50). Under the new law, no portion of software development costs are currently deductible and all such expenses must be amortized as research expenditures over 5 years.

Exclusion for acquisition costs of land and other property. As under prior law, expenditures for acquiring land, acquiring or improving depreciable property, or acquiring property subject to a depletion allowance are not treated as research expenditures even if used in connection with research and experimentation and depreciation and depletion allowances on such property are considered research expenditures (Code Sec. 174(c)(1), as amended by the 2017 Tax Cuts Act).

Exclusion for exploration expenditures. The new law also retains the prior rule that amounts paid or incurred for the purpose of determining the existence, location, extent, or quality of an ore, mineral, or oil and gas deposit are not research expenditures (Code Sec. 174(c)(2), as amended the 2017 Tax Cuts Act).

15-year amortization period for foreign research. A 15-year amortization period now applies to research or experimental expenditures which are attributable to foreign research (Code Sec. 174(a)(2)(B), as amended by the 2017 Tax Cuts Act). Foreign research is defined by reference to Code Sec. 41(d)(4)(F to mean any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

COMMENT

Prior law contained no restrictions on the deduction of research or experimental expenditures attributable to foreign research.

Amortization continues after a disposition. A taxpayer must continue to amortize its research or experimental expenditures even if the property with respect to which the expenditures were paid or incurred is disposed, retired, or abandoned during the amortization period. No deduction of the unamortized portion of the expenditures is allowed (Code Sec. 174(d), as amended by the 2017 Tax Cuts Act).

Change in accounting - provision applied on cut-off basis. Although the switch to a 5-year amortization period and other changes in this provision are considered a change in accounting method it will not be necessary to file an accounting method change and no Code Sec. 481(a) adjustment is required or allowed. The provision will only apply on a cut-off basis to research or experimental expenditures paid or incurred in tax years beginning after December 31, 2021. The change is treated as initiated by the taxpayer and as made with the consent with the IRS (Act Sec. 13206(b) of the 2017 Tax Cuts Act).

Coordination with research credit. The amount capitalized and otherwise eligible for amortization over 5-years under this provision is reduced by the excess (if any) of the research credit allowed for the tax year and the amount allowable as a deduction for the tax year as qualified research expenses or basic research expenses (Code Sec. 280C(d)(1), as amended by the 2017 Tax Cuts Act)).

COMMENT

Under current law, the deduction otherwise allowed for the portion of qualified research expenses (as defined in Code Sec. 41(b)) or basic research expenses (as defined in Code Sec. 41(e)(2)) is reduced by the amount of the research credit (Code Sec. 280C(d)(1), prior to amendment by the 2017 Tax Cuts Act). The same rule applies under the new provision except that only the amount otherwise allowed as an amortization deduction during the tax year that the credit is claimed reduces the research credit.

Definition of qualified research expenses. In a conforming amendment, the definition of qualified research for purposes of the research credit (Code Sec. 41) is adjusted to mean research with respect to which expenditures are treated as “specified research or experimental expenditures under section 174.” In other words, qualified research relates to research costs which must be amortized over five-years under section 174 (Code Sec. 41(d)(1)(A), as amended by the 2017 Tax Cuts Act. Under current law, qualified research is defined by reference to expenditures which may be currently deducted under Code Sec. 174. No change is made to the additional requirements imposed by Code Sec. 41 for qualified research, such the requirement that the research be undertaken for the purpose of discovering information which technological in nature and intended to be useful in the development of a new or improved business component of the taxpayer (Code Sec. 41(d)(1)(B)).

Effective date. The amendments made by this section apply to amounts paid or incurred in tax years beginning after December 31, 2025 (Act Sec. 13206(e) of the Tax Cuts and Jobs Act).

¶530 Repeal of the Domestic Production Activities Deduction (DPAD)

NEW LAW EXPLAINED

DPAD repealed.—The domestic production activities deduction (DPAD) is repealed for tax years beginning after December 31, 2017 (Code Sec. 199, as stricken by the Tax Cuts and Jobs Act).

Effective date. The amendment made by this section applies to tax years beginning after December 31, 2017 (Act 13305(c) of the Tax Cuts and Jobs Act).

ORDINARY AND NECESSARY EXPENSES

¶535 Employer's Deduction for Entertainment, Commuting Benefits, and Meals

NEW LAW EXPLAINED

Deductions eliminated for some entertainment, meal and transportation expenses.—Business expense deductions are eliminated or reduced as follows:

1) Deductions are eliminated for certain entertainment expenses after 2017 (Code Sec. 274(a)(1), as amended by the Tax Cuts and Jobs Act).
2) Deductions are eliminated for transportation and commuting benefits after 2017 (Code Sec. 274(a)(4), as added by the 2017 Tax Cuts Act, and Code Sec. 274(l), as amended by the 2017 Tax Cuts Act).
3) Deductions are eliminated after 2025 for employer-provided meals that are excludable from an employee's income or are de minimis fringes (Code Sec. 274(o), as added by the 2017 Tax Cuts Act).

Entertainment expenses. Entertainment expenses, including expenses for a facility used in connection with entertainment, that are paid or incurred after 2017 generally are not deductible. The exception that allowed deductions for entertainment expenses that were directly related to, or associated with, the active conduct of the taxpayer's trade or business is eliminated (Code Sec. 274(a)(1), as amended by the 2017 Tax Cuts Act).

Since directly-related and associated-with entertainment expenses are not deductible, the following related provisions are also removed: (a) the rules that treated a club as an entertainment facility unless it was used primarily to further, and was directly related to the active conduct of, the taxpayer's trade or business (Code Sec. 274(a)(2)(C), as stricken by the 2017 Tax Cuts Act); (b) the limit on deductions for tickets to entertainment and sporting events, including the special rules for seats in skyboxes and the special exception for charitable sporting events (Code Sec. 274(l)(1)(B), as stricken by the 2017 Tax Cuts Act); and (c) the 50-percent limit on entertainment expense deductions (Code Sec. 274(n)(1)(B), as stricken by the 2017 Tax Cuts Act).

COMMENT

Some entertainment-related rules do no change. As under current law, club dues and membership costs are not deductible (Code Sec. 274(a)(3)); and when entertainment deductions are disallowed with respect to any portion of a facility, that portion is treated as a personal, rather than a business asset (Code Sec. 274(g)).

Some entertainment expenses also remain fully deductible, including: (a) certain entertainment expenses for goods, services, and facilities that are treated as compensation to an employee-recipient; (b) expenses for recreational, social, or similar

activities and related facilities primarily for the benefit of employees who are not highly compensated employees; (c) expenses for entertainment sold to customers; and (d) entertainment expenses for goods, services, and facilities that are includible in the gross income of a non-employee recipient as compensation for services rendered or as a prize or award (Code Sec. 274(e) and (n)(2)(A)). As under current law, these deductions must satisfy strict substantiation requirements; however, the taxpayer will not have to substantiate the time and place of the entertainment (Code Sec. 274(d), as amended by the 2017 Tax Cuts Act).

Transportation and commuting benefits. An employer cannot deduct expenses paid or incurred after December 31, 2017, for any Code Sec. 132(f) qualified transportation fringe (van pools, transit passes, qualified parking, and bicycle commuting) (Code Sec. 274(a)(4), as added by the 2017 Tax Cuts Act).

An employer also cannot deduct expenses paid or incurred after 2017 for providing any transportation, or any payment or reimbursement, to an employee in connection with travel between the employee's residence and place of employment, except as necessary to ensure the employee's safety. However, this prohibition does not apply to a qualified bicycle commuting reimbursement (as described in Code Sec. 132(f)(5)(F)) that is paid or incurred after December 31, 2017, and before January 1, 2026 (Code Sec. 274(l), as added by the 2017 Tax Cuts Act).

COMMENT

Qualified bicycle commuting benefits are includible in the employee's income for tax years beginning after 2017 and before 2026 (Code Sec. 132(f)(8), as added by the 2017 Tax Cuts Act). See ¶615.

CAUTION

It is not clear how this exception for qualified bicycle commuting benefits will coordinate with the blanket prohibition on deductions for qualified transportation fringes.

Employer-provided meals. No deduction is allowed for amounts that an employer pays or incurs after December 31, 2025, for (a) meals that are excludable from an employee's income under Code Sec. 119(a) because they are provided to employees and their spouses and dependents for the employer's convenience and on the employer's business premises; or (b) food, beverage and facility expenses for meals that are minimis fringes under Code Sec. 132(e) (Code Sec. 274(o), as added by the 2017 Tax Cuts Act).

COMMENT

The employer's deduction for meal expenses is eliminated only for expenses described in Code Secs. 119(a) or 132(e). Thus, an employer may continue to deduct 50 percent of its expenses for food, beverages, and related facilities that are furnished on its business premises primarily for its employees, such as in a typical company cafeteria or executive dining room (Code Sec. 274(e)(1); Reg. §1.274-2(f)(2)(ii)).

Effective date. The amendments generally apply to amounts incurred or paid after December 31, 2017 (Act Sec. 13304(e) of the Tax Cuts and Jobs Act)).However, the elimination of the deduction for employer-provided meals that are excludable by employees or are de minimis fringes applies to amounts incurred or paid after December 31, 2025.

¶537 Prohibition on Non-Tangible Personal Property as Employee Achievement Awards

NEW LAW EXPLAINED

Non-tangible personal property prohibited as employee achievement award.—The term "tangible personal property," for purposes of what is a deductible "employee achievement award" does not include cash, cash equivalents, gift cards, gift coupons, or gift certificates (except an arrangement giving an employee the limited right to select and receive tangible personal property from a limited number of pre-selected or pre-approved items) (Code Sec. 274(j)(3)(ii)(I), as added by the Tax Cuts and Jobs Act). The term also excludes vacations, meal, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items (Code Sec. 274(j)(3)(A)(ii)(II), as added by the 2017 Tax Cuts Act). This amendment is not intended to be an inference that present law and guidance is changed (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Effective date. The amendments made by this provision apply to amounts paid or incurred after December 31, 2017 (Act Sec. 13310(b) of the Tax Cuts and Jobs Act).

¶540 Limitation on Excessive Employee Compensation

NEW LAW EXPLAINED

Requirements for the limitations on employee remuneration amended.— Effective for tax years beginning after December 31, 2017, the definitions of "covered employee," "compensation," and "publicly held corporation" have been modified for purposes of the limitation on the deduction for excessive employee compensation paid by publicly held corporations.

Covered employee. A covered employee is any employee of the corporation who:

1) is the principal executive officer (PEO) of the corporation (or an individual acting in such capacity) at any time during the tax year,
2) is the principal financial officer (PFO) of the corporation (or an individual acting in such capacity) at any time during the tax year,
3) is among the three highest compensated officers for the tax year (other than the PEO or the PFO), or
4) was a covered employee of the corporation (or any predecessor) for any prior tax year beginning on or after January 1, 2017 (Code Sec. 162(m)(3), as amended by the Tax Cuts and Jobs Act)).

COMMENT

Amendments to Code Sec. 162(m) reflect changes made by to the definition of covered employees made by Notice 2007-49.

Compensation. The exceptions for commissions and performance-based compensation are repealed (Code Sec. 162(m)(4), as amended by the 2017 Tax Cuts Act). Applicable employee compensation (remuneration) now includes any cash and noncash benefits paid for services, including commissions and performance-based compensation, but does not include:

1) income from specified employee trusts, annuity plans, or pensions,
2) any benefit that is reasonably anticipated to be tax free under the Code,
3) income payable under a written binding contract which was in effect on February 17, 1993, and
4) compensation paid before a corporation became publicly held (Code Sec. 162(m)(4), as amended by the 2017 Tax Cuts Act).

A covered employee's compensation is still subject to the deduction limit even if it is paid to or includible in the income of another person. This includes compensation paid to a covered employee's estate, a beneficiary of the employee's estate, or to a former spouse (Code Sec. 162(m)(4)(F), as added by the 2017 Tax Cuts Act; Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 344).

Publicly held corporations. The $1 million deduction cap for covered employees only applies to publicly held corporations. Publicly held corporations now include all domestic publicly traded corporations and all foreign companies publicly traded through American depository receipts (ADRs) (Code Sec. 162(m)(2) as amended by the 2017 Tax Cuts Act). According to the Conference Committee Report, publicly held corporations may also include large private C and S corporations that are not publicly traded (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 344).

Effective date. Except as otherwise provided, the amendments made by this provision apply to tax years beginning after December 31, 2017 (Act Sec. 13601(e) of the Tax Cuts and Jobs Act). The amendments do not apply to remuneration which is provided 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.

¶545 Amendment to the Deduction for Fines and Penalties

NEW LAW EXPLAINED

Prohibition of deduction for fines and penalties amended.—

Fines and penalties paid or incurred to, or at the direction of, any federal, state or foreign government or governmental entity due to the violation of a law (or the investigation or inquiry into the potential violation of a law) are not deductible business expenses (Code Sec. 162(f)(1), as amended by the Tax Cuts and Jobs Act).

However, there are certain exceptions to this rule. These exceptions include:

1) Amounts paid that constitute restitution (including the remediation of property) for damages due or may be be due to the violation (or potential violation) of a law (Code Sec. 162(f)(2)(A)(i)(I), as amended by the 2017 Tax Cuts Act),
2) Amounts paid to come into compliance with a violated law, or the investigation or inquiry into the violation or potential violation of a law (Code Sec. 162(f)(2)(A)(i)(II), as amended by the 2017 Tax Cuts Act).
3) Amounts paid to satisfy a court order where the government is not a party (Code Sec. 162(f)(3), as amended by the 2017 Tax Cuts Act), and
4) Amounts paid for taxes due (Code Sec. 162(f)(4), as amended by the 2017 Tax Cuts Act).

In order for the restitution or compliance exceptions to apply, the payment must be identified as restitution or compliance in a court order or settlement agreement. In addition, restitution for the failure to pay a tax imposed under the Internal Revenue Code, would be deductible only to the extent that deduction for the tax would have been allowable if it had been timely paid (Code Sec. 162(f)(2)(A)(ii) and (iii), as amended by the 2017 Tax Cuts Act.

Nongovernment entities. The following nongovernment entities are treated as governmental entities for purposes of Code Sec. 162(f):

- any nongovernmental entity which exercises self-regulatory powers (including the authority to impose sanctions) in connection with a qualified board or exchange , defined in Code Sec. 1256(g)(7) (Code Sec. 162(f)(5)(A), as amended by the 2017 Tax Cuts Act), and
- any nongovernmental entity with self-regulatory powers (including the authority to impose sanctions) that was established by governmental regulations in order to perform an essential governmental function (Code Sec. 162(f)(5)(B), as amended by the 2017 Tax Cuts Act.

Reporting requirements. The officer or employee that has control over the suit or agreement, or the individual designated by the government or entity must file a return with the IRS (Code Sec. 6050X(a) and (c), as amended by the 2017 Tax Cuts Act. This return must state:

1) the total amount to be paid as a result of the suit or agreement,
2) any amount to be paid for restitution or remediation of property, and
3) any amount to be paid for compliance (Code Sec. 6050X(a)(1), as added by the 2017 Tax Cuts Act).

The return must be filed at the time the agreement is entered into Code Sec. 6050X(a)(3), as added by the 2017 Tax Cuts Act)

In addition, the individual filing the return must also simultaneously provide a statement to each person or entity that is a party to the suit or agreement. The statement must provide:

1) the name of the government or entity and
2) the information included in the return that the individual filed with the IRS (Code Sec. 6050X(b), as added by the 2017 Tax Cuts Act).

Suit or agreement. For the purposes of the reporting requirements, a suit or agreement is defined as:

- a suit that results in a court order in which a government or entity has authority or
- an agreement that is entered into with respect to a violation or potential violation of the law, over which a government or entity has authority.

The amount of the suit or agreement must exceed $600. The IRS may change that amount as necessary to ensure efficient administration (Code Sec. 6050X(a)(2), as added by the 2017 Tax Cuts Act)

Effective date. The amendments by this section apply to amounts paid or incurred on or after December 22, 2017, the date of enactment, except that the amendments will not apply to amounts paid or incurred under any binding order or agreement entered into before December 22, 2017 (Act Sec. 13306(a)(2) and Act Sec. 13306(b)(3) of the Tax Cuts and Jobs Act). The exception will not apply to an order or agreement requiring court approval unless the approval was obtained before December 22, 2017.

¶550 Deduction for Settlements Paid for Sexual Harassment or Abuse Subject to Nondisclosure Agreements

NEW LAW EXPLAINED

Elimination of deduction for settlements paid for sexual harassment or abuse subject to nondisclosure agreements.— Deductions are prohibited for any settlement or payment related to sexual harassment or sexual abuse if the settlement is subject to a nondisclosure agreement. Attorney's fees related to such payments or agreements are also not deductible (Code Sec. 162(q), as added by the Tax Cuts and Jobs Act).

Effective date. The amendments made by this section apply to amounts paid or incurred after December 22, 2017 (Act Sec. 13307(b) of the Tax Cuts and Jobs Act).

¶555 Local Lobbying Expenses Deduction

NEW LAW EXPLAINED

Deductions for local lobbying expenses repealed.—The deduction for lobbying for local legislation is repealed (Code Sec. 162(e)(2), prior to removal by the Tax Cuts and Jobs Act). In addition to the elimination of the deduction for local lobbying expenses, the deduction for lobbying for Indian tribal government is also repealed, as an Indian tribal government is treated in the same manner as a local council or similar governing body (Code Sec. 162(e)(7), prior to removal by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section apply to amounts paid or incurred on or after December 22, 2017, the date of the enactment (Act Sec. 13308(c) of the Tax Cuts and Jobs Act).

¶560 Deduction for Living Expenses Incurred by Congressional Members

NEW LAW EXPLAINED

Deduction for living expenses incurred by members of Congress eliminated.—Members of Congress may no longer claim the deduction for up to $3,000 per year of living expenses incurred while on official business in the District of Columbia (Code Sec. 162(a), as amended by the Tax Cuts and Jobs Act).

Effective date. The amendment made by this section applies to tax years beginning after December 22, 2017, the date of the enactment (Act Sec. 1311(b) of the Tax Cuts and Jobs Act).

¶565 Deduction of FDIC Premiums

NEW LAW EXPLAINED

Limitation of deductions of FDIC premiums.— The deduction of the applicable percentage of FDIC premiums for banks and other financial institutions with over $10 billion in consolidated assets is limited (Code Sec. 162(r), as added by the Tax Cuts and Jobs Act). Banks and other financial institutions with more than $50 billion in assets may not deduct the applicable percentage of any FDIC premium paid.

Applicable percentage. The applicable percentage is determined by subtracting $10 billion from the total amount of consolidated assets in a tax year, and the dividing that amount by $40 billion.

EXAMPLE 1

Bank X ended the tax year with $26 billion in consolidated assets. No deduction is allowed for 40 percent of FDIC premiums ($26 billion - $10 billion) / $40 billion.

EXAMPLE 2

Bank Y ended the tax year with $46 billion in consolidated assets. No deduction is allowed for 90 percent of FDIC premiums ($46 billion - $10 billion) / $40 billion.

Banks with $50 billion or more in consolidated assets may not deduct the entire FDIC premiums. Such institutions have an applicable percentage of 100 percent (Code Sec. 162(r)(3), as added by the 2017 Tax Cuts Act). This provision does not apply to banks and other financial institutions with $10 billion or less in consolidated assets at the end of the tax year (Code Sec. 162(r)(2), as added by the 2017 Tax Cuts Act).

FDIC premiums. FDIC premiums refer to assessments imposed under section 7(b) of the Federal Deposit Insurance Act (12 U.S.C. sec. 1817(b)). The term total consolidated assets in this provision has the same meaning as the term in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203).

Expanded affiliated groups. When determining the amount of consolidated assets held in a bank or financial institution, the new provision treats members of an expanded affiliated group as a single taxpayer (Code Sec. 162(r)(6), as added by the 2017 Tax Cuts Act). An expanded affiliated group is defined under Code Sec. 1504(a), except that the phrase “more than 50 percent” is substituted for “at least 80 percent” in Code Sec. 1504(a)(2).

Thus, under Code Sec. 162(r), an expanded affiliated group is one or more chains of includible corporations connected through stock ownership with a common parent that meets the following requirements:

1) The common parent must directly own stock possessing more than 50 percent of the total voting power of at least one of the other includible corporations and having a value equal to at more than 50 percent of the total value of the stock of that corporation, and

2) Stock meeting the 50-percent test in each includible corporation other than the common parent must be owned directly by one or more of the other includible corporations.

Insurance companies and foreign corporations are exempt from the definition (Code Sec. 162(r)(6)(B)(i)(II), as added by the 2017 Tax Cuts Act). Partnerships or entities other than corporations are considered members of an expanded affiliated group if such entity is controlled by a corporation in the group.

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 13531(b) of the Tax Cuts and Job Act).

ACCOUNTING FOR BUSINESSES

¶570 Expanded Availability of Cash Method, Exceptions to Inventory and UNICAP Rules, and Small Construction Contract Exception

NEW LAW EXPLAINED

Single gross receipts test added for cash method, inventory, UNICAP, construction contract rules.—A single $25 million gross receipts test has been put in place for determining whether certain taxpayers qualify as small taxpayers that can use the cash method of accounting, are not required to use inventories, are not required to apply the UNICAP rules, and are not required to use the percentage of completion method for a small construction contract (Act Sec. 13102 of the Tax Cuts and Jobs Act).

COMMENT

The combined effect of the statutory changes is to replace a number of different gross receipts tests for determining what is a small taxpayer with a single gross receipts test with a $25 million threshold. In nearly all cases, the $25 million threshold is a significant increase from the prior thresholds which ranged from $1 million to $25 million. The changes not only increase the number of businesses that will qualify as a small taxpayer but also greatly simplify the gross receipts determinations.

Gross receipts test expanded. The exception to the general limit on the use of the cash method for small businesses is expanded for tax years beginning after December 31, 2017. Under the exception, a C corporation or a partnership with a C corporation partner that meets a gross receipts test can qualify to use the cash method of accounting (Code Sec. 448(b)(3), as amended by the 2017 Tax Cuts Act). A C corporation or a partnership with a C corporation partner meets the gross receipts test for a tax year if its average annual gross receipts for the three-tax-year period that ends with the tax year preceding such tax year do not exceed $25 million (to be adjusted for inflation for tax years beginning after 2018 (discussed below)) (Code Sec. 448(c)(1), as amended by the 2017 Tax Cuts Act, and Code Sec. 448(c)(4), as added by the 2017 Tax Cuts Act).

CAUTION

Tax shelters are not allowed to use the cash method even if they meet the gross receipts test (Code Sec. 448(a)(3)).

The steps for the gross receipts test are:

- determine gross receipts for each year in the three-tax-year period;
- compute the average annual gross receipts for the three-tax-year period; and
- determine if the average annual gross receipts for the three-tax-year period are $25 million or less (to be adjusted for inflation for tax years beginning after 2018 (discussed below)).

EXAMPLE

A C corporation wants to determine if it can use the cash method under the expanded gross receipts test for the 2018 tax year. For the three tax years ending with the 2017 tax year, the corporation has gross receipts of $21 million, $26 million and $25 million (tax years 2015, 2016 and 2017, respectively). Its average annual gross receipts for the three-tax-year period are $24 million (($21 million + $26 million + $25 million) ÷ 3). The corporation meets the gross receipts test for 2018.

COMMENT

Many additional C corporations and partnerships with a corporate partner will be able to use the cash method under the $25 million gross receipts test since the prior test capped the amount of qualifying annual gross receipts at only $5 million.

Inflation adjustment. The average annual gross receipts amount of $25 million is adjusted for inflation for tax years beginning after December 31, 2018 (Code Sec. 448(c)(4), as added by the 2017 Tax Cuts Act). The $25 million amount will be increased by an amount equal to the $25 million amount multiplied by the cost-of-living adjustment determined under Code Sec. 1(f)(3) (as amended by the 2017 Tax Cuts Act) for the calendar year in which the tax year begins by substituting "calendar year 2017" for "calendar year 2016" in Code Sec. 1(f)(3)(A)(ii). If the increased amount is not a multiple of $1 million, the amount is rounded down to the next lowest multiple of $1 million.

COMMENT

The other exceptions to the general limitation on the use of the cash method continue to apply for qualified personal service corporations and taxpayers other than C corporations. Thus, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other passthrough entities are allowed to use the cash method without regard to whether they meet the $25 million gross receipts test if the cash method clearly reflects income and the entity is not a tax shelter (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

A taxpayer making a change in accounting method under the Code Sec. 448 rules limiting the use of the cash method should treat the change as initiated by the taxpayer and made with the IRS's consent for purposes of any Code Sec. 481 adjustment (Code Sec. 448(d)(7), as amended by the 2017 Tax Cuts Act). The special Code Sec. 481 adjustment periods for Code Sec. 448 accounting method changes of up to four years and up to 10 years for a hospital have been eliminated for tax years beginning after December 31, 2017 (Code Sec. 448(d)(7), prior to amendment by the 2017 Tax Cuts Act).

COMPLIANCE TIP

Taxpayers make a change of accounting method by filing Form 3115, Application for Change in Accounting Method. The taxpayer should follow the IRS procedures for accounting method changes (Rev. Proc. 2015-13, I.R.B. 2015-5, 419, and Rev. Proc. 2017-30, I.R.B. 2017-18, 1131).

Use of cash method by large farming corporations expanded. The exception to the required use of the accrual method by large farming C corporations and farming partnerships with a C corporation partner has been expanded. For tax years beginning after December 31, 2017, a farming C corporation or a farming partnership in which a C corporation is a partner can use the cash method if it meets the $25 million gross receipts test of Code Sec. 448(c) (discussed above) (Code Sec. 447(c), as amended by the 2017 Tax Cuts Act).

COMMENT

Many additional farming corporations and farming partnerships with a corporate partner will be able to use the cash method under the $25 million gross receipts test since the prior test capped the amount of qualifying annual gross receipts at only $1 million.

COMMENT

Since the test for *family* farming corporations was already set at average annual gross receipts of $25 million, the rules in Code Sec. 447 that applied to *family* farming corporations are no longer needed and have been removed (Code Sec. 447(d), (e), (h) and (i), prior to being stricken by the 2017 Tax Cuts Act). However, the rules under former Code Sec. 447(i) for establishing suspense accounts for Code Sec. 481 adjustments from

accounting method changes will continue to apply to any suspense accounts established before the date of enactment (Act Sec. 13102(e)(2) of the 2017 Tax Cuts Act).

A farming corporation or farming partnership with a corporate partner making a change in accounting method under the Code Sec. 447 accounting method rules should treat the change as initiated by the taxpayer and made with the IRS's consent for purposes of any Code Sec. 481 adjustment (Code Sec. 447(d), as amended by the 2017 Tax Cuts Act).

Exception to required use of inventories expanded for small businesses. The exception to the required use of inventories for taxpayers that qualify as a small business has been expanded. For tax years beginning after December 31, 2017, a business is not required to use inventories if it meets the $25 million gross receipts test of Code Sec. 448(c) (discussed above) (Code Sec. 471(c)(1), as added by the 2017 Tax Cuts Act). Any taxpayer that is not a corporation or partnership should apply the gross receipts test as if each trade or business of the taxpayer were a corporation or a partnership (Code Sec. 471(c)(3), as added by the 2017 Tax Cuts Act). Thus, in the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

CAUTION

Tax shelters that are not allowed to use the cash method do not qualify as small businesses that can avoid using inventories (Code Sec. 448(a)(3); Code Sec. 471(c)(1), as added by the 2017 Tax Cuts Act).

A business that meets the $25 million gross receipts test can use a method of accounting for inventory that:

- treats inventory as non-incidental materials and supplies; or
- conforms to the business's financial accounting treatment of inventories (Code Sec. 471(c)(1)(B), as added by the 2017 Tax Cuts Act; Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

A business's financial accounting treatment of inventories is the method of accounting reflected in an applicable financial statement or, if the business does not have an applicable financial statement, in the business's books and records as prepared in accordance with its accounting procedures (Code Sec. 471(c)(1)(B), as added by the 2017 Tax Cuts Act). An "applicable financial statement" is defined in Code Sec. 451(b)(3) (see ¶580) (Code Sec. 471(c)(2), as added by the 2017 Tax Cuts Act).

A taxpayer making a change in accounting method under the exception to the required use of inventories for small businesses should treat the change as initiated by the taxpayer and made with the IRS's consent for purposes of any Code Sec. 481 adjustment (Code Sec. 471(c)(4), as added by the 2017 Tax Cuts Act).

Exception to required use of UNICAP rules expanded for small taxpayers. The exception to the UNICAP rules for small taxpayers that purchase personal property for resale has been expanded. For tax years beginning after December 31, 2017, a taxpayer is not required to apply the UNICAP rules for the tax year if it meets the $25 million gross receipts test of Code Sec. 448(c) (discussed above) (Code Sec. 263A(i)(1), as added by the 2017 Tax Cuts Act). The expanded exception to the UNICAP rules applies to any producer or reseller, other than a tax shelter, that meets the $25 million gross receipts test (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

A taxpayer that is not a corporation or partnership should apply the gross receipts test as if each trade or business of the taxpayer were a corporation or a partnership (Code Sec. 263A(i)(2), as added by the 2017 Tax Cuts Act). Thus, in the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

CAUTION

Tax shelters that are not allowed to use the cash method do not qualify as small businesses that can avoid the UNICAP rules (Code Sec. 448(a)(3); Code Sec. 263A(i)(1), as added by the 2017 Tax Cuts Act).

COMMENT

The prior exception to the UNICAP rules only applied to small taxpayers that purchase personal property for resale while the expanded exception to the UNICAP rules applies to any *producer or reseller*, other than a tax shelter, that meets the $25 million gross receipts test (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)). It also appears that the exception will apply to *real property* acquired for resale.

A taxpayer making a change in accounting method under the exception to the UNICAP rules for small businesses meeting the $25 million gross receipts test should treat the change as initiated by the taxpayer and made with the IRS's consent for purposes of any Code Sec. 481 adjustment (Code Sec. 263A(i)(3), as added by the 2017 Tax Cuts Act).

Small construction contract exception expanded. The small construction contract exception to the required use of the percentage of completion method for long-term contracts has been expanded. For contracts entered into after December 31, 2017, in tax years ending after such date, the exception applies to a construction contract entered into by a taxpayer:

- who estimates at the time the contract is entered into that the contract will be completed within the two-year period beginning on the contract commencement date; and
- who meets the $25 million gross receipts test of Code Sec. 448(c) (discussed above) for the tax year in which the contract is entered into (Code Sec. 460(e)(1)(B), as amended by the 2017 Tax Cuts Act).

A taxpayer that is not a corporation or partnership should apply the gross receipts test as if each trade or business of the taxpayer were a corporation or a partnership (Code Sec. 460(e)(2)(A), as added by the 2017 Tax Cuts Act). Thus, in the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

CAUTION

The expanded exception for small contraction contracts cannot be applied by a tax shelter that is not allowed to use the cash method of accounting under Code Sec. 448(a)(3) (Code Sec. 460(e)(1)(B), as amended by the 2017 Tax Cuts Act).

If a taxpayer changes its method of accounting based on the small construction contract exception, then:

- the change is treated as initiated by the taxpayer and made with the IRS's consent; and
- the change is made on a cut-off basis for all similarly classified contracts entered into on or after the year of change (Code Sec. 460(e)(2)(B), as added by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section generally apply to tax years beginning after December 31, 2017 (Act Sec. 13102(e)(1) of the Tax Cuts and Jobs Act). The amendments made by this provision for small construction contracts apply to contracts entered into after December 31, 2017, in tax years ending after such date (Act Sec. 13102(e)(3) of the 2017 Tax Cuts Act).

¶580 Special Rules for Accrual-Method Taxpayers on Deferral of Advance Payments and Including Amounts in Income Based on Financial Accounting Treatment

NEW LAW EXPLAINED

Special rules added on time for including amounts in income.—Two special rules have been added on the proper time for including amounts in income by accrual-method taxpayers. Under the first rule, amounts are generally included in income no later than when the amounts are included for financial accounting purposes (Code Sec. 451(b), as added by the Tax Cuts and Jobs Act). The second rule allows taxpayers to elect to defer including certain advance payments in income until the tax year after the tax year in which the payments were received, subject to limitations (Code Sec. 451(c), as added by the 2017 Tax Cuts Act). These income recognition rules generally apply to tax years beginning after December 31, 2017 (Act Sec. 13221(c) of the 2017 Tax Cuts Act). However, in the case of income from a debt instrument having original issue discount (OID), the rules apply to tax years beginning after December 31, 2018 (Act Sec. 13221(e)(1) of the 2017 Tax Cuts Act).

Amounts included in income based on financial accounting treatment. For an accrual-method taxpayer, the all-events test is met with respect to any item of gross income if all the events have occurred which fix the right to receive such income and the amount of such income can be determined with reasonable accuracy (Code Sec. 451(b)(1)(C), as added by the 2017 Tax Cuts Act). However, the all-events test with respect to any item of gross income or portion of such item cannot be treated as met any later than when the item of gross income or portion of such item is taken into account in revenue in the taxpayer's applicable financial statement or other financial statement specified by the IRS (Code Sec. 451(b)(1)(A), as added by the 2017 Tax Cuts Act).

Applicable financial statement. A taxpayer's applicable financial statement is:

1) a financial statement that is certified as being prepared according to generally accepted accounting principles and is:
   a) a 10-K or Annual Statement to Shareholders that is required to be filed with the U.S. Securities and Exchange Commission (SEC),
   b) if there is no statement described in (a), an audited financial statement that is used for credit purposes, reporting to shareholders, partners, or other proprietors, or to beneficiaries, or any other substantial non-tax purpose, or
   c) if there is no statement described in (a) or (b), a financial statement filed with any federal agency for purposes other than federal tax purposes;
2) if there is no statement described in (1), above, a financial statement that is made on the basis of international financial reporting standards and is filed with a foreign government agency that is equivalent to the SEC and which has reporting standards that are not less stringent than the SEC standards; or
3) if there is no statement described in (1) or (2), above, a financial statement filed with any other regulatory or governmental body specified by the IRS (Code Sec. 451(b)(3), as added by the 2017 Tax Cuts Act).

If the financial results of a taxpayer are reported on the applicable financial statement for a group of entities, the statement is treated as the applicable financial statement of the taxpayer (Code Sec. 451(b)(5), as added by the 2017 Tax Cuts Act).

Allocation of transaction price. In the case of a contract that contains multiple performance obligations, the allocation of the transaction price to each performance obligation is equal to the amount allocated to each performance obligation for purposes of including such item in revenue in the taxpayer's applicable financial statement (Code Sec. 451(b)(4), as added by the 2017 Tax Cuts Act).

Exceptions to financial statement rule. The rule for including amounts in income no later than they are included for financial accounting purposes does not apply to a taxpayer that does not have an applicable financial statement or other financial statement specified by the IRS. In addition, the rule does not apply to any item of gross income in connection with a mortgage servicing contract (Code Sec. 451(b)(1)(B), as added by the 2017 Tax Cuts Act). Income from mortgage servicing rights should continue to be recognized under the current rules where: (1) "normal" mortgage servicing rights are included in income upon the earlier of earned or received under the all-events test and not averaged over the life of the mortgage, and (2) "excess" mortgage servicing rights are treated as stripped coupons and subject to the original issue discount (OID) rules (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

The rule for including amounts in income no later than they are included for financial accounting purposes also does not apply with respect to any item of gross income for which the taxpayer uses a special method of accounting provided under the income tax provisions of the Internal Revenue Code, other than the rules for bonds and debt instruments in Code Secs. 1271-1288 (Code Sec. 451(b)(2), as added by the 2017 Tax Cuts Act). Thus, accrual-method taxpayers apply the applicable financial statement rule before applying the special rules in Code Secs. 1271-1288, which cover the original issue discount (OID) rules and also rules on the treatment of market discount on bonds, discounts on short-term obligations, OID on tax-exempt bonds, and stripped bonds and stripped coupons (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Accrual-method taxpayers allowed to defer including advance payments in income. Generally, for tax years beginning after December 31, 2017, an accrual-method taxpayer who receives an advance payment during the tax year must either:

1) include the advance payment in gross income for the tax year of receipt; or
2) make an election to defer the inclusion of the advance payment in gross income with respect to the category of advance payments to which the advance payment belongs (Code Sec. 451(c)(1), as added by the 2017 Tax Cuts Act).

Under the deferral election, any portion of the advance payment that is required to be included in gross income under the financial statement rule described above would be included in gross income in the tax year in which it is received and the remaining portion of the advance payment would be included in gross income in the tax year following the tax year in which it is received (Code Sec. 451(c)(1)(B), as added by the 2017 Tax Cuts Act). An item of gross income is received by the taxpayer if it is actually or constructively received, or if it is due and payable to the taxpayer (Code Sec. 451(c)(4)(C), as added by the 2017 Tax Cuts Act).

COMMENT

The new rule for deferring advance payments from income essentially codifies IRS guidance in Rev. Proc. 2004-34 on deferral of advance payments with some modifications.

Advance payment defined. An advance payment is any payment:

1) the full inclusion of which in the taxpayer's gross income for the tax year of receipt is a permissible method of accounting without regard to this advance payment rule;
2) any portion of which is included in revenue by the taxpayer in a 10-K or Annual Statement to Shareholders that is required to be filed with the U.S. Securities and Exchange Commission (SEC) or an audited financial statement that is used for credit purposes, reporting to shareholders, partners, or other proprietors, or to beneficiaries, or any other substantial non-tax purpose, for a subsequent tax year; and
3) which is for goods, services, or such items as may be identified by the IRS (Code Sec. 451(c)(4)(A), as added by the 2017 Tax Cuts Act).

An advance payment does not include:

1) rent;
2) insurance premiums governed by subchapter L (Insurance Companies);
3) payments with respect to financial instruments;
4) payments with respect to warranty or guarantee contracts under which a third party is the primary obligor;
5) payments subject to Code Sec. 871(a) or Code Sec. 881 (tax on certain amounts received from U.S sources by a nonresident alien or foreign corporation) or Code Sec. 1441 or Code Sec. 1442 (payments subject to the withholding rules for nonresident aliens or foreign corporations);
6) payments to which Code Sec. 83 applies (property transferred in connection with the performance of services); and
7) any other payment identified by the IRS for this purpose (Code Sec. 451(c)(4)(B), as added by the 2017 Tax Cuts Act).

For purposes of the advance payment rules, rules similar to the allocation of transaction price rules of Code Sec. 451(b)(4), above, apply (Code Sec. 451(c)(4)(D), as added by the 2017 Tax Cuts Act). Thus, if advance payments are received for a combination of services, goods, or other specified items, the taxpayer should allocate the transaction price according to the allocation made in the taxpayer's applicable financial statement (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Unless otherwise provided by the IRS, the deferral election for advance payments will not apply to advance payments received by a taxpayer during a tax year if the taxpayer ceases to exist during or with the close of such tax year (Code Sec. 451(c)(3), as added by the 2017 Tax Cuts Act). Thus, any deferred advance payment must be included in gross income if the taxpayer ceases to exist (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

How to elect to defer inclusion of advance payments in income. The IRS is instructed to provide details on making the election to defer the inclusion of advance payments in income. This includes the time, form and manner, and the categories of advance payments. The election will be effective for the tax year with respect to which it is first made and for all subsequent tax years, unless the taxpayer obtains the IRS's consent to revoke the election (Code Sec. 451(c)(2), as added by the 2017 Tax Cuts Act).

Change of accounting method. The computation of taxable income under the deferral election for advance payments is treated as a method of accounting (Code Sec. 451(c)(2)(B), as added by the 2017 Tax Cuts Act). In the case of any qualified change of accounting method for the taxpayer's first tax year beginning after December 31, 2017, the change is treated as initiated by the taxpayer and made with the IRS's consent. A qualified change of accounting method is any change of accounting method that is required by the new income recognition rules or was prohibited and is now permitted under the new rules (Act Sec. 13221(d) of the 2017 Tax Cuts Act). For a qualified change of accounting method involving income from a debt instrument with original issue discount (OID), taxpayers should use a six-year period for taking into account any required Code Sec. 481 adjustments (Act Sec. 13221(e)(2) of the 2017 Tax Cuts Act).

Effective date. The amendments made by this provision generally apply to tax years beginning after December 31, 2017 (Act Sec. 13221(c) of the Tax Cuts and Jobs Act). In the case of income from a debt instrument having original issue discount (OID), the amendments made by this provision apply to tax years beginning after December 31, 2018 (Act Sec. 13221(e)(1) of the 2017 Tax Cuts Act).

BUSINESS TAX CREDITS

¶585 Employer Credit for Paid Family and Medical Leave

Employer credit for paid family and medical leave provided.—A new credit for paid family and medical leave (FML) is available. An eligible employer is allowed the FML credit in an amount equal to the applicable percentage of the wages paid to qualifying employees during the period in which such employees are on FML (Code Sec. 45S(a)(1), as added by the Tax Cuts and Jobs Act). Applicable percentage means 12.5 percent increased (but not above 25 percent) by 0.25 percentage points for each percentage point by which the rate of payment exceeds 50 percent (Code Sec. 45S(a)(2), as added by the 2017 Tax Cuts Act).

> **CAUTION**
>
> The credit is only available with respect to wages paid in tax years beginning in 2018. Wages incurred but unpaid in a tax year beginning in 2018 do not qualify for the credit (Act Sec. 13403(e) of the 2017 Tax Cuts Act; Code Sec. 45S(i), as added by the 2017 Tax Cuts Act.

The credit allowed with respect to any employee for any tax year shall not exceed an amount equal to the product of (1) the normal hourly wage rate of the employee for each hour (or fraction thereof) of actual services performed for the employer and (2) the number of hours (or fraction thereof for which FML is taken) (Code Sec. 45S(b)(1), as added by the 2017 Tax Cuts Act). If an employee is not paid an hourly wage rate, the wages of such an employee should be prorated to an hourly wage rate in accordance with regulations established by the IRS (Code Sec. 45S(b)(2), as added by the 2017 Tax Cuts Act). The maximum amount of leave subject to the credit for any employee for any tax year may not exceed 12 weeks (Code Sec. 45S(b)(3), as added by the 2017 Tax Cuts Act).

An eligible employer is an employer that has a written policy in place that meets the following requirements:

- The policy provides: (a) in the case of a qualifying employee who is not a part-time employee, not less than 2 weeks of annual paid FML, and (b) in the case of a qualifying employee who is a part-time employee, annual paid FML that is not less than an amount which bears the same ratio to the amount of annual paid FML that is provided to a qualified employee who is not part-time as (i) the number of hours the employee is expected to work during any week, over (ii) the number of hours an equivalent qualifying employee who is not part-time is expected to work during the week.
- The policy requires that the rate of payment under the program is not less than 50 percent of the wages normally paid to the employee for services performed for the employer (Code Sec. 45S(c)(1), as added by the 2017 Tax Cuts Act).

An "added employer" is not treated as an eligible employer unless the employer provides FML that conforms with a written policy that ensures that the employer (i) will not interfere with, restrain, or deny the exercise of or the attempt to exercise, any right provided under the policy, and (ii) will not discharge or in any other manner discriminate against any individual for opposing any practice prohibited by the policy (Code Sec. 45S(c)(2)(A), as added by the 2017 Tax Cuts Act). An "added employee" is defined as a qualifying employee who is not covered by Title I of the Family and Medical Leave Act of 1993 (P.L. 103-3) (Code Sec. 45S(c)(2)(B)(i), as added by the 2017 Tax Cuts Act). An "added employer" is defined to mean an eligible employer whether or not covered by Title I of the Family and Medical Leave Act, who offers paid family and medical leave to added employees (Code Sec. 45S(c)(2)(B)(ii), as added by the 2017 Tax Cuts Act).

Entities that are treated as a single employer under Code Secs. 52(a) and (b) are treated as a single taxpayer for purposes of the family and medical leave credit (Code Sec. 45S(c)(3), as added by the 2017 Tax Cuts Act). In addition, any leave that is paid by a state or local government or is required by state or

local law is not considered in determining the amount of paid FML that is provided by the employer (Code Sec. 45S(c)(4), as added by the 2017 Tax Cuts Act). Failure to provide paid family and medical leave by an employer will not subject an employer to any penalty, liability, or other consequence, except that the employer is not eligible to take the credit (Code Sec. 45S(c)(5), as added by the 2017 Tax Cuts Act).

A qualifying employee is any employee, which is defined in section 3(e) of the Fair Labor Standard Act of 1938, who has been employed by the employer for at least 1 year and, in the preceding year, received compensation not in excess of an amount equal to 60 percent of the amount applicable for such year under Code Sec. 414(q)(1)(B)(i) (Code Sec. 45S(d), as added by the 2017 Tax Cuts Act).

KEY RATES AND FIGURES

The Code Sec. 414(q)(1)(B)(i) amount is $80,000, adjusted for inflation. In 2018, the amount is $120,000.

Family and medical leave is defined as leave for any one or more purposes described in Sections 102(a)(1)(A)-(E) or (3) of the Family and Medical Leave Act of 1993, whether that leave is provided under the Act or due to an employer's policy (Code Sec. 45S(e)(1), as added by the 2017 Tax Cuts Act). An eligible employee is entitled to FML under the following circumstances, according to the Family and Medical Leave Act:

- the birth of a child of the employee and in order to care for such child;
- the placement of a child for adoption or foster care;
- a serious health condition of a spouse, child, or parent requiring the employee to care for such person;
- the employee's serious health condition that makes the employee unable to perform the functions of the employee's position;
- any "qualifying exigency" arising out of the fact that the employee's spouse, child, or parent is a military member on covered active duty or call to covered active duty status; or
- to care for a covered service member with a serious injury or illness.

If the employer provides paid leave as vacation leave, personal leave, or medical or sick leave (other than leave specifically for one or more of the purposes referred to above), that paid leave is not considered FML (Code Sec. 45S(e)(2), as added by the 2017 Tax Cuts Act). Determinations as to whether an employer or employee meets the requirements to be an "eligible employer" or "qualifying employee" are made by the IRS (Code Sec. 45S(f), as added by the 2017 Tax Cuts Act). The term wages has the same meaning as that given in Code Sec. 3306(b), which is generally all remuneration paid for employment, including the cash value of all remuneration, including benefits, paid in any medium other than cash. Wages do not include any amount taken into account for purposes of determining any other credit allowed under Subpart D—Business Related Credits (Code Sec. 45S(g), as added by the 2017 Tax Cuts Act). An employer may elect to have the credit for paid family and medical leave not apply (Code Sec. 45S(h)(1), as added by the 2017 Tax Cuts Act). The election can be made at any time before the expiration of the three-year period beginning on the last day for filing the tax return for the year of the election (without regard to extensions) (Code Sec. 45S(h)(2), as added by the 2017 Tax Cuts Act). The election is made in the manner prescribed by regulations as issued by the Secretary (Code Sec. 45S(h)(2), as added by the 2017 Tax Cuts Act).

The credit for paid FML is treated as a component of the general business credit (Code Sec. 38(b), as amended by the 2017 Tax Cuts Act). The credit for paid FML is allowed as a credit against the alternative minimum tax (AMT) (Code Sec. 38(c)(4)(B), as amended by the 2017 Tax Cuts Act).

Effective date. The provision applies to wages paid in tax years beginning after December 31, 2017 (Act Secs. 13403(e) of the Tax Cuts and Jobs Act).

¶590 Rehabilitation Credit

NEW LAW EXPLAINED

Rehabilitation credit limited to certified historic structures; claimed ratably over five years.— The rehabilitation credit is limited to 20 percent of qualified rehabilitation expenditures (QREs) of the taxpayer for qualified rehabilitated buildings and is claimed ratably over a five-year period beginning in the tax year in which the rehabilitated building is placed in service (Code Sec. 47(a), as amended by the Tax Cuts and Jobs Act). The definition of a "qualified rehabilitated building" remains a building and its structural components for which depreciation is allowable and that has been substantially rehabilitated and placed in service before the beginning of the rehabilitation (Code Sec. 47(c)(1), as amended by the 2017 Tax Cuts Act). However, the building must be a certified historic structure, but any expenditure attributable to rehabilitation of the structure is not a QRE unless it is a certified rehabilitation (Code Sec. 47(c)(2)(B)(iv), as amended by the 2017 Tax Cuts Act). The 10 percent rehabilitation credit for QREs with respect to qualified rehabilitated buildings placed in service before 1936 that are not certified historic structures is eliminated.

COMPLIANCE TIP

The rehabilitation credit is part of the investment credit that a taxpayer claims on Form 3468, Investment Credit.

STATE TAX CONSEQUENCES

States with historic building rehabilitation credits that incorporate federal law for purposes of determining eligibility and/or credit amounts will be affected by the changes to Code Sec. 47. For example, Maine allows a credit for QREs incurred for a certified historic structure in the state that is equal to the taxpayer's federal rehabilitation credit (limited to $100,000 annually per taxpayer). Therefore, any change in a taxpayer's federal rehabilitation credit resulting from the Code Sec. 47 amendments will also have a corresponding effect on the taxpayer's Maine credit. In addition, taxpayers in Wisconsin, which adopts the federal definitions of qualified rehabilitated buildings and qualified rehabilitation expenditures for its historic rehabilitation credit, may gain or lose eligibility for the state credit because of changes to Code Sec. 47.

Effective date. The amendments made by this provision generally apply to amounts paid or incurred after December 31, 2017 (Act Sec. 13402(c)(1) of the Tax Cuts and Jobs Act). Under a transition rule, in case of qualified rehabilitation expenditures (for either a certified historic structure or a pre-1936 building), with respect to any building owned or leased by the taxpayer at all times after December 31, 2017, the 24-month period selected by the taxpayer, or the 60-month period selected by the taxpayer under the rule for phased rehabilitation, begins no later than the end of the 180-day period beginning on the date of the enactment, and the amendments made by the provision apply to such expenditures paid or incurred after the end of the tax year in which such 24-month or 60-month period ends (Act Sec. 13402(c)(2) of the Tax Cuts Act).

¶595 Orphan Drug Credit

NEW LAW EXPLAINED

Orphan drug credit amount reduced to 25 percent; election of reduced credit.—The amount of the orphan drug credit is reduced to 25 percent of qualified clinical testing expenses paid or incurred by a taxpayer for tax years beginning after December 31, 2017 (Code Sec. 45C(a), as amended by the Tax Cuts and Jobs Act). A taxpayer also may elect a reduced credit amount in lieu of reducing otherwise allowable deductions. In the case of any tax year for which a reduced credit election is made, the amount of the credit will be the amount equal to the excess of: (1) the amount of credit otherwise determined without regard to the reduction, over (2) the product of the credit amount determined and the maximum income tax for a corporation. An election of reduced credit for any tax year must be made no later than the time for filing the taxpayer's return for the year (including extensions). Once made, the election is irrevocable.

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 13401(c) of the Tax Cuts and Jobs Act of 2017).

CHAPTER 6. COMPENSATION, RETIREMENT, EDUCATION AND DISABILITY BENEFITS

COMPENSATION

¶605 Qualified Equity Grants

NEW LAW EXPLAINED

Treatment of qualified equity grants.— A qualified employee of a privately held company may elect to defer including in his or her gross income the amount of income attributable to qualified stock transferred to the employee by the employer (Code Sec. 83(i), as added by the Tax Cuts and Jobs Act). This election is an alternative to being taxed in the year in which the property vests under Code Sec. 83(a) or in the year it is received under Code Sec. 83(b). The election to defer income inclusion for qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier (Code Sec. 83(i)(4), as added by the 2017 Tax Cuts Act).

If a qualified employee elects to defer income inclusion under the provision, the employee must include the income in his or her gross income for the tax year that includes the earliest of:

1) the first date the qualified stock becomes transferable, including transferable to the employer;
2) the date the employee first becomes an excluded employee;
3) the first date on which any stock of the employer becomes readily tradable on an established securities market;
4) the date five years after the first date the employee's right to the stock becomes substantially vested; or
5) the date on which the employee revokes his or her inclusion deferral election (Code Sec. 83(i)(1), as added by the 2017 Tax Cuts Act).

The inclusion deferral election is made in a manner similar to that for a section 83(b) election. The election is not allowed for income with respect to nonvested stock that is includible in gross income as a result of a section 83(b) election (Code Sec. 83(i)(4)(B), as added by the 2017 Tax Cuts Act).

An employee may not make an inclusion deferral election for a year with respect to qualified stock if the corporation purchased any of its outstanding stock in the preceding calendar year, unless (1) at least 25 percent of the total dollar amount of the stock so purchased is stock with respect to which an inclusion deferral election is in effect ("deferral stock"), and (2) the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis (Code Sec. 83(i)(4)(B) and (C), as added by the 2017 Tax Cuts Act). These two requirements are met if the corporation purchases all of its deferral stock (Code Sec. 83(i)(4)(C)(iii), as added by the 2017 Tax Cuts Act).

Stock that the corporation purchased from an individual is not treated as deferral stock (and the purchase is not treated as a purchase of deferral stock) if, immediately after the purchase, the individual holds any deferral stock for which a deferral election has been in effect for a longer period than the election regarding the purchased stock (Code Sec. 83(i)(4)(C)(ii), as added by the 2017 Tax Cuts Act).

Deferred income inclusion applies also for purposes of the employer's deduction of the amount of income attributable to the qualified stock. If an employee makes an inclusion deferral election, the employer's deduction is deferred until the employer's tax year in which or with which ends the tax year of the employee for which the amount is included in the employee's income as described above (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 355; see Code Sec. 83(h)).

Qualified stock. Qualified stock is any stock in a corporation which is the employer of the qualified employee if (1) the stock is received in connection with the exercise of an option or in settlement of a restricted stock unit (RSU), and (2) the option or RSU was granted by the corporation in connection with the performance of services as an employee and during a calendar year in which such corporation was an eligible corporation (Code Sec. 83(i)(2)(A), as added by the 2017 Tax Cuts Act).

However, qualified stock does not include any stock if, at the time the employee's right to the stock becomes substantially vested, the employee may sell the stock to, or otherwise receive cash in lieu of

stock from, the corporation (Code Sec. 83(i)(2)(B), as added by the 2017 Tax Cuts Act). Qualified stock can only be such if it relates to stock received in connection with options or RSUs, and does not include stock received in connection with other forms of equity compensation, including stock appreciation rights or restricted stock (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 356).

A corporation is an eligible corporation for a calendar year if:

1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year, and
2) the corporation has a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the corporation in the United States (or any U.S. possession) are granted stock options, or RSUs , with the same rights and privileges to receive qualified stock ("80-percent requirement") (Code Sec. 83(i)(2)(C), as added by the 2017 Tax Cuts Act).

COMMENT

Under a transition rule, until the Treasury issues regulations or other implementing guidance, a corporation will be treated as being in compliance with the 80-percent requirement if it complies with a reasonable good faith interpretation of the requirement (Act Sec. 13603(g) of the 2017 Tax Cuts Act).

In general, the determination of rights and privileges with respect to stock is determined in a manner similar to that under the employee stock purchase plan rules at Code Sec. 423(b)(5). Employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, provided that the number of shares available to each employee is more than a *de minimis* amount. Further, rights and privileges with respect to the exercise of an option cannot be treated as the same as rights and privileges with respect to the settlement of an RSU (Code Sec. 83(i)(2)(C)(ii), as added by the 2017 Tax Cuts Act). The requirement that 80 percent of all applicable employees be granted stock options or RSUs with the same rights and privileges cannot be satisfied in a tax year by granting a combination of stock options and RSUs, and instead all such employees must either be granted stock options or be granted restricted stock units for that year (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466), p. 357).

All persons treated as a single employer under the controlled group rules are treated as one corporation (Code Sec. 83(i)(5), as added by the 2017 Tax Cuts Act).

Qualified employees and excluded employees. A qualified employee is an individual who is not an "excluded employee," and who agrees, in the inclusion deferral election, to meet the requirements the IRS deems necessary to ensure that the employer corporation's income tax withholding requirements regarding the qualified stock are met (Code Sec. 83(i)(3)(A), as added by the 2017 Tax Cuts Act).

The deferral election is not available to "excluded employees" of the employer corporation. This is any employee:

1) who is a one-percent owner of the corporation at any time during the calendar year, or was at any time during the 10 preceding calendar years,
2) who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation, or an individual acting in either capacity,
3) who is a family member of an individual described in (1) or (2), or
4) who has been one of the four highest compensated officers of the corporation for the tax year or for any of the 10 preceding tax years (Code Sec. 83(i)(3)(B), as added by the 2017 Tax Cuts Act).

Notice, withholding, and reporting requirements. An election to defer income inclusion with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is

substantially vested or is transferable, whichever occurs earlier (Code Sec. 83(i)(4), as added by the 2017 Tax Cuts Act).

Employers are required to provide notice to their employees that they are eligible for this election at the time (or a reasonable period before) the employee's right to the qualified stock is substantially vested (and income attributable to the stock would first be includible absent an inclusion deferral election) (Code Sec. 83(i)(6), as added by the 2017 Tax Cuts Act). The notice to the employee must:

1) certify that the stock is qualified stock;
2) notify the employee that he or she may be eligible to elect to defer income inclusion with respect to the stock; and
3) notify the employee that, if he or she makes the election, the amount of income required to be included at the end of the deferral period will be—
    a) based on the value of the stock at the time the employee's right to the stock first becomes substantially vested, notwithstanding that the stock's value may have declined during the deferral period (and even if the stock's value has declined below the employee's tax liability with respect to such stock); and
    b) subject to withholding as provided under the provision, as well as of the employee's required withholding responsibilities.

After December 31, 2017, failure on the part of the employer to provide this notice can result in a fine of $100 for each failure, not to exceed $50,000 (Code Sec. 6652(p), as added by the 2017 Tax Cuts Act).

COMMENT

Under a transition rule, until the Treasury issues regulations or other implementing guidance, a corporation will be treated as being in compliance with the employee notice requirement under Code Sec. 83(i)(6) if it complies with a reasonable good faith interpretation of the requirement (Act Sec. 13603(g) of the 2017 Tax Cuts Act).

For withholding purposes, qualified stock with respect to which an Code Sec. 83(i) election is made, will be treated as wages received on the earliest date possible under Code Sec. 83(i)(1)(B) and in the amount included as income (Code Sec. 3401(i), as added by the 2017 Tax Cuts Act). For the tax year for which income subject to an inclusion deferral election is required to be included in income by the employee (as described above), the amount required to be included in income is treated as wages with respect to which the employer is required to withhold income tax at a rate not less than the highest income tax rate applicable to individual taxpayers (Code Sec. 3402(t), as added by the 2017 Tax Cuts Act).

Effective date. Except as otherwise provided, the provision applies to stock attributable to options exercised, or restricted stock units settled, after December 31, 2017. The penalty for the failure of an employer to provide notice of tax consequences to a qualified employee applies to failures after December 31, 2017 (Act Sec. 13603(f) of the Tax Cuts and Jobs Act).

¶610 Qualified Moving Expense Reimbursement

NEW LAW EXPLAINED

Exclusion for Qualified Moving Expenses Reimbursement is Suspended.— The exclusion for qualified moving expense reimbursements is suspended for tax years 2018 through 2025 (Code Sec. 132(g), as amended by the Tax Cuts and Jobs Act). However, members of the United States Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station will still be permitted to exclude qualified moving expense reimbursements from their income (Code Sec. 132(g)(2), as amended by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section shall apply to tax years beginning after December 31, 2017 (Act Sec. 11048(b) of the Tax Cuts and Jobs Act).

¶615 Qualified Bicycle Commuting Reimbursements

NEW LAW EXPLAINED

Exclusion for qualified bicycle commuting reimbursement suspended.— The exclusion from gross income and wages for qualified bicycle commuting reimbursements is repealed for tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 132(f)(8), as added by the Tax Cuts and Jobs Act)).

Effective date. The amendment shall apply to tax years beginning after December 31, 2017 (Act Sec. 11047(b)) of the Tax Cuts and Jobs Act).

RETIREMENT PLANS AND BENEFITS

¶620 Recharacterization of IRA Contributions

NEW LAW EXPLAINED

Recharacterization of Roth IRA contversions are no longer permitted.— For tax years beginning after December 31, 2017, the special rule that allows a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA. Thus, recharacterization cannot be used to unwind a Roth IRA conversion (Code Sec. 408A(d)(6)(B)(iii), amended by the Tax Cut and Jobs Act).

COMMENT

Earlier versions of the Tax Cut and Jobs Act enacted by both the House and Senate eliminated recharacterization entirely. The provision was narrowed considerably in the reconciled version to target only conversions to Roth IRAs. So, for example, an individual may still make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA. In addition, an individual may still make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, but the individual is precluded from later unwinding the conversion through a recharacterization.

COMMENT

The strategy behind recharacterizing a conversion hinged on changes in the market price of the IRA assets during the course of the year. The owner pays tax in a conversion based on the value of the assets on the conversion date, so the tax liability is locked in on that date. If the value of the assets goes up significantly, the conversion looks like a shrewd move because the tax bill would have been higher if the taxpayer had waited. If instead the value goes down (e.g., through a market correction or recession), the conversion looks like a foolish mistake because the tax bill is much higher than if the owner had waited until the asset prices fell. The option to recharacterize reduced the risk.

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 13611(b) of the Tax Cuts and Jobs Act).

¶625 Rollovers of Plan Loan Offset Amounts

NEW LAW EXPLAINED

Employees whose plans terminate or who are severed from employment have extra time to roll over plan loan offsets.— An employee can exclude from income a transfer of a qualified plan loan offset amount as long as it is made by the due date (including extensions) for filing the return of tax for the tax year in which the amount is treated as distributed from a qualified employer plan (Code Sec. 402(c)(3)(C)(i), added by the Tax Cut and Jobs Act). A qualified plan loan offset amount is a plan loan offset amount that is distributed solely by reason of:

- the termination of the qualified employer plan, or
- a severance from employment (Code Sec. 402(c)(3)(C)(ii), added by the 2017 Tax Cuts Act).

A 'plan loan offset amount' is the amount by which the participant's accrued benefit under the plan is reduced in order to repay a loan from the plan (Code Sec. 402(c)(3)(C)(iii), added by the 2017 Tax Cuts Act).

This treatment of plan loan offset amounts is available only if the loan qualifies under Code Sec. 72(p)(2) (Code Sec. 401(c)(3)(C)(iv), added by the 2017 Tax Cuts Act), and only if the plan qualifies as a qualified employer plan under Code Sec. 72(p)(4) (Code Sec. 401(c)(3)(C)(v), added by the 2017 Tax Cuts Act).

Effective date. This provision applies to plan loan offset amounts that are treated as distributed in tax years beginning after December 31, 2017 (Act Sec. 13613(c) of the Tax Cut and Jobs Act).

¶630 Qualified 2016 Disaster Distributions from Retirement Plans

NEW LAW EXPLAINED

Qualified 2016 disaster distributions provide relief.— Congress has provided relief for victims in the 2016 disasters area. The 10 percent additional tax under Code Sec. 72(t) is waived for any qualified 2016 disaster distribution. Eligible individuals who take such distributions can spread their taxable income over three years, and have three years to repay the amount. A 2016 disaster area includes any area with respect to which a major disaster has been declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act during calendar year 2016 (Act Sec. 11028(a) of the Tax Cuts and Jobs Act).

The 10 percent additional tax under Code Sec. 72(t) is waived for any qualified 2016 disaster distribution (Act Sec. 11028(b)(1)(A) of the 2017 Tax Cuts Act). The aggregate dollar amount is limited to the excess (if any) of—

- $100,000, over
- The aggregate amounts treated as qualified 2016 disaster distributions received by such individual for all prior tax years (Act Sec. 11028(b)(1)(B)(i) of the 2017 Tax Cuts Act).

If an individual's total distributions from all plans exceed this amount, a plan will not lose its tax exempt status merely because it treats such distribution as a qualified 2016 disaster distribution, provided that the aggregate amount of such distributions from all plans maintained by the employer (and any member of any controlled group which includes the employer) do not exceed the $100,000 limit (Act Sec. 11028(b)(1)(B)(ii) of the 2017 Tax Cuts Act). A controlled group for these purposes means any group treated as a single employer under Code Sec. 414(b), (c), (m), or (o) (Act Sec. 11028(b)(1)(B)(iii) of the 2017 Tax Cuts Act).

A qualified 2016 disaster distribution is any distribution from an eligible retirement plan made on or after January 1, 2016, and before January 1, 2018, to an individual whose principal place of abode at any time during calendar year 2016 was located in a 2016 disaster area and who has sustained an economic loss by reason of the events giving rise to the Presidential declaration which was applicable to such area (Act Sec. 11028(b)(1)(D)(i) of the 2017 Tax Cuts Act). Eligible retirement plans include Individual retirement accounts (Code Sec. 408(a)) or annuities (Code Sec. 408(b)), qualified plans (Code Sec. 401), annuity plans (Code Sec. 403(a)), eligible deferred compensation Code Sec. 457(b) plans, and an tax sheltered annuity plans (Code Sec. 403(b)) (Act Sec. 11028(b)(1)(D)(ii) of the 2017 Tax Cuts Act).

Qualified 2016 disaster distributions are exempt from trustee to trustee transfer and withholding rules (Code Sec. 401(a)(31), 402(f) and 3405) (Act Sec. 11028(b)(1)(F)(i) of the 2017 Tax Cuts Act), and they are treated as meeting plan distribution requirements of Code Sec. 401(k)(2)(B)(i), Code Sec. 403(b)(7)(A)(ii), Code Sec. 403(b)(11), and Code Sec. 457(d)(1)(A) (Act Sec. 11028(b)(1)(F)(ii) of the 2017 Tax Cuts Act).

The amount distributed may be repaid over three years. Any individual who receives a qualified 2016 disaster distribution may, at any time during the three-year period beginning on the day after the date on which such distribution was received, make one or more contributions in an aggregate amount not to exceed the amount of such distribution to an eligible retirement plan of which such individual is a beneficiary and to which a rollover contribution of such distribution could be made under Code Sec. 402(c), Code Sec. 403(a)(4), Code Sec. 403(b)(8), Code Sec. 408(d)(3), or Code Sec. 457(e)(16), as the case may be (Act Sec. 11028(b)(1)(C)(i) of the 2017 Tax Cuts Act).

Repayments are treated as rollover contributions. If a contribution is made with respect to a qualified 2016 disaster distribution from an eligible retirement plan other than an individual retirement plan, then the taxpayer will, to the extent of the amount of the contribution, be treated as having received the qualified 2016 disaster distribution in an eligible rollover distribution (Code Sec. 402(c)(4)), and as having transferred the amount to the eligible retirement plan in a direct trustee to trustee transfer within 60 days of the distribution (Act Sec. 11028(b)(1)(C)(ii) of the 2017 Tax Cuts Act). If a contribution is made with

respect to a qualified 2016 disaster distribution from an individual retirement plan (Code Sec. 7701(a)(37)), then to the extent of the amount of the contribution, the qualified 2016 disaster distribution is treated as a rollover contribution under Code Sec. 408(d)(3), and as having been transferred to the eligible retirement plan in a direct trustee to trustee transfer within 60 days of the distribution (Act Sec. 11028(b)(1)(C)(iii) of the 2017 Tax Cuts Act).

Plan amendment relief is to be provided (Act Sec. 11028(b)(2)(B)(ii) of the 2017 Tax Cuts Act).

Effective date. No specific effective date is provided by the Act. The provision is, therefore, considered effective on December 22, 2017, the date of enactment.

¶635 Length of Service Award Exclusion for Bona Fide Public Safety Volunteers

NEW LAW EXPLAINED

$3,000 accrued benefit limit for bona fide public safety volunteers is increased to $6,000.—The maximum deferral amount is increased from $3,000 to $6,000, with inflation adjustments for years beginning after December 31, 2017 (Code Sec. 457(e)(11)(B), amended by the Tax Cut and Jobs Act).

In the case of a defined benefits plan paying solely length of service awards to bona fide volunteers on account of qualified services performed by such volunteers, the $6,000 limitation applies to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service. The actuarial present value with respect to any year shall be calculated using reasonable actuarial assumptions and methods, assuming payment will be made under the most valuable form of payment under the plan with payment commencing at the later of the earliest age at which unreduced benefits are payable under the plan or the participant's age at the time of the calculation (Code Sec. 457(e)(11)(B)(iv), as amended by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 13612(d) of the Tax Cut and Jobs Act).

EDUCATION AND DISABILITY BENEFITS

¶640 Distributions from Qualified Tuition Programs

NEW LAW EXPLAINED

Distributions from qualified tuition programs allowed for elementary and secondary tuition.— Qualified tuition plans are modified to allow for distributions to be made for elementary and secondary tuition. The reference to qualified higher education expenses is expanded to include tuition in connection with attendance or enrollment at an elementary or secondary school (Code Sec. 529(c)(7), as added by the Tax Cuts and Jobs Act). Distributions for elementary or secondary tuition are limited to no more than $10,000 incurred during the tax year in connection with the enrollment or attendance of the designated beneficiary (Code Sec. 529(e)(3)(A), as added by the 2017 Tax Cuts Act). The limitation applies on a per-student, not per-account basis. As a result, if an individual is a designated beneficiary of multiple accounts, a maximum of $10,000 in distributions will be free of income tax, regardless of whether the funds are distributed from multiple accounts. Any distribution in excess of $10,000 would be subject to tax under the rules of Code Sec. 529 (Conference Report on H.R. 1, the Tax Cuts and Jobs Act (H.R. Rept. 115-466)).

Effective date. The amendments made by this provision shall apply to distributions made after December 31, 2017 (Act Sec. 11024(b) of the Tax Cuts and Jobs Act).

¶645 Contributions and Rollovers to ABLE Accounts

NEW LAW EXPLAINED

Contribution amount to ABLE accounts increased and rollovers from qualified tuition plans allowed.—An increase to the contribution limitation to ABLE accounts is permitted in certain circumstances. The general contribution limit of an amount equal to the inflation-adjusted annual gift tax exclusion amount remains ($15,000 in 2018). However, the limitation is increased with regard to contributions made by the designated beneficiary before January 1, 2026 (Code Sec. 529A(b)(2)(B), as amended by the Tax Cuts and Jobs Act). The additional contribution amount that is allowed after the overall limitation on contributions is reached is the lesser of (1) the designated beneficiary's compensation for the tax year, or (2) the federal poverty line for a one-person household (Code Sec. 529A(b)(2)(B)(ii), as amended by the 2017 Tax Cuts Act). The designated beneficiary, or a person acting on behalf of the designated beneficiary, is required to keep adequate records for purposes of ensuring, and is responsible for ensuring, that the additional contribution amount is the appropriate amount as set forth in Code Sec. 529A(b)(2)(B)(ii) (Code Sec. 529A(b)(2), as amended by the 2017 Tax Cuts Act).

For purposes of the increased contribution amount, the "designated beneficiary" is an employee (including a self-employed individual or owner-employee), for whom no contribution was made for the tax year to: (1) a qualified trust or annuity defined contribution plan (including a 401(k) plan); (2) a 403(b) tax sheltered annuity plan; and (3) an eligible 457(b) deferred compensation plan (Code Sec. 529A(b)(7)(A), as added by the 2017 Tax Cuts Act). In addition, "poverty line" has the same meaning that is given to the term by section 673 of the Community Services Block Grant Act (P.L. 105-285) (Code Sec. 529A(b)(7)(B), as added by the 2017 Tax Cuts Act). Furthermore, the saver's credit can be claimed by a designated beneficiary of an ABLE account for contributions made to the designated beneficiary's ABLE account before January 1, 2026 (Code Sec. 25B(d)(1)(D), as added by the 2017 Tax Cuts Act).

> **COMMENT**
>
> Poverty line is defined in section 673 of the Community Services Block Grant Act as the official poverty line set forth by the Office of Management and Budget based on the most recent census data. Annual adjustments are made to the poverty line multiplying the official poverty line by the percentage change in the Consumer Price Index for All Urban Consumers.

Amounts from qualified tuition plans (also known as section 529 accounts) can be rolled over to an ABLE account without penalty if the ABLE account is owned by the designated beneficiary of that 529 account or a member of the designated beneficiary's family before January 1, 2026 (Code Sec. 529(c)(3)(C)(i)(III), as added by the 2017 Tax Cuts Act). Any rolled-over amounts count towards the overall limitation on amounts that can be contributed to an ABLE account within a tax year (flush language of Code Sec. 529(c)(3)(C)(i)(III), as added by the 2017 Tax Cuts Act). As provided in Code Sec. 529(c)(3)(A), an amount rolled over that is in excess of the limitation will be included in the beneficiary's gross income under the annuity rules of Code Sec. 72, unless excludable under another Code section.

Effective date. The amendments made by these sections shall apply to tax years beginning after December 22, 2017, the date of enactment of this Act (Act Secs. 11024(c) and 11025(b) of the Tax Cuts and Jobs Act).

CHAPTER 7. INTERNATIONAL TAX PROVISIONS

TAXATION OF FOREIGN INCOME

¶705 Participation Exemption Deduction for Foreign-Source Portion of Dividends

NEW LAW EXPLAINED

100-percent participation exemption deduction allowed for foreign-source portion of dividends.— A 100-percent deduction is allowed for the foreign-source portion of dividends received from a specified 10-percent owned foreign corporation by a domestic corporation that is a U.S. shareholder of the foreign corporation (a participation dividends-received deduction (DRD)) (Code Sec. 245A(a), as added by the Tax Cuts and Jobs Act).

COMMENT

The new law generally establishes a participation exemption (territorial) system for the taxation of foreign income that replaces the prior-law system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when the earnings are distributed. The exemption, which is provided in the form of a participation DRD, is intended to encourage U.S. companies to repatriate their accumulated foreign earnings and invest them in the United States.

CAUTION

Dividends from foreign companies that are less than 10 percent owned by domestic corporations are not eligible for the participation DRD and will continue to be treated the same as under prior law (i.e., such dividends generally will be taxed when distributed, subject to any applicable anti-deferral rules). Also, dividends received by non-corporate U.S. shareholders are not eligible for the participation DRD.

COMMENT

According to the Conference Committee Report, it is intended that the term “dividend received” be interpreted broadly, consistently with the meaning of “amount received as dividends” and “dividends received” used in Code Sec. 243 and 245, respectively. Thus, for example, gain included in gross income as a dividend under Code Sec. 1248(a) or 964(e) would constitute a dividend for which the participation DRD may be available. Regulations or other guidance issued pursuant to the regulatory authority granted under Code Sec. 245A(g) (discussed below) may clarify the intended broad scope of the term "dividend received." For example, if a domestic corporation indirectly owns stock of a foreign corporation through a partnership and the domestic corporation would qualify for the participation DRD with respect to dividends from the foreign corporation if the domestic corporation owned the stock directly, the domestic corporation would be allowed a participation DRD with respect to its distributive share of the partnership’s dividend from the foreign corporation (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

A specified 10-percent owned foreign corporation is any foreign corporation (other than a PFIC that is not also a CFC) with respect to which any domestic corporation is a U.S. shareholder (Code Sec. 245A(b), as added by the 2017 Tax Cuts Act).

COMMENT

The subpart F definitions of a U.S. shareholder and CFC are expanded so that they are used for purposes of Title 26 (including the participation DRD), and not just the subpart F provisions (Code Secs. 951(b) and 957(a), as amended by the 2017 Tax Cuts Act). The

U.S. shareholder definition is further expanded so that a U.S. shareholder includes a U.S. person that owns at least 10 percent of the total combined voting power of all classes of stock entitled to vote or at least 10 percent of the total value of all classes of stock of the foreign corporation (Act Sec. 14214(a) of the 2017 Tax Cuts Act, amending Code Sec. 951(b); see ¶745).

COMMENT

Taxation of income earned by PFICs remains subject to the anti-deferral PFIC regime and dividends received from non-CFC PFICs are ineligible for the participation DRD.

COMMENT

A domestic corporation includes a CFC treated as a domestic corporation for purposes of computing its taxable income (Reg. §1.952-2(b)(1)). Therefore, a CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes subpart F income may be eligible for the DRD with respect to that income. In addition, the participation DRD is available only to C corporations that are not RICs or REITs (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Foreign-source portion of a dividend. The foreign-source portion of any dividend from a specified 10-percent owned foreign corporation is the amount that bears the same ratio to the dividend as (1) the undistributed foreign earnings of the specified 10-percent owned foreign corporation, bears to (2) the total undistributed earnings of that corporation (Code Sec. 245A(c)(1), as added by the 2017 Tax Cuts Act).

Undistributed earnings are the earnings and profits of a specified 10-percent owned foreign corporation (computed in accordance with Code Secs. 964(a) and 986) as of the close of the tax year of the specified 10-percent owned foreign corporation in which the dividend is distributed that are not reduced by dividends distributed during that tax year (Code Sec. 245A(c)(2), as added by the 2017 Tax Cuts Act).

COMMENT

Under Code Sec. 959(d), a distribution of previously taxed income does not constitute a dividend, even if it reduces earnings and profits.

Undistributed foreign earnings of a specified 10-percent owned foreign corporation are the portion of the undistributed earnings of that corporation that is not attributable to (1) the corporation's income that is effectively connected with the conduct of a trade or business within the United States, and subject to tax under Chapter 1 of the Code, or (2) any dividend received (directly or through a wholly owned foreign corporation) from an 80-percent owned (by vote or value) domestic corporation (Code Sec. 245A(c)(3), as added by the 2017 Tax Cuts Act).

Foreign tax credit disallowance. No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a dividend that qualifies for the participation DRD (Code Sec. 245A(d), as added by the 2017 Tax Cuts Act).

For purposes of computing the Code Sec. 904(a) foreign tax credit limitation, a domestic corporation that is a U.S. shareholder of a specified 10-percent owned foreign corporation must compute its foreign-source taxable income by disregarding (1) the foreign-source portion of any dividend received from that foreign corporation for which a participation DRD is allowed, and (2) any deductions properly allocable or apportioned to that foreign source portion or the stock with respect to which it is paid. For this purpose, any term that is used in this rule and in Code Sec. 245A has the meaning used in Code Sec. 245A (Code Sec. 904(b)(5), as added by the 2017 Tax Cuts Act).

Hybrid dividends. The participation DRD is not available for any dividend received by a U.S. shareholder from a CFC if the dividend is a hybrid dividend (Code Sec. 245A(e)(1), as added by the 2017 Tax Cuts Act).

A hybrid dividend is an amount received from a CFC for which a participation DRD would otherwise be allowed and for which the CFC received a deduction (or other tax benefit) with respect to any income, war

profits, or excess profits taxes imposed by any foreign country or U.S. possession (Code Sec. 245A(e)(4), as added by the 2017 Tax Cuts Act).

If a CFC with respect to which a domestic corporation is a U.S. shareholder receives a hybrid dividend from any other CFC with respect to which the domestic corporation is also a U.S. shareholder, then:

1) the hybrid dividend is treated as subpart F income of the recipient CFC for the tax year of the CFC in which the dividend was received, and
2) the U.S. shareholder must include an amount equal to the shareholder's pro rata share of such subpart F income in gross income (Code Sec. 245A(e)(2), as added by the 2017 Tax Cuts Act).

No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any hybrid dividend received by a U.S. shareholder or included in the U.S. shareholder's income under the rules, discussed above (Code Sec. 245A(e)(3), as added by the 2017 Tax Cuts Act).

Special rule for purging distributions of PFICs. Any amount that is treated as a dividend pursuant to the deemed dividend election under Code Sec. 1291(d)(2)(B) is not treated as a dividend for purposes of the participation DRD (Code Sec. 245A(f), as added by the 2017 Tax Cuts Act).

Regulatory authority. The Secretary of the Treasury is authorized to issue regulations or other guidance that is necessary or appropriate to carry out these provisions, including regulations for the treatment of U.S. shareholders owning stock of a specified 10-percent owned foreign corporation through a partnership (Code Sec. 245A(g), as added by the 2017 Tax Cuts Act).

One-year holding period requirement. A domestic corporation is not permitted a participation DRD for any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend (Code Sec. 246(c)(5)(A), as added by the 2017 Tax Cuts Act).

COMMENT

The special holding period rule for preference dividends in Code Sec. 246(c)(2) does not apply in this case.

The holding period requirement is treated as met only if the foreign corporation is a specified 10-percent owned foreign corporation and the taxpayer is a U.S. shareholder with respect to that specified 10-percent owned foreign corporation at *all* times during the required period (Code Sec. 246(c)(5)(B), as added by the 2017 Tax Cuts Act).

COMMENT

Under Code Sec. 246, the participation DRD is not permitted for any dividend on any share of stock to the extent the domestic corporation that owns the share is under an obligation (under a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property. In addition, the required holding periods must be reduced for any period during which the domestic corporation has diminished its risk of loss in respect of stock on which a dividend is paid.

Application of other rules. The participation DRD does not apply to dividends received from Code Sec. 501 tax-exempt organizations and farmers' cooperative associations exempt from tax under Code Sec. 521 (Code Sec. 246(a)(1), as amended by the 2017 Tax Cuts Act).

In addition, the participation DRD reduces the amount of the dividend includible in gross income for purposes of computing the nontaxed portion of an extraordinary dividend (Code Sec. 1059(b)(2)(B), as amended by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section apply to distributions made (and for purposes of determining a taxpayer's foreign tax credit limitation under Code Sec. 904, deductions with respect to tax years ending) after December 31, 2017 (Act Sec. 14101(f) of the Tax Cuts and Jobs Act).

¶707 Sales or Transfers Involving Specified 10-Percent Owned Foreign Corporations

NEW LAW EXPLAINED

Special rules provided for sales or transfers involving specified 10-percent owned foreign corporations.— Sale of stock by U.S. persons. If a domestic corporation sells or exchanges stock in a foreign corporation held for one year or more, any amount received by the domestic corporation that is treated as a dividend under Code Sec. 1248 is treated as a dividend for purposes of the 100-percent participation exemption deduction for the foreign-source portion of dividends under new Code Sec. 245A (the participation dividends-received deduction (DRD)) (Code Sec. 1248(j), as added by the Tax Cuts and Jobs Act).

COMMENT

This rule allows gain on the disposition of the foreign corporation stock to be reduced or eliminated as a result of the recharacterization of the gain as a dividend for which a 100-percent participation DRD is allowed.

COMMENT

The new law generally establishes a participation exemption (territorial) system for the taxation of foreign income that replaces the prior-law system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when the earnings are distributed. The exemption, which is provided in the form of a participation DRD, is intended to encourage U.S. companies to repatriate their accumulated foreign earnings and invest them in the United States. See ¶705 for a discussion of the participation DRD.

Reduction in the basis of certain foreign stock. If a domestic corporation receives a dividend from a specified 10-percent owned foreign corporation in any tax year, solely for the purpose of determining a loss on the disposition of the stock of that foreign corporation in that tax year or any subsequent tax year, the domestic corporation's basis in that stock is reduced (but not below zero) by the amount of the participation DRD allowable to the domestic corporation with respect to that stock. The basis in the specified 10-percent owned foreign corporation stock is not reduced under this rule to the extent the basis was reduced under Code Sec. 1059 by reason of a dividend for which the participation DRD was allowable (Code Sec. 961(d), as added by the 2017 Tax Cuts Act).

COMPLIANCE TIP

Thus, the reduction in basis is for the portion of the dividend received from the foreign corporation that was exempt from tax by reason of the participation DRD in any tax year of the domestic corporation.

COMMENT

The reduction in basis addresses the concern that taxpayers may obtain inappropriate double benefit that would otherwise be created as a result of the participation DRD. In particular, a distribution from a foreign corporation that is eligible for a participation DRD would reduce the value of the foreign corporation, thus reducing any built-in gain or increasing any built-in loss in the shareholder’s stock of the foreign corporation. While reducing gain in this way is consistent with the application of Code Sec. 1248 to recharacterize such gain as a dividend for which a participation DRD is allowed (see above), increasing any loss in the stock will create an inappropriate double U.S. tax benefit - first, a tax-free distribution from the foreign corporation and second, a tax loss on the disposition of the foreign corporation’s stock.

A specified 10-percent owned foreign corporation is any foreign corporation (other than a passive foreign investment company (PFIC) that is not also a CFC) with respect to which any domestic corporation is a U.S. shareholder (Code Sec. 245A(b), as added by the 2017 Tax Cuts Act; see ¶705).

COMMENT

The subpart F definitions of a U.S. shareholder and CFC are expanded so that they are used for purposes of Title 26 (including the participation DRD), and not just the subpart F provisions (Act Sec. 14101(e)(1) and (2) of the 2017 Tax Cuts Act, amending Code Secs. 951(b) and 957(a), respectively; see ¶705). The U.S. shareholder definition is further expanded so that a U.S. shareholder includes a U.S. person that owns at least 10 percent of the total combined voting power of all classes of stock entitled to vote or at least 10 percent of the total value of all classes of stock of the foreign corporation (Act Sec. 14214(a) of the 2017 Tax Cuts Act, amending Code Sec. 951(b); see ¶745).

Sale by a CFC of a lower-tier CFC. If for any tax year of a CFC beginning after December 31, 2017, an amount is treated as a dividend under Code Sec. 964(e)(1) because of a sale or exchange by the CFC of stock in another foreign corporation held for one year or more, then:

1) the foreign-source portion of the dividend is treated as subpart F income of the selling CFC for that tax year for purposes of the subpart F income inclusion rules;
2) a U.S. shareholder with respect to the selling CFC includes in income for the tax year of the shareholder with or within which the tax year of the CFC ends, an amount equal to the shareholder's pro rata share of the amount treated as subpart F income under item (1), above; and
3) a participation DRD is allowable to the U.S. shareholder with respect to the included subpart F income under item (2), above, in the same manner as if the subpart F income were a dividend received by the shareholder from the selling CFC (Code Sec. 964(e)(4)(A), as added by the 2017 Tax Cuts Act).

PRACTICE NOTE

The foreign-source portion of any amount treated as a dividend under this rule is determined in the same manner as the foreign-source portion of a dividend eligible for the participation DRD (see ¶705) (Code Sec. 964(e)(4)(C), as added by the 2017 Tax Cuts Act).

If a CFC sells or exchanges stock in another foreign corporation in a tax year of the selling CFC beginning after December 31, 2017, stock basis adjustment rules similar to the rules of Code Sec. 961(d) apply (Code Sec. 964(e)(4)(B), as added by the 2017 Tax Cuts Act).

Treatment of foreign branch losses transferred to specified 10-percent owned foreign corporations. If a domestic corporation transfers substantially all of the assets of a foreign branch (within the meaning of Code Sec. 367(a)(3)(C), as in effect before December 22, 2017, the date of the enactment of the 2017 Tax Cuts Act) to a specified 10-percent owned foreign corporation with respect to which it is a U.S. shareholder after the transfer, the domestic corporation includes in income, for the tax year of the transfer, an amount equal to the transferred loss amount, subject to certain limitations (Code Sec. 91(a), as added by the 2017 Tax Cuts Act).

The transferred loss amount, with respect to any transfer of substantially all of the assets of a foreign branch, is the excess (if any) of:

1) the losses incurred by the foreign branch after December 31, 2017, and before the transfer, for which a deduction was allowed to the domestic corporation, over

2) the sum of (i) any taxable income earned by the foreign branch in tax years after the tax year in which the loss is incurred and through the close of the tax year of the transfer, and (ii) gain recognized by reason of a Code Sec. 904(f)(3) overall foreign loss recapture arising out of disposition of assets on account of the underlying transfer (Code Sec. 91(b), as added by the 2017 Tax Cuts Act).

COMMENT

According to the Conference Committee Report, this loss recapture rule addresses the concern that taxpayers may wish to arbitrarily apply the participation exemption system to foreign subsidiaries but not foreign branches. Specifically, a taxpayer may deduct losses from a foreign branch operation against U.S. taxable income and then incorporate that branch once it becomes profitable. Even though there are other loss recapture rules, such as Code Sec. 367(a)(3)(C), these rules generally rely on the worldwide system of taxation to recapture losses in excess of built-in gains by taxing future earnings when the earnings are repatriated to the United States. Instead of only recapturing such losses upon later repatriation of earnings, the new law intends to recapture the U.S. tax benefits of these losses immediately upon the incorporation of a foreign branch that has generated losses. This way, the repatriation of foreign earnings will not carry negative tax consequences, thus discouraging repatriation, which is one of the reasons to transition to a participation exemption system of taxation (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

The transferred loss amount is reduced (but not below zero) by the amount of gain recognized by the taxpayer (other than gain recognized by reason of an overall foreign loss recapture) on account of the transfer (Code Sec. 91(c), as added by the 2017 Tax Cuts Act).

Amounts included in gross income under the above foreign branch loss recapture rules are treated as derived from sources within the United States (Code Sec. 91(d), as added by the 2017 Tax Cuts Act).

Consistent with regulations or other guidance as the Secretary of the Treasury may prescribe, proper adjustments are made in the adjusted basis of the taxpayer's stock in the specified 10-percent owned foreign corporation to which the transfer is made, and in the transferee's adjusted basis in the property transferred, to reflect amounts included in gross income under the foreign branch loss recapture rules, discussed above (Code Sec. 91(e), as added by the 2017 Tax Cuts Act).

Under a transition rule, the amount of gain taken into account under Code Sec. 91(c) is reduced by the amount of gain that would be recognized under Code Sec. 367(a)(3)(C) (determined without regard to the repeal of the Code Sec. 367(a)(3) active trade or business requirement by the 2017 Tax Cuts Act, discussed below) with respect to losses incurred before January 1, 2018 (Act Sec. 14102(d)(4) of the 2017 Tax Cuts Act).

Repeal of the active trade or business exception under Code Sec. 367. The active trade or business exception to the Code Sec. 367(a) rule requiring recognition of gain on the outbound transfer of property by a U.S. transferor to a foreign corporation is repealed (Act Sec. 14102(e)(1) of the 2017 Tax Cuts Act, striking Code Sec. 367(a)(3)).

COMMENT

As a result of the repeal, transfers of property used in the active conduct of a trade or business from a U.S. corporation to a foreign corporation in an otherwise tax-free transaction will be treated as taxable exchanges since the foreign corporation will not be considered a corporation.

Effective date. The amendments made by this section relating to sales or exchanges of foreign corporation stock by a domestic corporation and sales or exchanges of a lower-tier CFC stock by a CFC apply to sales or exchanges after December 31, 2017 (Act Secs. 14102(a)(2) and (c)(2) of Tax Cuts and Jobs Act). The amendment relating to the reduction of basis in stock of a specified 10-percent owned foreign corporation for purposes of determining loss applies to distributions made after December 31,

2017 (Act Sec. 14102(b)(2) of the 2017 Tax Cuts Act). The amendments relating to the transfer of loss amounts from foreign branches to certain foreign corporations and to the repeal of the active trade or business exception under Code Sec. 367 apply to transfers after December 31, 2017 (Act Secs. 14102(d)(3) and (e)(3) of the 2017 Tax Cuts Act). No specific effective dates are provided for the other provisions; therefore, such provisions are considered effective on December 22, 2017, the date of enactment.

¶710 Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation

NEW LAW EXPLAINED

Transition tax imposed on accumulated foreign earnings upon transition to participation exemption system.— A transition tax is imposed on accumulated post-1986 foreign earnings determined as of a certain measurement date, without requiring an actual distribution, upon the transition to the new participation exemption system. The transition rule requires mandatory inclusion of such deferred foreign income as subpart F income by U.S. shareholders of deferred foreign income corporations. The included amount is taxed at a reduced rate that depends on whether the deferred earnings are held in cash or other assets (Code Sec. 965, as amended by the Tax Cuts and Jobs Act).

COMMENT

In transitioning to the new participation exemption (territorial) system of taxation, many U.S. corporations with undistributed accumulated foreign earnings will be eligible for the 100-percent participation exemption deduction for foreign-source dividends under new Code Sec. 245A (a participation dividends-received deduction (DRD)). To avoid a potential windfall for such corporations, and to ensure that all distributions from foreign corporations are treated in the same manner under the participation exemption system, a transition rule is provided under which accumulated foreign earnings are taxed as if they had been distributed under prior law, but at a reduced rate of tax. Generally, the new participation exemption system for taxation of foreign income replaces the prior-law system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when the earnings are distributed. The exemption is provided in the form of a participation DRD, which is intended to encourage U.S. companies to repatriate their accumulated foreign earnings and invest them in the United States. See ¶705 for a discussion of the participation DRD.

Subpart F income inclusion of deferred foreign income. As mentioned above, the mechanism for the mandatory inclusion of accumulated foreign earnings is subpart F. In particular, for the last tax year beginning before January 1, 2018, the subpart F income of a deferred foreign income corporation (as otherwise determined for that tax year under Code Sec. 952) is increased by the greater of (i) the accumulated post-1986 deferred foreign income of the corporation determined as of November 2, 2017, or (ii) the accumulated post-1986 deferred foreign income of the corporation determined as of December 31, 2017 (Code Sec. 965(a), as amended by the 2017 Tax Cuts Act).

COMMENT

Foreign corporations no longer in existence and for which there is no tax year beginning or ending in 2017 are not within the scope of this transition rule.

For this purpose, a deferred foreign income corporation with respect to any U.S. shareholder is any specified foreign corporation of the U.S. shareholder that has accumulated post-1986 deferred foreign

income as of November 2, 2017, or December 31, 2017, greater than zero (Code Sec. 965(d)(1), as amended by the 2017 Tax Cuts Act).

A specified foreign corporation is (1) a CFC, or (2) any foreign corporation in which a domestic corporation is a U.S. shareholder, other than a PFIC that is not a CFC. For purposes of the Code Sec. 951 subpart F inclusion rules and the Code Sec. 961 rules requiring adjustments to the basis of the CFC stock, a foreign corporation described in item (2), above, is treated as a CFC solely for purposes of taking into account the subpart F income of the corporation under the transition rule and determining the U.S. shareholder pro rata share of that income (Code Sec. 965(e), as amended by the 2017 Tax Cuts Act).

COMMENT

A non-CFC foreign corporation must have at least one U.S. shareholder that is a domestic corporation in order for the foreign corporation to be a specified foreign corporation. In addition, unlike the participation DRD that is available only to domestic corporations that are U.S. shareholders under subpart F, the transition rule applies to all U.S. shareholders of a specified foreign corporation. The subpart F definitions of a U.S. shareholder and CFC are expanded so that they are used for purposes of Title 26, and not just the subpart F provisions (Act Sec. 14101(e)(1) and (2) of the 2017 Tax Cuts Act, amending Code Secs. 951(b) and 957(a); see ¶705). The U.S. shareholder definition is further expanded so that a U.S. shareholder includes a U.S. person that owns at least 10 percent of the total combined voting power of all classes of stock entitled to vote or at least 10 percent of the total value of all classes of stock of the foreign corporation (Act Sec. 14214(a) of the 2017 Tax Cuts Act, amending Code Sec. 951(b); see ¶745).

COMMENT

For purposes of taking into account its subpart F income under the transition rule, a noncontrolled 10/50 corporation is treated as a CFC (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

The accumulated post-1986 deferred foreign income includes the post-1986 earnings and profits that (i) are not attributable to income that is effectively connected with the conduct of a trade or business in the United States and subject to tax under Chapter 1 of the Code, or (ii) if distributed, in the case of a CFC, would be excluded from the gross income of a U.S. shareholder as previously taxed income under Code Sec. 959 (Code Sec. 965(d)(2), as amended by the 2017 Tax Cuts Act).

To the extent provided in regulations or other guidance, the accumulated post-1986 deferred foreign income of a CFC that has non-U.S. shareholders is appropriately reduced by amounts which would be described in item (ii), above (i.e., amounts excluded from the U.S. shareholder's income as previously taxed earnings) if such shareholders were U.S. shareholders.

Post-1986 earnings and profits include the earnings and profits of the foreign corporation accumulated in tax years beginning after December 31, 1986, and determined (i) as of November 2, 2017, or December 31, 2017, whichever measurement date applies to the foreign corporation, and (ii) without decrease for dividends distributed during the last tax year beginning before January 1, 2018, other than dividends distributed to another specified foreign corporation. Post-1986 earnings and profits are computed under the rules of Code Secs. 964(a) and 986 for determining earnings and profits of a CFC, but only taking into account periods when the foreign corporation was a specified foreign corporation (Code Sec. 965(d)(3), as amended by the 2017 Tax Cuts Act).

PRACTICE NOTE

Therefore, post-1986 earnings and profits that are subject to the transition tax do not include earnings and profits that were accumulated by a foreign corporation prior to attaining its status as a specified foreign corporation. However, post-1986 earnings and profits are taken into account even if arising from periods during which the U.S. shareholder did not own stock of the foreign corporation.

Reduction of amounts included in the U.S. shareholder's income. Consistent with the general operation of subpart F, each U.S. shareholder of a deferred foreign income corporation must include in income its pro rata share of the foreign corporation's subpart F income attributable to its accumulated post-1986 deferred foreign income. In the case where the taxpayer is a U.S. shareholder of at least one deferred foreign income corporation and at least one E&P deficit foreign corporation, the mandatory inclusion amount of the U.S. shareholder that otherwise would be taken into account as the U.S. shareholder's pro rata share of the subpart F income of each deferred foreign income corporation is reduced by the amount of the U.S. shareholder's aggregate foreign earnings and profits (E&P) deficit that is allocated to that deferred foreign income corporation (Code Sec. 965(b)(1), as amended by the 2017 Tax Cuts Act).

COMMENT

In other words, the mandatory inclusion amount under the transition rule is reduced by the portion of the aggregate foreign E&P deficit allocated to the U.S. shareholder by reason of the shareholder's interest in one or more E&P deficit foreign corporations.

PRACTICE NOTE

For purposes of the mandatory inclusion rule, the determination of the U.S. shareholder's pro rata share of any amount with respect to any specified foreign corporation is determined under the subpart F inclusion rules by treating that amount in the same manner as subpart F income, and by treating the specified foreign corporation as a CFC. The portion of the U.S. shareholder's mandatory inclusion amount that is equal to the deduction allowed under Code Sec. 965(c) (discussed further below) is treated tax-exempt income for purposes of Code Sec. 705(a)(1)(B) (which requires an increase in a partner's basis in a partnership by the partner's distributive share of the partnership's tax-exempt income) and Code Sec. 1367(a)(1)(A) (which requires an increase in an S shareholder's basis in stock for tax-exempt income). However, that amount is not treated as tax-exempt income for purposes of determining whether an adjustment is made to an accumulated adjustment account under Code Sec. 1368(e)(1)(A) (Code Sec. 965(f), as amended by the 2017 Tax Cuts Act).

The U.S. shareholder allocates the aggregate foreign E&P deficit among the deferred foreign income corporations in which the shareholder is a U.S. shareholder. The aggregate foreign E&P deficit is allocable to a specified foreign corporation in the same ratio as (i) the U.S. shareholder's pro rata share of post-1986 deferred income in that corporation bears to (ii) the aggregate of the U.S. shareholder's pro rata share of accumulated post-1986 deferred foreign income from all deferred income companies of the shareholder (Code Sec. 965(b)(2), as amended by the 2017 Tax Cuts Act).

The aggregate foreign E&P deficit is the lesser of (i) the aggregate of the U.S. shareholder's pro rata shares of the specified E&P deficits of the E&P deficit foreign corporations of the shareholder, or (ii) the aggregate of the U.S. shareholder's pro rata share of the accumulated post-1986 deferred foreign income of all deferred foreign income corporations (Code Sec. 965(b)(3)(A)(i), as added by the 2017 Tax Cuts Act). If the amount described in (ii), above, is less than the amount described in (i), above, then the shareholder must designate (in the form and manner determined by the Secretary of the Treasury):

1) the amount of the specified E&P deficit that is to be taken into account for each E&P deficit corporation with respect to the taxpayer; and
2) in the case of an E&P deficit corporation that has a qualified deficit (as defined in Code Sec. 952), the portion (if any) of the deficit taken into account under item (1), above, that is attributable to a qualified deficit, including the qualified activities to which such portion is attributable (Code Sec. 965(b)(3)(A)(ii), as added by the 2017 Tax Cuts Act).

An E&P deficit foreign corporation is any specified foreign corporation with respect to which the taxpayer is a U.S. shareholder, if as of November 2, 2017 (i) the specified foreign corporation has a deficit in post-1986 earnings and profits, (ii) the corporation was a specified foreign corporation, and (iii) the taxpayer was a U.S. shareholder of the corporation. The specified E&P deficit with respect to any E&P deficit foreign corporation is the amount of the deficit in its post-1986 earnings and profits, described in the previous sentence (Code Sec. 965(b)(3)(B), as amended by the 2017 Tax Cuts Act).

COMMENT

Accordingly, the deficits of a foreign subsidiary that accumulated prior to its acquisition by the U.S. shareholder may be taken into account in determining the aggregate foreign E&P deficit of the U.S. shareholder.

COMMENT

According to the Conference Committee Report, the deficits (including hovering deficits described in Reg. §1.367(b)-17(d)(2)) of a foreign subsidiary that accumulated while it was a specified foreign corporation may be taken into account in determining the aggregate foreign E&P deficit of a U.S. shareholder. Therefore, the amount of post-1986 earnings and profits of a specified foreign corporation is the amount of positive earnings and profits accumulated as of the measurement date reduced by any deficit in earnings and profits of the specified foreign corporation as of the measurement date, without regard to the foreign tax credit limitation category of the earnings or deficit.

For example, if a foreign corporation organized after December 31, 1986, has $100 of accumulated earnings and profits as of November 2, 2017, and December 31, 2017 (determined without reduction for dividends distributed during the tax year and after any increase for qualified deficits), which consist of $120 general limitation earnings and profits and a $20 passive limitation deficit, the foreign corporation's post-1986 earnings and profits would be $100, even if the $20 passive limitation deficit was a hovering deficit. Foreign income taxes related to the hovering deficit, however, would not generally be deemed paid by the U.S. shareholder recognizing an incremental income inclusion. However, it is expected that the Secretary may issue guidance to provide that, solely for purposes of calculating the amount of foreign income taxes deemed paid by the U.S. shareholder with respect to a mandatory inclusion, a hovering deficit may be absorbed by current year earnings and profits and the foreign income taxes related to the hovering deficit may be added to the specified foreign corporation's post-1986 foreign income taxes in that separate category on a pro rata basis in the year of inclusion (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Treatment of earnings and profits in future years. For purposes of excluding previously taxed earnings from the U.S. shareholder's income in any tax year beginning with the last tax year beginning before January 1, 2018, an amount equal to the reduction for the U.S. shareholder's aggregate foreign E&P deficit allocated to the deferred foreign income corporation is treated as an amount included in the U.S. shareholder's gross income under the subpart F inclusion rules (Code Sec. 965(b)(4)(B), as amended by the 2017 Tax Cuts Act).

COMMENT

Accordingly, the reduced earnings and profits are treated as previously taxed income when distributed.

In addition, the U.S. shareholder's pro rata share of the earnings and profits of any specified E&P deficit foreign corporation is increased by the amount of the corporation's specified E&P deficit taken into account in computing the mandatory inclusion. For purposes of determining subpart F income, this increase is attributable to the same activity to which the deficit taken into account was attributable (Code Sec. 965(b)(4)(A), as amended by the 2017 Tax Cuts Act).

Intragroup netting among U.S. shareholders in an affiliated group. The transition rule permits intragroup netting among U.S. shareholders in an affiliated group in which there is at least one U.S. shareholder with a net E&P surplus (i.e., the shareholder's mandatory inclusion amount is greater than zero) and another with a net E&P deficit (i.e., the aggregate foreign E&P deficit of the shareholder exceeds the shareholder's mandatory inclusion amount). The net E&P surplus shareholder may reduce its net surplus by the shareholder's applicable share of the group's aggregate unused E&P deficit, based on the group ownership percentage of the members (Code Sec. 965(b)(5), as amended by the 2017 Tax Cuts Act).

COMMENT

Accordingly, deferred earnings of a U.S. shareholder are reduced by the shareholder's share of deficits as of November 2, 2017, from a specified foreign corporation that is not a deferred foreign income corporation, including the pro rata share of deficits of another U.S. shareholder in a different U.S. ownership chain within the same U.S. affiliated group.

The applicable share with respect to any E&P net surplus shareholder in the group is the amount that bears the same proportion to the group's aggregate unused E&P deficit as (i) the product of the shareholder's group ownership percentage, multiplied by the mandatory inclusion amount that would otherwise be taken into account by the shareholder, bears to (ii) the aggregate amount in item (i) determined with respect to all E&P net surplus shareholders in the group (Code Sec. 965(b)(5)(E), as amended by the 2017 Tax Cuts Act).

The group's aggregate unused E&P deficit is the lesser of the sum of the net E&P deficit of each E&P net deficit shareholder in the group (or a percentage of that amount based on the group ownership percentage of each shareholder), or the amount determined in item (ii), above (Code Sec. 965(b)(4)(D), as amended by the 2017 Tax Cuts Act).

The group ownership percentage with respect to a U.S. shareholder in the group is the percentage of the value of the U.S. shareholder stock that is held by other includible corporations in the group. However, the group ownership percentage of the common parent of the affiliated group is 100 percent (Code Sec. 965(b)(5)(F), as amended by the 2017 Tax Cuts Act).

EXAMPLE

A U.S. corporation has two domestic subsidiaries, X and Y, each of which it owns 100 percent and 80 percent, respectively. If X has a $1,000 net E&P surplus, and Y has $1,000 net E&P deficit, X is an E&P net surplus shareholder, and Y is an E&P net deficit shareholder. The net E&P surplus of X is reduced by the net E&P deficit of Y to the extent of the group's ownership percentage in Y, which is 80 percent. The remaining net E&P deficit of Y is unused. If the U.S. shareholder Z is also a wholly owned subsidiary of the same U.S. parent as X and Y, the group ownership percentage of Y is unchanged, and the surpluses of X and Z are reduced ratably by 800 of the net E&P deficit of Y.

COMMENT

The Conference Committee Report states that it is expect that the Secretary of the Treasury will exercise his authority under the consolidated return provisions to appropriately limit the netting across chains of ownership within a group of related parties in the application of the mandatory inclusion rules. However, nothing in these rules is intended to be interpreted as limiting the Secretary's authority to use such regulatory authority to prescribe regulations on proper application of the mandatory inclusion rules on a consolidated basis for affiliated groups filing a consolidated return (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Deduction from mandatory inclusion. A U.S. shareholder of a specified foreign corporation is allowed a deduction of a portion of the increased subpart F income attributable to the mandatory inclusion of deferred foreign income. The amount of the deduction is the sum of (i) the 15.5-percent rate equivalent percentage of the inclusion amount that is the shareholder's aggregate foreign cash position, and (ii) the eight percent rate equivalent percentage of the portion of the inclusion amount that exceeds the shareholder's aggregate foreign cash position (Code Sec. 965(c)(1), as added by the 2017 Tax Cuts Act).

COMMENT

The calculation is based on the highest rate of tax applicable to corporations in the tax year of inclusion, even if the U.S. shareholder is an individual.

The eight-percent rate equivalent percentage (or the 15.5-percent rate equivalent percentage) with respect to any U.S. shareholder for any tax year is the percentage that would result in the amount to which that percentage applies being subject to an eight-percent rate of tax (or a 15.5-percent rate of tax, respectively) determined by only taking into account a deduction equal to the percentage of that amount and the highest rate of tax under Code Sec. 11 for the tax year. In the case of any tax year of a U.S. shareholder to which Code Sec. 15 applies, the highest rate of tax under Code Sec. 11 before the effective date of the change in rates and the highest rate of tax under that section after the effective date of that change is each taken into account under this rule in the same proportions as the portion of the year that is before and after that effective date, respectively (Code Sec. 965(c)(2), as added by the 2017 Tax Cuts Act).

COMMENT

The use of rate equivalent percentages is intended to ensure that the rates of tax imposed on the deferred foreign income is similar for all U.S. shareholders, regardless of the year of the mandatory inclusion. By stating the permitted deduction in the form of a tax rate equivalent percentage, the transition rule ensures that the accumulated post-1986 deferred foreign income is subject to either an eight-percent or 15.5-percent rate of tax, depending on the underlying assets as of the measurement date, without regard to the corporate tax rate that may be in effect at the time of the inclusion. For example, fiscal-year corporate taxpayers may report the increased subpart F income in a tax year for which a reduced corporate tax rate would otherwise apply (on a prorated basis under Code Sec. 15), but the allowable deduction would be reduced so that the rate of U.S. tax on the income inclusion would be eight or 15.5 percent.

Aggregate foreign cash position. With respect to any U.S. shareholder, the aggregate foreign cash position is the greater of:

1) the aggregate of the U.S. shareholder's pro rata share of the cash position of each specified foreign corporation of the U.S. shareholder determined as of the close of the last tax year of the specified foreign corporation that begins before January 1, 2018; or
2) one half of the sum of:
    a) the aggregate described in item (1), above, determined as of the close of the last tax year of each specified foreign corporation that ends before November 2, 2017, plus
    b) the aggregate described in item (1), above, determined as of the close of the tax year of each specified foreign corporation that precedes the tax year referred to in item (a), above (Code Sec. 965(c)(3)(A), as amended by the 2017 Tax Cuts Act).

COMMENT

In other words, the aggregate foreign cash position is the greater of the aggregate cash position as of the last day of the last tax year beginning before January 1, 2018, and the average aggregate cash position as of the last day of each of the last two years ending before the date of introduction (November 2, 2017).

The cash position of any specified foreign corporation is the sum of:

1) cash held by the foreign corporation;
2) the net accounts receivable of the foreign corporation (the excess (if any) of the corporation's accounts receivable over its accounts payable, determined under Code Sec. 461), plus
3) the fair market value of the following assets held by the corporation:
    a) Actively traded personal property for which there is an established financial market.
    b) Commercial paper, certificates of deposit, the securities of the Federal government and of any State or foreign government.
    c) Any foreign currency.
    d) Any obligation with a term of less than one year.
    e) Any asset that the Secretary identifies as being economically equivalent to the assets described above (Code Sec. 965(c)(3)(B) and (C), as amended by the 2017 Tax Cuts Act).

To avoid double counting, cash assets described in items (2), (3)(a) and (3)(d), above, are not taken into account in determining the aggregate foreign cash position to the extent that the U.S. shareholder demonstrates to the satisfaction of the Secretary that the amount is taken into account by the shareholder with respect to another specified foreign corporation (Code Sec. 965(c)(2)(D), as added by the 2017 Tax Cuts Act).

COMMENT

Thus, cash holdings of a specified foreign corporation in the form of publicly traded stock may be excluded to the extent that a U.S. shareholder can demonstrate that the value of the stock was taken into account as cash or cash equivalent by another specified foreign corporation of the U.S. shareholder.

Cash positions of certain noncorporate entities. A noncorporate entity is treated as a specified foreign corporation of a U.S. shareholder for purposes of determining the shareholder's aggregate foreign cash position if (i) any interest in the entity is held by a specified foreign corporation of the U.S. shareholder (determined after application of this rule), and (ii) the entity would be a specified foreign corporation of the shareholder if the entity were a foreign corporation (Code Sec. 965(c)(2)(E), as added by the 2017 Tax Cuts Act).

COMMENT

As stated in the Conference Committee Report, the cash position of a U.S. shareholder does not generally include the cash attributable to a direct ownership interest in a partnership, but cash positions of certain noncorporate foreign entities owned by a specified foreign corporation are taken into account if such entities would be specified foreign corporations if the entity were a foreign corporation. For example, if a U.S. shareholder owns a five-percent interest in a partnership, the balance of which is held by specified foreign corporations of the U.S. shareholder, the partnership is treated as a specified foreign corporation with respect to the U.S. shareholder, and the cash or cash equivalents held by the partnership are includible in the aggregate cash position of the U.S. shareholder on a look-through basis. It is expected that the Secretary will provide guidance for taking into account only the specified foreign corporation's share of the partnership's cash position, and not the five-percent interest directly owned by the U.S. shareholder (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Anti-abuse rule. The Secretary is authorized to disregard transactions that are determined to have the principal purpose of reducing the aggregate foreign cash position (Code Sec. 965(c)(2)(F), as added by the 2017 Tax Cuts Act).

Disallowance of foreign tax credit and deduction for taxes. No foreign tax credit or deduction is allowed for a portion (referred to as an applicable percentage) of any foreign income taxes paid or accrued (or deemed paid or accrued) with respect to any mandatory inclusion amount for which a deduction is allowed under the above rules (Code Sec. 965(g)(1) and (3), as added by the 2017 Tax Cuts Act).

The disallowed portion of the foreign tax credit is 55.7 percent of foreign taxes paid attributable to the portion of the inclusion amount attributable to the U.S. sahreholder's aggregate foreign cash position, plus 77.1 percent of foreign taxes paid attributable to the remaining portion of the mandatory inclusion amount (Code Sec. 965(g)(2), as added by the 2017 Tax Cuts Act).

COMMENT

Other foreign tax credits used by a taxpayer against tax liability resulting from the deemed inclusion apply in full.

COMMENT

As a result of this foreign tax credit disallowance rule, the foreign tax credit is limited to the taxable portion of the mandatory inclusion amount.

A special rule coordinates the disallowance of foreign tax credits, described above, with the Code Sec. 78 requirement that a domestic corporate shareholder is deemed to receive a dividend in an amount equal to foreign taxes it is deemed to have paid and for which it claimed a credit. Under the coordination rule, the foreign taxes treated as paid or accrued by a domestic corporation as a result of the mandatory inclusion are limited to those taxes in proportion to the taxable portion of the mandatory inclusion. The gross-up amount equals the total foreign income taxes multiplied by a fraction, the numerator of which is the taxable portion of the increased subpart F income inclusion under the transition rule and the denominator of which is the total increase in subpart F income under the transition rule (Code Sec. 965(g)(4), as added by the 2017 Tax Cuts Act).

Installment payments. A U.S. shareholder of a deferred foreign income corporation may elect to pay the net tax liability resulting from the mandatory inclusion of deferred foreign income in eight installments. If installment payment is elected, the payments for each of the first five years equals eight percent of the net tax liability. The amount of the sixth installment is 15 percent of the net tax liability, increasing to 20 percent for the seventh installment and 25 percent for the eighth installment (Code Sec. 965(h)(1), as added by the 2017 Tax Cuts Act).

The first installment must be paid on the due date (determined without regard to extensions) of the tax return for the last tax year that begins before January 1, 2018 (the tax year of the mandatory inclusion). Succeeding installments must be paid annually no later than the due dates (without extensions) for the income tax return of each succeeding tax year (Code Sec. 965(h)(2), as added by the 2017 Tax Cuts Act).

COMMENT

Thus, a U.S. shareholder can elect to pay the transition tax arising from the mandatory inclusion over a period of eight years.

Making the election. An election to pay the net tax liability from the mandatory inclusion in installments must be made by the due date of the tax return for the last tax year that begins before January 1, 2018 (the tax year in which the pre-effective-date undistributed earnings are included in income under the transition rule). The Treasury Secretary has authority to prescribe the manner of making the election (Code Sec. 965(h)(5), as added by the 2017 Tax Cuts Act).

Net tax liability. The net tax liability that may be paid in installments is the excess of (i) the U.S. shareholder's net income tax for the tax year in which an amount is included in income under the mandatory inclusion rules, over (ii) the taxpayer's net income tax for that year determined without regard to the mandatory inclusion and any income or deduction properly attributable to a dividend received by the U.S. shareholder from any deferred foreign income corporation. The net income tax is the regular tax liability reduced by the general business credit (Code Sec. 965(h)(6), as added by the 2017 Tax Cuts Act).

Acceleration rule. If (1) there is an addition to tax for failure to pay timely any required installment of the transition tax, (2) there is a liquidation or sale of substantially all of the U.S. shareholder's assets (including in a bankruptcy case), (3) the U.S. shareholder ceases business, or (4) another similar circumstance arises, the unpaid portion of all remaining installments is due on the date of the event (or, in a bankruptcy proceeding or similar case, the day before the petition is filed). This acceleration rule does not apply to the sale of substantially all the assets of the U.S. shareholder to a buyer if the buyer enters into an agreement with the Secretary under which the buyer is liable for the remaining installments due in the same manner as if the buyer were the U.S. shareholder (Code Sec. 965(h)(3), as added by the 2017 Tax Cuts Act).

Proration of deficiency to installments. If an election is made to pay the net tax liability from the mandatory inclusion in installments and a deficiency is later determined with respect to that net tax liability, the additional tax due is prorated among the installment payments. The portions of the deficiency prorated to an installment that was due before the deficiency was assessed must be paid upon notice and demand. The portion prorated to any remaining installment is payable with the timely payment of that installment payment. However, these rules do not apply if the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax (Code Sec. 965(h)(4), as added by the 2017 Tax Cuts Act).

COMMENT

If the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax, the entire deficiency is payable upon notice and demand.

COMMENT

The timely payment of an installment does not incur interest. If a deficiency is determined that is attributable to an understatement of the net tax liability due under the transition rule, the deficiency is payable with underpayment interest for the period beginning on the date on which the net tax liability would have been due, without regard to an election to pay in installments, and ending with the payment of the deficiency. Furthermore, any amount of deficiency prorated to a remaining installment also bears interest on the deficiency, but not on the original installment amount (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Special rules for S corporations. A special rule permits deferral of the transition net tax liability for shareholders of a U.S. shareholder that is an S corporation. Under this rule, any shareholder of the S corporation may elect to defer the payment of his portion of the net tax liability resulting from the mandatory inclusion until the shareholder's tax year in which a triggering event occurs. The deferred transition tax is assessed as an addition to tax on the shareholder's return for the tax year of the triggering event (Code Sec. 965(i)(1), as added by the 2017 Tax Cuts Act).

For purposes of this rule, the shareholder's net tax liability is the net tax liability that would be determined under the transition rule if the only subpart F income taken into account by the shareholder under the mandatory inclusion were allocations from the S corporation (Code Sec. 965(i)(3), as added by the 2017 Tax Cuts Act).

The S corporation shareholder must make the election to defer the transition tax not later than the due date for the shareholder's return for the tax year that includes the close of the S corporation's last tax year that begins before January 1, 2018, in which the mandatory inclusion is made. The election is made in the manner provided by the Secretary (Code Sec. 965(i)(8), as added by the 2017 Tax Cuts Act).

Triggering events. The following three types of events may trigger an end to deferral of the net tax liability of an S corporation shareholder:

1) The corporation ceases to be an S corporation (determined as of the first day of the first tax year that the corporation is not an S corporation).
2) A liquidation, a sale of substantially all of the S corporation's assets (including in a bankruptcy or similar case), a termination of the S corporation, a cessation of its business, or a similar event.
3) A transfer of shares of stock in the S corporation by the electing taxpayer, whether by sale, death or otherwise, unless the transferee of the stock agrees with the Secretary to be liable for net tax liability in the same manner as the transferor (Code Sec. 965(i)(2), as added by the 2017 Tax Cuts Act).

Partial transfers of the S corporation stock trigger the end of deferral only with respect to the portion of tax properly allocable to the portion of stock sold.

Election to pay deferred liability in installments. After a triggering event occurs, an S corporation shareholder that has elected to defer the net tax liability may elect to pay the net tax liability in eight installments, subject to rules similar to those generally applicable absent deferral. However, if the triggering event is a liquidation, sale of substantially all corporate assets, termination of the S corporation or end of its business, or similar event, the installment payment election can be made only with the consent of the Secretary. The installment election must be made by the due date of the return for the tax year in which the triggering event occurs, and the first installment payment is required by that due date, determined without regard to extensions of time to file (Code Sec. 965(i)(4), as added by the 2017 Tax Cuts Act).

Joint and several liability; extension of limitation on collection. If a shareholder of an S corporation has elected deferral and a triggering event occurs, the S corporation and the electing shareholder are jointly and severally liable for any net tax liability and related interest or penalties (Code Sec. 965(i)(5), as added by the 2017 Tax Cuts Act). The period within which the IRS may collect a deferred liability does not begin before the date of the triggering event (Code Sec. 965(i)(6), as added by the 2017 Tax Cuts Act).

Annual reporting of net tax liability. If an election to defer payment of the net tax liability is in effect for an S corporation shareholder, the shareholder must report the amount of the deferred net tax liability on its return for the tax year for which the election is made and on each subsequent tax year return until the deferred amount has been fully assessed on the returns. Failure to include that information with each income tax return during the period that the election is in effect will result in a penalty equal to five-percent of the amount that should have been reported. For this purpose, a deferred net tax liability is the amount of the net tax liability the payment of which has been deferred under these rules and which has not been assessed on a return of tax for any prior tax year (Code Sec. 965(i)(7), as added by the 2017 Tax Cuts Act).

Reporting by S corporations. An S corporation that is a U.S. shareholder of a specified foreign corporation is required to report on its income tax return the amount includible in gross income under the mandatory inclusion rules, as well as the amount of deduction from mandatory inclusion that would be allowable under the transition rule. In addition, the corporation must furnish a copy of that information to its shareholders. The information provided to shareholders also must include a statement of the shareholder's pro rata share of these amounts (Code Sec. 965(j), as added by the 2017 Tax Cuts Act).

Limitations on assessment extended. Under an exception to the otherwise generally applicable limitations period for assessment of tax, the period for the assessment of the transition net tax liability arising from the mandatory inclusion does not expire prior to six years from the date on which the tax return initially reflecting the mandatory inclusion was filed (Code Sec. 965(k), as added by the 2017 Tax Cuts Act).

Recapture for expatriated entities. A special recapture rule applies if a U.S. shareholder is allowed a deduction from mandatory inclusion under the transition rule and first becomes an expatriated entity at any time during the 10-year period beginning on December 22, 2017, with respect to a surrogate foreign corporation that first becomes a surrogate foreign corporation during that period (i.e., post-enactment). In this case, the tax imposed by Chapter 1 of the Code is increased for the first tax year in which the taxpayer becomes an expatriated entity by an amount equal to 35 percent of the amount of the allowed deduction from mandatory inclusion. In addition, no tax credits are allowed against the additional tax due as a result of the recapture rule (Code Sec. 965(l)(1), as added by the 2017 Tax Cuts Act).

COMMENT

Although the amount due is computed by reference to the year in which the deemed subpart F income was originally reported, the additional tax arises and is assessed for the tax year in which the U.S. shareholder becomes an expatriated entity.

For purposes of this rule, an expatriated entity is a domestic corporation or partnership acquired in an inversion transaction and the surrogate foreign corporation is the foreign corporation acquiring the expatriated entity in the inversion transaction (Code Sec. 7874(a)(2)). However, an entity is not treated as an expatriated entity, and is not within the scope of this recapture rule, if the surrogate foreign corporation is treated as a domestic corporation under Code Sec. 7874(b) because former shareholders or partners of the acquired entity hold 80 percent or more (by vote or value) of the stock of the surrogate foreign corporation after the transaction (Code Sec. 965(l)(2) and (3), as added by the 2017 Tax Cuts Act).

Special rules for U.S. shareholders that are REITs. Special rules are provided if a U.S. shareholder is a REIT in order to reduce the burden of compliance with the transition rule by REITs. First, if a real estate investment trust (REIT) is a U.S. shareholder in one or more deferred foreign income corporations, any amount required to be included as mandatory subpart F inclusion is not taken into account as gross income of the REIT for purposes of determining the qualified REIT's income in applying the Code Sec. 856(c)(2) and (3) income tests to any tax year for which the amount is taken into account under the subpart F inclusion (Code Sec. 965(m)(1)(A), as added by the 2017 Tax Cuts Act).

In addition, although a REIT generally must take into account the mandatory inclusion in determining its taxable income under Code Sec. 857(b), the REIT is allowed to make an election to defer the mandatory inclusion and take it into income over the period of eight years as follows:

1) Eight percent of the amount in the case of each of the tax years in the five-tax year period beginning with the tax year in which the amount would otherwise be included.
2) 15 percent of the amount in the case of the first tax year following that period.
3) 20 percent of the amount in the case of the second tax year following that period.
4) 25 percent of the amount in the case of the third tax year following that period (Code Sec. 965(m)(1)(B), as added by the 2017 Tax Cuts Act).

COMMENT

A REIT is required to distribute at least 90 percent of the REIT income (other than net capital gain) annually under Code Sec. 857. A required inclusion under the transition rule may trigger a requirement that the REIT distribute an amount equal to 90 percent of that inclusion despite the fact that it did not receive distribution from the deferred foreign income corporation. To avoid the requirement that any distribution requirement be satisfied in one year, an election to defer the mandatory inclusion is permitted.

The election for deferred inclusion must be made not later than the due date for the first tax year in the five-tax year period in the manner provided by the Secretary (Code Sec. 965(m)(2)(A), as added by the 2017 Tax Cuts Act).

Special rules apply if the deferral election is in effect. Thus, in each of those years, the REIT may claim a partial deduction from mandatory inclusion under Code Sec. 965(c)(1) in the applicable percentages in proportion to the amount included in each of the eight years. The REIT also cannot elect to use the installment payment for any tax year from the eight-year period, discussed above (Code Sec. 965(m)(2)(B)(i), as added by the 2017 Tax Cuts Act).

In addition, if there is a liquidation or sale of substantially all the assets of the REIT (including in a bankruptcy or similar case), a cessation of business by the REIT, or any similar circumstance, any portion of the required inclusion not yet taken into income is accelerated and required to be included as gross income as of the day before the event and the unpaid portion of any tax liability with respect to such inclusion will be due on the date of the event (or in the case of a bankruptcy or similar case, the day before the petition is filed) (Code Sec. 965(m)(2)(B)(ii), as added by the 2017 Tax Cuts Act).

Election not to apply the NOL deduction. A U.S. shareholder of a deferred foreign income corporation can make an election for the last tax year beginning before January 1, 2018 (the tax year of the mandatory subpart F inclusion) not to take into account the mandatory inclusion and certain other amounts (described below) in determining (i) the net operating loss (NOL) deduction under Code Sec. 172 for that tax year, or (ii) the amount of taxable income for that tax year which may be reduced by NOL carryovers or carrybacks to that tax year (Code Sec. 965(n)(1), as added by the 2017 Tax Cuts Act).

The amount not taken into account includes the mandatory inclusion and, in the case of a domestic corporation that chooses to have the benefits of subpart A of part III of subchapter N for the tax year, the taxes deemed to be paid by the corporation under the deemed-paid credit rules of Code Sec. 960(a) and (b) for the tax year with respect to the mandatory inclusion that are treated as dividends under Code Sec. 78 (Code Sec. 965(n)(2), as added by the 2017 Tax Cuts Act).

The election is made not later than the due date (including extensions) for filing the return for the tax year in the manner prescribed by the Secretary (Code Sec. 965(n)(3), as added by the 2017 Tax Cuts Act).

Regulations. The Secretary is authorized to issue regulations or other guidance as may be necessary or appropriate to carry out the mandatory inclusion provisions or to prevent the avoidance of the purposes of these rules, including through a reduction in earnings and profits through changes in entity classification, changes in accounting methods, or otherwise (Code Sec. 965(o), as added by the 2017 Tax Cuts Act).

COMMENT

According to the Conference Committee Report, in order to avoid double-counting and double non-counting of earnings, the Secretary may provide guidance to adjust the amount of post-1986 earnings and profits of a specified foreign corporation to ensure that a single item of a specified foreign corporation is taken into account only once in determining the income of a U.S. shareholder subject to mandatory inclusion. Such an adjustment may be necessary, for example, when there is a deductible payment (e.g., interest or royalties) from one specified foreign corporation to another specified foreign corporation between measurement dates.

In addition, taxpayers may engage in tax strategies designed to reduce the amount of post-1986 earnings and profits in order to decrease the amount of the mandatory

inclusion. Such tax strategies may include a change in entity classification, accounting method, and tax year, or intragroup transactions such as distributions or liquidations. It is expected that the Secretary will prescribe rules to adjust the amount of post-1986 earnings and profits in such cases in order to prevent the avoidance of the purposes of the transition rule (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Effective date. No specific effective date is provided. The amendment is, therefore, considered effective on December 22, 2017, the date of enactment.

FOREIGN TAX CREDIT

¶715 Recapture of Overall Domestic Losses

NEW LAW EXPLAINED

Recapture of ODLs accelerated.— A taxpayer who claims the foreign tax credit and has an overall domestic loss (ODL) may elect to recapture the ODL by recharacterizing up to 100 percent of U.S. source taxable income earned in subsequent years as foreign source taxable income. The amount that is recharacterized each year is limited to the lesser of the aggregate amount in the ODL account or up to 100 percent of the taxpayer's U.S. source taxable income for the year (Code Sec. 904(g)(5)(A), as added by the Tax Cuts and Jobs Act).

The increased recapture amount applies to the pre-2018 unused ODL, meaning a loss that arises in a qualified tax year beginning before January 1, 2018, and that has not been used for any tax year before that date (Code Sec. 904(g)(5)(B), as added by the 2017 Tax Cuts Act). A qualified tax year is a year for which the taxpayer elects the foreign tax credit (Code Sec. 904(g)(2)(C)). The pre-2018 unused ODL must be taken into account for tax years of the taxpayer beginning after December 31, 2017, and before January 1, 2028 (Code Sec. 904(g)(5)(C), as added by the Tax Cuts Act).

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 14304(b) of the Tax Cuts and Jobs Act).

¶720 Deemed-Paid Foreign Tax Credit

NEW LAW EXPLAINED

Code Sec. 902 deemed-paid credit repealed.— The Code Sec. 902 deemed-paid foreign tax credit is repealed. The credit was allowed for income tax paid with respect to dividends received by a domestic corporation that owned 10 percent or more of the voting stock of a foreign corporation. The deemed-paid credit is repealed as a result of the implementation of the participation exemption system (Code Sec. 902, stricken by the Tax Cuts and Jobs Act).

Under the participation exemption system, a specified 10-percent owned foreign corporation (i.e., a foreign corporation with domestic corporate shareholders that own 10 percent or more of the foreign corporation's stock by vote or value) is provided a 100-percent deduction for the foreign-source portion of the dividends received from the foreign corporation (Code Sec. 245A, as added by the 2017 Tax Cuts Act). This deduction is referred to as the "participation DRD". No foreign tax credit or deduction is allowed for any foreign taxes paid or accrued with respect to the deductible portion of the dividend (see ¶705).

COMMENT

The House Committee Report states that to continue to provide a Code Sec. 902 deemed-paid credit in light of the participation DRD would provide a double tax benefit, by allowing the dividend exemption and then reducing U.S. tax with a credit for taxes paid on the foreign source income (House Committee Report for Tax Cuts and Jobs Act (P.L. 115-97) (H. R. Rep. No. 115-409)).

Code Sec. 960 deemed-paid credit for subpart F inclusions. The Code Sec. 960 deemed-paid foreign tax credit for subpart F inclusions is retained, but modified as a result of the repeal of Code Sec. 902. The deemed-paid credit for subpart F inclusions is no longer computed under the principles of Code Sec. 902. Rather, the credit is determined on a current year basis. If income is included in the gross income of a domestic corporation that is a U.S. shareholder of a controlled foreign corporation (CFC), the deemed-paid credit is the amount of the foreign corporation's foreign income taxes properly attributable to the subpart F income inclusion (Code Sec. 960(a), as added by the 2017 Tax Cuts Act).

COMMENT

The provision changes the method for computing the deemed-paid taxes, which required the domestic corporation to multiply the foreign subsidiary's post-1986 foreign income tax payments by the ratio of: (1) the Code Sec. 951(a)(1) inclusion, to (2) the foreign subsidiary's post-1986 undistributed earnings pool. The provision eliminates the need for tracking cumulative tax pools.

The look-through rule that applied for purposes of determining the foreign tax credit limitation for dividends received from a Code Sec. 902 noncontrolled foreign corporation now applies to dividends received from a noncontrolled 10-percent owned foreign corporation. A noncontrolled 10-percent owned foreign corporation is a specified foreign corporation, defined in Code Sec. 245A(b). The term also includes a passive foreign investment company, defined in Code Sec. 1297(a), with respect to which the taxpayer meets the stock ownership requirements of Code Sec. 902(a) or (b), as in effect before repeal by the 2017 Tax Cuts Act. A CFC will not be treated as a noncontrolled 10-percent owned foreign corporation with respect to any distribution out of its earnings and profits for periods during which it was a CFC (Code Sec. 904(d)(2)(E)(i) and Code Sec. 904(d)(4), as amended by the 2017 Tax Cuts Act).

COMMENT

The limitation on the Code Sec. 960 deemed-paid credit with respect to Code Sec. 956 inclusions of domestic corporate shareholders in Code Sec. 960(c) was eliminated (Act Sec. 14301(b)(1), striking Code Sec. 960(c)). Note that provisions in the House-passed bill would have made the Code Sec. 956 amount zero with respect to a domestic corporation,

while the Senate-passed bill excepted domestic corporations from Code Sec. 956. Code Sec. 956 was not modified in the final version of the 2017 Tax Cuts Act.

Code Sec. 960 deemed-paid credit and distributions from previously taxed earnings and profits. The amount of foreign taxes deemed paid upon a distribution of previously taxed income is also no longer determined under the principles of Code Sec. 902. If a domestic corporation that is a U.S. shareholder receives a distribution from a CFC, any part of which is excluded from gross income as previously taxed income under Code Sec. 959(a), the domestic corporation is deemed to pay the foreign corporation's foreign income taxes as: (1) are properly attributable to the previously taxed income, and (2) that were not deemed paid by the domestic corporation under Code Sec. 960, for the tax year or any prior tax year (Code Sec. 960(b)(1), as added by the 2017 Tax Cuts Act).

If a CFC receives a distribution from another CFC, any portion of which was excluded from gross income of the CFC because the amounts were attributable to previously taxed income under Code Sec. 959(b), the CFC receiving the distribution will be deemed to have paid so much of the other CFC's taxes as: (1) are attributable to such portion, and (2) have not been deemed to have been paid by a domestic corporation under Code Sec. 960, for the tax year or any prior tax year (Code Sec. 960(b)(2), as added by the 2017 Tax Cuts Act).

Adjustments to the Code Sec. 960 deemed-paid credit. Accrued foreign income taxes that were not paid within two years from the close of the tax year to which they relate and so reduce the foreign tax credit, but that are subsequently paid, are taken into account for the tax year to which the taxes relate. The same rule applies for both taxes deemed paid under Code Sec. 960 and foreign income taxes directly paid (Code Sec. 905(c)(2)(B)(i), as amended by the 2017 Tax Cuts Act).

COMMENT

Temporary Reg. §1.905-3T(d)(2), which requires adjustments to the earnings and tax pools, in lieu of a foreign tax redetermination, is inconsistent with the determination of the Code Sec. 960 deemed-paid credit on a current basis.

Other provisions related to the Code Sec. 960 deemed-paid credit. For purposes of the Code Sec. 960 deemed-paid credit, the term foreign income taxes means income, war profits, or excess profits taxes paid or accrued to any foreign country or possession of the United States (Code Sec. 960(e), as added by the 2017 Tax Cuts Act).

The IRS may provide regulations or other guidance necessary to carry out the provisions of Code Sec. 960 (Code Sec. 960(f), as added by the 2017 Tax Cuts Act). According to the House Committee Report, this could include providing regulations with rules similar to those in Reg. §1.904-6(a) for allocating taxes to specific foreign tax credit baskets. Under these rules, taxes are not attributable to an item of subpart F income if the base upon which the tax was imposed does not include the item of subpart F income. For example, if foreign law exempts from tax certain income from its tax base, no deemed credit can result from the subpart F inclusion. Tax that is not imposed on subpart F income is not attributable to subpart F income (House Committee Report for Tax Cuts and Jobs Act (P.L. 115-97) (H. R. Rep. No. 115-409)).

A domestic corporation that owns or is treated as owning under the attribution of ownership rules of Code Sec. 1298(a), the stock of a qualified electing fund (QEF) can claim the Code Sec. 960 deemed-paid credit for the inclusion of income of the QEF. The domestic corporation must meet the stock ownership requirements in Code Sec. 902(a) and (b), prior to repeal by the 2017 Tax Cuts Act (Code Sec. 1293(f)(3), as added by the 2017 Tax Cuts Act).

Code Sec. 78 gross-up. The Code Sec. 78 gross-up for foreign taxes deemed paid under Code Sec. 902, no longer applies, as a result of the repeal of Code Sec. 902. The gross-up applies to taxes deemed paid under Code Sec. 960(a) and (b). The Code Sec. 78 gross-up also applies to foreign income taxes deemed paid with respect to amounts of global intangible low-taxed income (GILTI) included in the gross income of a domestic corporation under Code Sec. 951A (see ¶735). A domestic corporation's deemed-paid credit for GILTI is 80 percent of the product of the corporation's inclusion percentage and the aggregate tested foreign income taxes paid or accrued, with respect to tested income, by each CFC with

respect to which the domestic corporation is a U.S. shareholder. The Code Sec. 78 gross-up, however, takes into account 100 percent of the product of the inclusion percentage and aggregate tested foreign taxes. The Code Sec. 78 gross-up applies for all purposes, except for the deductions for dividends received under Code Sec. 245 and Code Sec. 245A. The amounts are treated as a dividend received by a domestic corporation from a foreign corporation (Code Sec. 78, as amended by the 2017 Tax Cuts Act and Code Sec. 960(d), as added by the 2017 Tax Cuts Act).

Code Sec. 909 matching rule. The special matching rule that applied to Code Sec. 902 corporations is replaced with a rule that applies to specified 10-percent owned foreign corporations. Under the rule, if there is a foreign tax credit splitting event, a foreign income tax paid or accrued by a specified 10-percent owned foreign corporation will not be taken into account, for purposes of Code Sec. 960 or determining earnings and profits under Code Sec. 964(a), before the tax year in which the related income is taken into account by the corporation or a domestic corporation which is a U.S. shareholder of the corporation (Code Sec. 909(b), as amended by the 2017 Tax Cuts Act). A specified 10-percent owned foreign corporation is any corporation with respect to which a domestic corporation is a U.S. shareholder. The definition is modified for this purpose to include passive foreign investment companies, as defined under Code Sec. 1297, that are not CFCs (Code Sec. 245A(b), as added by the 2017 Tax Cuts Act) (see ¶705). A U.S. shareholder is a U.S. person who owns, either directly, indirectly, or constructively: (1) 10 percent or more of the total combined voting power of all classes of stock of the foreign corporation, or (2) 10 percent or more of the total value of shares of all classes of stock of the foreign corporation (see ¶745) (Code Sec. 951(b), as amended by the 2017 Tax Cuts Act).

Foreign tax credit limitation look-through rule. The look-through rule that applied for purposes of determining the foreign tax credit limitation for dividends received from a Code Sec. 902 noncontrolled foreign corporation now applies to dividends received from a noncontrolled 10-percent owned foreign corporation. A noncontrolled 10-percent owned foreign corporation is a specified 10-percent owned foreign corporation, defined in Code Sec. 245A(b) (see ¶705). The term also refers to a passive foreign investment company, defined in Code Sec. 1297(a), with respect to which the taxpayer meets the stock ownership requirements of Code Sec. 902(a) or (b), as in effect before repeal by the 2017 Tax Cuts Act. A CFC will not be treated as a noncontrolled 10-percent owned foreign corporation with respect to any distribution out of its earnings and profits for periods during which it was a CFC (Code Sec. 904(d)(2)(E)(i) and (d)(4), as amended by the 2017 Tax Cuts Act).

Dividends received deduction. The U.S. source portion of a dividend received from a 10-percent foreign corporation that may be deducted under Code Sec. 245 is the amount of the dividend multiplied by the ratio of post-1986 undistributed U.S. earnings to the post-1986 undistributed earnings. Post-1986 undistributed earnings were defined by reference to Code Sec. 902(c)(1). The definition of post-1986 undistributed earnings from Code Sec. 902(c)(1) is now included in Code Sec. 245 (Code Sec. 245(a)(4), as amended by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end (Act Sec. 14301(d) of the Tax Cuts and Jobs Act).

¶725 Foreign Tax Credit Limitation Baskets

NEW LAW EXPLAINED

Foreign tax credit limitation basket added.— A new separate foreign tax credit limitation basket is added for foreign branch income (Code Sec. 904(d)(1)(B), as added by the Tax Cuts and Jobs). Foreign branch income means the business profits of a U.S. person that are attributable to one or more qualified business units (QBUs) in one or more foreign countries. A QBU is defined as any separate and clearly identified unit of a trade or business of a taxpayer that maintains separate books and records (Code Sec. 989(b)). The rules for determining the amount of business profits attributable to a QBU will be set forth in regulations (Code Sec. 904(d)(2)(J)(i), as added by the 2017 Tax Cuts Act).

COMMENT

The income of a foreign branch is subject to U.S. tax and a foreign tax credit may be claimed. If the foreign branch is located in a high-tax country, absent the new foreign tax credit limitation basket, those taxes could offset taxes paid in low-tax countries in the general category basket. The addition of the new basket also means that carrybacks and carryforwards of excess foreign tax credits in the foreign branch company basket will be allowed only to the extent of the excess limitation in the basket.

The additional foreign tax credit limitation basket does not apply to income of the foreign branch that is passive category income (Code Sec. 904(d)(2)(J)(ii)). Passive category income includes passive income and specified passive income (Code Sec. 904(d)(2)(A)(i);Reg. §1.904-4(b)(1)). Passive income is generally any type of income that would qualify as subpart F income foreign personal holding company income under Code Sec. 954(c) if the recipient was a controlled foreign corporation (CFC) (e.g., dividends, interest, rents, royalties, and annuities). Specified passive category income includes dividends from a domestic international sales corporation (DISC) or former DISC and distributions from a former foreign sales corporation (FSC) (Code Sec. 904(d)(2)(v); Reg. §1.904-4(b)(3)).

COMMENT

Passive category income is typically low-taxed income that would not be subject to cross-crediting.

A new separate foreign tax credit limitation basket was also added for global intangible low-taxed income (see¶735).

Effective date. The amendments made by this section apply tax years beginning after December 31, 2017 (Act Sec. 14302(c) of the Tax Cuts and Jobs Act).

¶730 Source of Income Rules for Cross-Border Inventory Sales

NEW LAW EXPLAINED

Cross-border inventory sales sourced based on production activities.— Gains, profits, and income from the sale or exchange of inventory property that is produced in whole or in part within the United States and sold outside of the United States (or vice versa) is allocated and apportioned between U.S. and foreign sources solely on the basis of the production activities with respect to the property (Code Sec. 863(b), as amended by the Tax Cuts and Jobs Act). Under the rule, if income is produced entirely in the United States, it is U.S. source income and income produced entirely in a foreign country is foreign source income. Inventory produced in both the United States and a foreign country is mixed-source income.

> **COMMENT**
>
> Cross-border inventory sales will now be sourced without regard to the title passage rule. The title passage rule is seen as a means by which taxpayers can manipulate the source of income rules.

The current regulations, which provide rules for sourcing income attributable to production activity, should continue to apply with respect to determining where production activities are located and allocating and apportioning mixed-source income. The regulations provide rules for sourcing income attributable to production activity. Under the regulations, production activity means activity that creates, fabricates, manufactures, extracts, processes, cures or ages inventory. With some exceptions, the only production activities that are taken into account are those carried on by the taxpayer. The income attributable to production activities is sourced according to the location of the production assets, where the production activity is solely in the United States (Reg. §1.863-3(c)(1)(i)(A)). Production assets include only tangible and intangible assets that are directly used by the taxpayer to produce inventory. Production assets do not include assets that are not directly used to produce inventory, such as accounts receivable, marketing intangibles and customer lists (Reg. §1.863-3(c)(1)(i)(B)).

If there is production both inside and outside of the United States, the regulations provide that the source of the income is determined by multiplying the income attributable to the production activities by the ratio of the average adjusted basis of the production assets located outside of the United States to the total adjusted basis of all production assets. The remaining income is U.S. source income (Reg. §1.863-3(c)(1)(ii)).

Effective date. The amendment made by this section applies to tax years beginning after December 31, 2017 (Act Sec. 14303(b) of the Tax Cuts and Jobs Act)

CFCS AND SUBPART F INCOME

¶735 Foreign High Return Amounts of U.S. Shareholders of Controlled Foreign Corporations (CFCs)

NEW LAW EXPLAINED

Global intangible low-taxed income and foreign-derived intangible income.—A person who is a U.S. shareholder of any controlled foreign corporation (CFC) is required to include its global intangible low-taxed income (GILTI) in gross income for the tax year. The amounts are treated in the same manner as subpart F income for various purposes, including for example, determining previously taxed earnings and profits (Code Sec. 951A(a), (f), as added by the Tax Cuts and Jobs Act). The Treasury may issue rules and other guidance to assist in coordinating the GILTI inclusion with provisions that require the determination of subpart F income at the CFC level (Code Sec. 961A(f)(1)(B), as added by the 2017 Tax Cuts Act).

GILTI defined. The term "global intangible low-taxed income" is defined as the excess (if any) of (1) the U.S. shareholder's net CFC tested income for that tax year, over (2) the U.S. shareholder's net deemed tangible income return for that tax year (Code Sec. 951A(b)(1), as added by the 2017 Tax Cuts Act).

Net deemed intangible income return. The term "net deemed tangible income return" means with respect to any U.S. shareholder for the tax year, the excess (if any) of (1) 10 percent of the aggregate of its pro rata share of the qualified business asset investment (QBAI) of each CFC in which it is a U.S. shareholder, over (2) the amount of interest expense taken into account in determining its net CFC tested income for the tax year to the extent that the interest expense exceeds the interest income properly allocable to the interest expense that is taken into account in determining its net CFC tested income (Code Sec. 951A(b)(2), as added by the 2017 Tax Cuts Act).

The formula for calculating GILTI is: GILTI = Net CFC Tested Income - [(10% x QBAI) - Interest Expense]. As noted in the Conference Agreement, if the amount of interest expense exceeds 10% x QBAI, then the quantity in brackets in the formula equals zero in the determination of GILTI (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Net CFC tested income. A CFC's tested income for any tax year is the gross income of the corporation in excess of the properly allocated deductions, without regard to the following:

1) effectively connected income of the CFC, defined in Code Sec. 952(b);
2) gross income taken into account in determining subpart F income;
3) gross income excluded from foreign base company income and insurance income as high-taxed income under Code Sec. 954(b)(4);
4) dividends received from related persons, defined in Code Sec. 954(d)(3); and
5) foreign oil and gas extraction income, as defined in Code Sec. 907(c)(1) (Code Sec. 951A(c)(2)(A), as added by the 2017 Tax Cuts Act).

A CFC's tested loss for any tax year is the excess of the properly allocated deductions over the CFC's tested income (Code Sec. 951A(c)(2)(B), as added by the 2017 Tax Cuts Act).

The term "net CFC tested income" means with respect to a U.S. shareholder for any tax year of the shareholder, the excess (if any) of (1) the aggregate of the shareholder's pro rata share of the tested income of each CFC with respect to which the shareholder is a U,S. shareholder for the tax year of the U.S. shareholder, over (2) the aggregate of the shareholder's pro rata share of the tested loss of each CFC with respect to which the shareholder is a U.S. shareholder for the tax year of the U.S. shareholder. The amounts are determined for each tax year of the CFC which ends in or with such tax year of the U.S. shareholder (Code Sec. 951A(c)(1), as added by the 2017 Tax Cuts Act).

COMMENT

The definition of a U.S. shareholder was expanded by the 2017 Tax Cuts Act to include a U.S. person that owns at least 10 percent of the total value of all classes of stock of the foreign corporation, in addition to a U.S. person that owns at least 10 percent of the voting stock of the foreign corporation. The definition applies for purposes of Title 26 and not just subpart F (Code Sec. 951(b) and Code Sec. 957(a), as amended by the 2017 Tax Cuts Act).

Qualified business asset investment (QBAI). The term "qualified business asset investment " is defined by reference to specific tangible personal property used in a trade or business that is depreciable under Code Sec. 167. Specified tangible property is property used in the production of tested income, unless the rule for dual use property applies. Specifically, QBAI is the CFC's average aggregate adjusted bases as of the close of each quarter of the tax year in the property (Code Sec. 951A(d)(1), as added by the 2017 Tax Cuts Act). Dual use property-property used both in the production of tested income and income that is not tested- is treated as specified tangible property in the same proportion that the CFC's tested income produced with respect to the property bears to the total gross income produced with respect to the property (Code Sec. 951A(d)(2)(B), as added by the 2017 Tax Cuts Act).

The adjusted basis of the property is determined using the alternative depreciation system under Code Sec. 168(g) and allocating depreciation deductions for the property ratably to each day during the period in the tax year to which the depreciation relates (Code Sec. 951A(d)(3), as added by the 2017 Tax Cuts Act).

Further, if a CFC holds an interest in a partnership at the end of the CFC's tax year, the CFC takes into account its distributive share of the aggregate of the partnership's adjusted basis in tangible property held by the partnership if the property is used in the trade or business of the partnership, is of a type to which a deduction is allowed under Code Sec. 167, and is used in the production of tested income. The CFC's distributive share of the adjusted basis of any property is the CFC's distributive share of income with respect to the property (Code Sec. 951A(d)(3)[sic], as added by the 2017 Tax Cuts Act; Conference Report on H.R.1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Pro rata share. A shareholder's pro rata share for purposes of determining GILTI and net CFC tested income is determined under the rules ofCode Sec. 951(a)(2) with respect to subpart F income. The pro rata shares are taken into account in the tax year of the U.S. shareholder in which or with which the tax year of the CFC ends (Code Sec. 951A(e)(1), as added by the 2017 Tax Cuts Act). A person is treated as a U.S. shareholder of a CFC only if the person owns, within the meaning ofCode Sec. 958(a) (direct or indirect ownership) stock in the foreign corporation on the last day of the tax year of the foreign corporation on which the foreign corporation is a CFC (Code Sec. 951A(e)(2), as added by the 2017 Tax Cuts Act). A foreign corporation is treated as a CFC for any tax year if the foreign corporation is a CFC at any time during the tax year (Code Sec. 951A(e)(3), as added by the 2017 Tax Cuts Act).

Foreign tax credit. Foreign tax credits are allowed for foreign income taxes paid on GILTI included in the gross income of a domestic corporation but the provision restricts this to 80 percent of the foreign income taxes paid. Under the provision, these are considered deemed-paid credits for taxes properly attributed to tested income and a separate foreign tax credit basket is created for GILTI (see¶725). No carryforward or carryback of excess taxes paid or accrued is permitted (Code Sec. 960(d), as added by the 2017 Tax Cuts Act).

Deduction for FDII and GILTI. The provision provides domestic corporations with reduced rates of U.S. tax on foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). For tax years beginning after December 31, 2017 and before January 1, 2026, the provision allows, as a deduction, generally, an amount equal to the sum of 37.5 percent of its FDII plus 50 percent of its GILTI, if any (Code Sec. 250(a)(1), as added by the 2017 Tax Cuts Act). For tax years beginning after December 31, 2025, the deduction for FDII is 21.875 percent and 37.5 percent for GILTI (Code Sec. 250(a)(3), as added by the 2017 Tax Cuts Act). The amount of the deduction is limited based on taxable income. If the

sum of a domestic corporation's FDII and GILTI amounts exceeds its taxable income, then the amount of the FDII and GILTI deduction is similarly reduced by an amount determined by the excess (Code Sec. 250(b)(2), as added by the 2017 Tax Cuts Act).

FDII defined. A domestic corporation's foreign-derived intangible income (FDII) is the portion of its intangible income, determined according to a codified formula, that is derived from serving foreign markets, meaning, income derived in connection with property that is sold by the taxpayer to any person who is not a U.S. person and that such property is for foreign use, consumption or disposition that is not within the United States (Code Sec. 250(b), as added by the 2017 Tax Cuts Act).

A domestic corporation's FDII is generally its deemed intangible income multiplied by the percentage of its deduction-eligible income that is foreign derived: FDII = Deemed Intangible Income x Foreign-Derived Deduction Eligible Income over Deduction Eligible Income, where deduction eligible income means the excess of the gross income of the domestic corporation over deductions (including taxes) properly allocated to gross income (Code Sec. 250(b)(3), as added by the 2017 Tax Cuts Act). This is determined without taking into account certain exceptions to deduction eligible income. These exceptions include:

- Subpart F income of the corporation determined under Code Sec. 951;
- GILTI of the corporation;
- Financial services income of the corporation;
- Dividends received from a CFC with respect to which the corporation is a U.S. shareholder;
- Domestic oil and gas extraction income of the corporation; and
- Foreign branch income of the corporation.

Foreign-derived deduction eligible income means deduction eligible income derived in connection with (1) property sold by the taxpayer to any person who is not a U.S. person if the taxpayer satisfies the IRS that the property was for foreign use, and (2) services provided by the taxpayer if the taxpayer satisfies the IRS that the services are provided to any person or with respect to any property not located in the United States (Code Sec. 250(b)(4), as added by the 2017 Tax Cuts Act). Special rules apply for purposes of determining foreign use, including rules for related parties (Code Sec. 250(b)(5), as added by the 2017 Tax Cuts Act).

Deemed intangible income is the excess of the deduction eligible income over the deemed tangible income return of the corporation (Code Sec. 250(b)(2), as added by the 2017 Tax Cuts Act).

The Treasury may issue regulations or other guidance as necessary (Code Sec. 250(c), as added by the 2017 Tax Cuts Act) (Code Sec. 250(c), as added by the 2017 Tax Cuts Act).

COMMENT

According to clarifications and modifications provided in the Conference Agreement, the deduction for FDII and GILTI is only available to C corporations that are not RICs or REITs. Further, the deduction for GILTI applies to the amount treated as a dividend received by a domestic corporation under Code Sec. 78 that is attributable to the corporation's GILTI amount under new Code Sec. 951A (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Effective date. The GILTI provisions apply to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end (Act Sec. 14201(d) of the Tax Cuts and Jobs Act). The deduction for foreign-derived intangible income and GILTI provisions apply to tax years beginning after December 31, 2017 (Act Sec. 14202(c) of the 2017 Tax Cuts Act).

¶737 Foreign Base Company Oil Related Income

NEW LAW EXPLAINED

Foreign base company oil related income eliminated from foreign base company income.— Foreign oil related income is eliminated as a category of foreign base company income. Thus, U.S. shareholders of controlled foreign corporations (CFCs) are no longer required to include this type of income in gross income as subpart F income (Code Sec. 954(a), as amended by the Tax Cuts and Jobs Act). Foreign base company oil related income was defined as income of a foreign corporation and large oil producer (i.e., producer of 1,000 barrels a day or more) that is foreign oil related income (FORI), defined in Code Sec. 907(c)(2) and (c)(3). Foreign base company oil related income did not include oil related income of a CFC from sources within a foreign country where the oil or gas was extracted (extraction exception) or within the foreign country where the oil or gas is used or consumed (or is loaded in the foreign country on a vessel or aircraft as fuel for the vessel or aircraft) (use or consumption exception) (Code Sec. 954(g), prior to being stricken by the 2017 Tax Cuts and Jobs Act).

COMMENT

According to the House Committee Report, the foreign base company oil related income rules were not necessary in the context of the other international tax reforms. Moving to the participation exemption system could put U.S. oil and gas companies at a competitive disadvantage because of the loss of the Code Sec. 902 credit (see ¶705). Additionally, separate anti-base erosion rules under the bill (see ¶750 et seq.) make the separate anti-base erosion rules for oil and gas operations unnecessary (House Committee Report for the Tax Cuts and Jobs Act) (H. R. Rep. No. 115-409)).

Effective date. The amendments made by this section apply to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders with or within which such tax years of foreign corporations end (Act Sec. 14211(c) of the Tax Cuts and Jobs Act).

¶741 Subpart F Inclusions for Withdrawal of Qualified Investments

NEW LAW EXPLAINED

Subpart F inclusions for withdrawal of qualified investments repealed.—The provision repeals Code Sec. 955, which provides rules for determining a U.S. shareholder's pro rata share of the controlled foreign corporation's previously excluded subpart F income withdrawn from qualified investment in foreign base shipping operations (Act Sec. 14212(a) of the Tax Cuts and Jobs Act), striking Code Sec. 955). The U.S. shareholder's corresponding subpart F inclusion for the decrease in investment in foreign base company shipping operations is repealed. Also repealed are the provisions requiring a subpart F inclusion for: (1) a U.S. shareholder's pro rata share of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries, and (2) a decrease in export trade assets, with respect to deferred export trade income (Code Sec. 951(a)(1)(A), as amended by the 2017 Tax Cuts Act and Act Sec. 14213(b)(5), striking Code Sec. 970(b)).

COMMENT

The House Committee Report states that because foreign base company shipping income is no longer taxed under Subpart F, a corresponding decrease in the CFC's investment should not result in an income inclusion for a U.S. shareholder of the CFC (House Committee Report for the Tax Cuts and Jobs Act) (H. R. Rep. No. 115-409)).

Effective date. The amendments made by this section apply to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end (Act Sec. 14212(c) of the Tax Cuts and Jobs Act).

¶743 CFC Stock Attribution Rules

NEW LAW EXPLAINED

CFC constructive stock ownership attribution rule modified.— The modified constructive ownership rule of Code Sec. 958(b)(4), which precludes the attribution rules of Code Sec. 318(a)(3) from applying when stock of a foreign person would be treated as owned by a U.S. person, is eliminated. Elimination of this provision allows for the downward attribution of stock ownership from a foreign person to a related U.S. person (Code Sec. 958(b), as amended by the Tax Cuts and Jobs Act).

EXAMPLE

Foreign Corporation A owns 100 percent of one class of stock of Domestic Corporation B and 100 percent of one class of stock of another Foreign Corporation C. Under the constructive ownership rule, Domestic Corporation B is considered as owning the stock owned by its sole shareholder Foreign Corporation A, in Foreign Corporation C.

COMMENT

According to the Conference Committee Report, the reason for modifying the constructive stock ownership rule is to prevent the avoidance of the subpart F rules by turning off the constructive stock ownership rules that would otherwise treat a U.S. person as owning the stock of a foreign person. This type of avoidance transaction converts former CFCs to non-CFCs despite continuous ownership by U.S. shareholders (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)). The subpart F inclusion amount continues to be determined based on direct or indirect ownership of the CFC, without application of the new downward attribution rule.

Effective date. The amendments made by this section apply to: (1) the last tax year of foreign corporations beginning in January 1, 2018, and each subsequent tax year of such foreign corporations, and (2) tax years of U.S. shareholders in which or with which such tax years of foreign corporations end (Act Sec. 14213(b) of the Tax Cuts and Jobs Act).

¶745 Definition of U.S. Shareholder

NEW LAW EXPLAINED

Definition of U.S. shareholder expanded.— The definition of a U.S. shareholder is expanded to include a U.S. shareholder who owns 10 percent or more of the foreign corporation's stock by value. A U.S. shareholder is defined as any U.S. person who owns directly, indirectly, or constructively: (1) 10 percent or more of the total combined voting power of all classes of stock of the foreign corporation, or (2) 10 percent or more of the total value of shares of all classes of stock of the foreign corporation (Code Sec. 951(b), as amended by the Tax Cuts and Jobs Act). The definition of a U.S. shareholder also applies for purposes of Title 26, and not just the subpart F provisions (Act Sec. 14101(e)(1) of the 2017 Tax Cuts Act, amending Code Sec. 951(b)).

COMMENT

Expanding the definition of U.S. shareholder also expands the number of shareholders who will be subject to the subpart F rules. The definition of a U.S. shareholder now corresponds to the definition of a CFC in Code Sec. 957(a), which looks to vote or value.

See ¶747 for a discussion of the elimination of the 30-day required period of CFC status.

Effective date. The amendment made by this section applies to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders with or within which such tax years of foreign corporations end (Act Sec. 14214(b) of the Tax Cuts and Jobs Act).

¶747 Required Period of CFC Status

NEW LAW EXPLAINED

Required period of CFC status eliminated.— In determining whether a U.S. shareholder is required to include amounts in income under subpart F, the required period that the controlled foreign corporation (CFC) must be controlled by U.S. shareholders is eliminated (Code Sec. 951(a)(1), as amended by the Tax Cuts and Jobs Act). The foreign corporation is no longer required to be a CFC for an uninterrupted period of 30 days or more during the tax year. Instead, if the foreign corporation is a CFC at any time during the tax year, U.S. shareholders must include amounts in income under subpart F.

COMMENT

The provision now corresponds to the definition of a CFC in Code Sec. 957, which only requires that the stock ownership requirements be met on any day during the tax year. The House Committee Report states that the original purpose of the provision to facilitate tax administration is no longer necessary in light of technology that tracks owner and corporate tax attributes on a daily basis. It also states that the rule presents opportunities for taxpayers to structure transactions to avoid tax (House Committee Report for the Tax Cuts and Jobs Act) (H. Rept. 115-409)).

See¶745 for a discussion of the expanded definition of a U.S. shareholder.

Effective date. The amendment made by this section applies to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders with or within which such tax years of foreign corporations end (Act Sec. 14215(b) of the Tax Cuts and Jobs Act).

BASE EROSION PREVENTION

¶750 Base Erosion and Anti-Abuse Tax

NEW LAW EXPLAINED

Tax on base erosion payments of taxpayers with substantial gross receipts imposed.— Applicable taxpayers are required to pay for any tax year a tax equal to the base erosion minimum tax amount for the year. The tax is paid in addition to any other income taxes imposed under Subtitle A of the Code (Code Sec. 59A(a), as added by the Tax Cuts and Jobs Act of 2017).

The base erosion minimum tax amount for any tax year is the excess, if any, of:

1) 10 percent (five percent for tax years beginning in calendar year 2018) of the modified taxable income of the taxpayer for the tax year, over
2) the regular tax liability for the tax year reduced (but not below zero) by the excess, if any, of:
    a) the credits allowed against regular tax liability under Chapter 1 of the Code, over
    b) the sum of (i) the credit allowed under Code Sec. 38 (the general business credit) that is allocable to the research credit determined under Code Sec. 41(a), plus (ii) the portion of the applicable Code Sec. 38 credits that do not exceed 80 percent of the lesser of the amounts of those credits or the base erosion minimum tax amount (Code Sec. 59A(b)(1), as added by the 2017 Tax Cuts Act).

For tax years beginning after December 31, 2025, for purposes of determining the base erosion minimum tax amount, the 10-percent rate is increased to 12.5 percent of the taxpayer's modified taxable income and the regular tax liability is reduced (but not below zero) by the aggregate amount of allowable credits, rather than the excess described in item (2), above, (Code Sec. 59A(b)(2), as added by the Tax Cuts and Jobs Act).

Applicable taxpayers that are members of an affiliated group that includes a bank or registered securities dealer under section 15(a) of the Securities Exchange Act of 1934 are subject to an additional increase of one percentage point in the tax rates, discussed above (i.e., 11 percent for tax years prior to December 31, 2025, and 13.5 percent for tax years beginning after December 31, 2025) (Code Sec. 59A(b)(3), as added by the 2017 Tax Cuts Act).

For purposes of the above computation, the applicable Code Sec. 38 credits are the credits allowed under Code Sec. 38 for the tax year that are properly allocable to:

1) the low-income housing credit under Code Sec. 42(a);
2) the low-income housing credit under Code Sec. 42(a);
3) the investment credit under Code Sec. 46, but only to the extent it is properly allocable to the Code Sec. 48 energy credit (Code Sec. 59A(b)(4), as added by the 2017 Tax Cuts Act).

An applicable taxpayer's modified taxable income is determined by computing the taxpayer's taxable income under Chapter 1 for the tax year without regard to (i) any base erosion tax benefit with respect to any base erosion payment, or (ii) the base erosion percentage of any net operating loss deduction allowed under Code Sec. 172 for the tax year (Code Sec. 59A(c)(1), as added by the 2017 Tax Cuts Act).

Base erosion payment. A base erosion payment is any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable under Chapter 1 of the Code (Code Sec. 59A(d)(1), as added by the 2017 Tax Cuts Act). These payments include any amount paid or accrued by the taxpayer to the related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance of depreciation (or amortization in lieu of depreciation) (Code Sec. 59A(d)(2), as added by the 2017 Tax Cuts Act). A base erosion payment also includes any premium or other consideration paid or accrued by the taxpayer to a foreign person that is a related party of the taxpayer for any reinsurance payments

taken into account under Code Secs. 803(a)(1)(B) or 832(b)(4)(A) (Code Sec. 59A(d)(3), as added by the 2017 Tax Cuts Act).

COMMENT

Base erosion payments generally do not include any amount that constitutes reductions in gross receipts including payments for costs of goods sold (COGS). However, an exception applies for certain payments to expatriated entities, described below.

Base erosion payments include any amount that results in a reduction of gross receipts of the taxpayer that is paid or accrued by the taxpayer with respect to: (1) a surrogate foreign corporation that is a related party of the taxpayer, but only if such corporation first became a surrogate foreign corporation after November 9, 2017, or (2) a foreign person that is a member of the surrogate foreign corporation's expanded affiliated group (EAG) (Code Sec. 59A(d)(4), as added by the 2017 Tax Cuts Act).

PRACTICE NOTE

For this purpose, a surrogate foreign corporation is a foreign corporation that: (1) acquires (after March 4, 2003) substantially all of the properties held by a U.S. corporation, or substantially all of the properties constituting a trade or business of a domestic partnership, (2) after the acquisition, the U.S. corporation's former shareholders or the domestic partnership's former partners, own at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation, and (3) the surrogate foreign corporation's EAG does not have substantial business activities in the country where that corporation is organized or created compared to the total business activities of the EAG (Code Sec. 7874(a)(2)(B)). A surrogate foreign corporation does not include a foreign corporation treated as a domestic corporation under Code Sec. 7874(b) (where the former shareholders of the U.S. corporation or the former partners of the domestic partnership hold 80 percent or more (by vote or value) of the stock of the foreign acquiring corporation after the transaction). The EAG includes the foreign acquiring corporation and all companies connected to it by a chain of greater than 50-percent ownership (Code Sec. 7874(c)(1)).

A base erosion payment does not include any amount paid or accrued by a taxpayer for services, if such services meet the requirements for eligibility for use of the services cost method described in Reg. §1.482-9, determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure, and if the payments are made for services that have no markup component (Code Sec. 59A(d)(5), as added by the 2017 Tax Cuts Act).

Exception for certain payments in the ordinary course of trade or business. There is an exception provided for some types of payments made in the ordinary course of a trade or business. Under this exception, qualified derivative payments are generally not treated as base erosion payments (Code Sec. 59A(h)(1), as added by the 2017 Tax Cuts Act).

A qualified derivative payment is any payment made by a taxpayer pursuant to a derivative where the taxpayer:

1) recognizes gain or loss as if the derivative were sold for its fair market value (FMV) on the last business day of the tax year (and at additional times that are required by Title 26 or the taxpayer's method of accounting),
2) treats any gain or loss recognized as ordinary, and
3) treats the character of all items of income, deduction, gain or loss regarding a payment pursuant to the derivative as ordinary (Code Sec. 59A(h)(2)(A), as added by the 2017 Tax Cuts Act).

Payments are not treated as qualified derivative payments unless the taxpayer includes in the information required to be reported under Code Sec. 6038B(b)(2) information that is necessary to identify which

payments are to be treated as qualified derivative payments and such other information as the Secretary of the Treasury determines necessary (Code Sec. 59A(h)(2)(B), as added by the 2017 Tax Cuts Act).

The rule for qualified derivative payments does not apply if the payment would be treated as a base erosion payment if it was not made pursuant to a derivative (including royalty, interest or service payments) or where a contract has derivative and nonderivative component and the payment is allocable to the nonderivative component (Code Sec. 59A(h)(3), as added by the 2017 Tax Cuts Act).

For these purposes, a derivative is any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) whose value, or any payment or other transfer with respect to said contract, is (directly or indirectly) determined by reference to one or more of the following:

1) any share of stock of a corporation,
2) any evidence of indebtedness,
3) any commodity which is actively traded,
4) any currency,
5) any rate, price, amount, index, formula, or algorithm (Code Sec. 59A(h)(4)(A), as added by the 2017 Tax Cuts Act).

However, a derivative does not include any item described in items (1) through (5), above.

Except as otherwise provided by the Secretary, American depository receipts (and similar instruments), with respect to shares of stock in foreign corporations, are treated as shares of stock in such foreign corporations for purposes of Part VII, Subchapter A of Chapter 1 (Code Sec. 59A(h)(4)(B), as added by the 2017 Tax Cuts Act).

In addition, a derivative does not include any insurance, annuity, or endowment contract issued by an insurance company (to which subchapter L applies) or issued by any foreign corporation where subchapter L would apply if such foreign corporation were a domestic corporation (Code Sec. 59A(h)(4)(C), as added by the 2017 Tax Cuts Act).

Base erosion tax benefit. A base erosion tax benefit includes:

1) any deduction allowed under Chapter 1 for the tax year with respect to any base erosion payment;

2) for base erosion payments made to purchase property subject to depreciation (or amortization in lieu of depreciation), any deduction allowed in Chapter 1 for depreciation (or amortization in lieu of depreciation) for the tax year with respect to the property acquired with the payment;

3) in the case of reinsurance payments, any reduction under Code Sec. 803(a)(1)(B) for the gross amounts or premiums or other consideration on insurance, annuity contracts or indemnity insurance, and any deduction under Code Sec. 832(b)(4)(A) from the amount of gross premiums written on insurance contracts during the tax year for the premiums paid for reinsurance; and

4) in the case of a payment to with respect to a surrogate foreign corporation or a foreign member of that corporation's expanded affiliated group, any reduction in gross receipts with respect to that payment in computing the taxpayer's gross income for the tax year (Code Sec. 59A(c)(2)(A), as added by the 2017 Tax Cuts Act).

The base erosion tax benefit attributable to any base erosion payment on which tax is imposed by Code Secs. 871 and 881, and with respect to which tax has been deducted and withheld under Code Secs. 1441 and 1442, is not taken into account in computing modified taxable income. However, the amount not taken into account in computing modified taxable income is reduced under rules similar to the rules under Code Sec. 163(j)(5)(B), as in effect before December 22, 2017, the date of the enactment of the 2017 Tax Cuts Act (which determines whether interest is treated as tax-exempt to the extent of a treaty reduction) (Code Sec. 59A(c)(2)(B), as added by the 2017 Tax Cuts Act).

For purposes of determining an applicable taxpayer's modified taxable income, in the case of a taxpayer to which Code Sec. 163(j) applies for the tax year, the reduction in the amount of interest for which a

deduction is allowed by reason of that provision is treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to related parties (Code Sec. 59A(c)(3), as added by the 2017 Tax Cuts Act).

Base erosion percentage. The base erosion percentage is the percentage, for any tax year, that is determined by dividing:

1) the aggregate amount of base erosion tax benefits of the taxpayer for the tax year, by
2) the aggregate amount of the deductions allowable to the taxpayer for the tax year, taking into account the base erosion tax benefits and disregarding (i) any deduction allowed under Code Secs. 172, 245A or 250 for the tax year, (ii) any deduction for amounts paid or accrued for services to which the exception for the services cost method (described in Reg. §1.482-9) applies, and (iii) any deduction for qualified derivative payments that are not treated as a base erosion payment (Code Sec. 59A(c)(4), as added by the 2017 Tax Cuts Act).

Applicable taxpayer. The base erosion tax applies to applicable taxpayers. Applicable taxpayers include corporations, other than a regulated investment company (RIC), a real estate investment trust (REIT), or an S corporation, that have average annual gross receipts of at least $500 million over the past three tax years and a base erosion percentage of three percent for the tax year (two percent for taxpayers that are members of an affiliated group that includes a bank or registered securities dealer) (Code Sec. 59A(e)(1), as added by the 2017 Tax Cuts Act).

In the case of a foreign person (that is, any person who is not a U.S. person) the gross receipts of which are taken into account for purposes of this provision, the gross receipts test described above generally only takes into account gross receipts that are taken into account in determining ECI. This rule does not apply to the gross receipts of any U.S. person that are aggregated with the gross receipts of a foreign person under the aggregation rules, discussed below. In determining gross receipts, rules similar to the rules of Code Sec. 448(c)(3)(B), (C), and (D) apply (Code Sec. 59A(e)(2), and (f), as added by the 2017 Tax Cuts Act).

Under the aggregation rules, persons treated as a single employer under Code Sec. 52(a) are treated as one person for purposes of determining the average annual gross receipts and the base erosion percentage, except that the exception for foreign corporations under Code Sec. 1563(b)(2)(C) is disregarded (Code Sec. 59A(e)(3), as added by the 2017 Tax Cuts Act).

COMMENT

Accordingly, if a foreign person's gross receipts are aggregated with a U.S. person's gross receipts, the gross receipts of the U.S. person that are aggregated with the foreign person's gross receipts are not limited to the gross receipts taken into account in determining ECI.

Related party. For purposes of the base erosion tax rules, a related party is (i) any 25-percent owner (of the vote or value) of the taxpayer, (ii) any person who is related to the taxpayer, or to any 25-percent owner (of the vote or value) of the taxpayer, within the meaning of Code Secs. 267(b) or 707(b)(1), and (iii) any other person related to the taxpayer within the meaning of Code Sec. 482 (Code Sec. 59A(g)(1), as added by the 2017 Tax Cuts Act).

A 25-percent owner with respect to any corporation is any person who owns at least 25 percent of (i) the total voting power of all classes of stock of a corporation entitled to vote, or (ii) the total value of all classes of stock of the corporation (Code Sec. 59A(g)(2), as added by the 2017 Tax Cuts Act).

For purposes determining a related party, the Code Sec. 318 constructive stock ownership rules apply to these related party rules except that "10-percent" is substituted for "50-percent" in Code Sec. 318(a)(2)(C), and Code Secs. 318(a)(3)(A), (B) and (C) do not apply to cause a U.S. person to own stock owned by a person who is not a U.S. person (Code Sec. 59A(g)(3), as added by the 2017 Tax Cuts Act).

Regulatory authority. The Secretary of the Treasury is authorized to prescribe such regulations or other guidance as may be necessary or appropriate to carry out this provision, including regulations providing

for such adjustments to the application of this provision necessary to prevent avoidance of the provision, including through: (1) the use of unrelated persons, conduit transactions, or other intermediaries, or (2) transactions or arrangements designed in whole or in part: (a) to characterize payments otherwise subject to this provision as payments not subject to this provision, or (b) to substitute payments not subject to this provision for payments otherwise subject to this provision. The regulations or other guidance may also include regulations for the application of the related party rules, including rules to prevent the avoidance of the exceptions to the application of Code Sec. 318 (Code Sec. 59A(i), as added by the 2017 Tax Cuts Act).

Reporting requirements and penalties. The Secretary of the Treasury is authorized to prescribe additional reporting requirements under Code Sec. 6038A relating to: (i) the name, principal place of business, and country or countries in which organized or resident of each person that is a related party to the reporting corporation, and that had any transaction with the reporting corporation during its tax year, (ii) the manner of relation between the reporting corporation and the person referred to in (i), and (iii) the transactions between the reporting corporation and each related foreign person (Code Sec. 6038A(b)(1), as amended by the 2017 Tax Cuts Act).

Additional information is required regarding base erosion payments. Specifically, for purposes of information reporting under Code Secs. 6038A and 6038C, if the reporting corporation or the foreign corporation to which Code Sec. 6038C applies is an applicable taxpayer, the information that may be required includes: (i) information that the Secretary determines necessary to determine the base erosion minimum tax amount, base erosion payments, and base erosion tax benefits of the taxpayer for purposes of Code Sec. 59A for the tax year, and (ii) such other information as the Secretary of the Treasury determines is necessary. For these purposes, any term used in this provision and Code Sec. 59A has the meaning as when used in Code Sec. 59A (Code Sec. 6038A(b)(2), as amended by the 2017 Tax Cuts Act).

The $10,000 penalties for failure to furnish information or maintain records provided in Code Sec. 6038A(d)(1) and (2) are both increased to $25,000 (Code Sec. 6038A(d)(1) and (2), as amended by the 2017 Tax Cuts Act).

Other changes. The base erosion and anti-abuse tax of Code Sec. 59A is excluded from regular tax liability for purposes of the limitation on nonrefundable personal credits (Code Sec. 26(b)(2)(B), as added by the 2017 Tax Cuts Act). The new law also clarifies that a foreign corporation engaged in a trade or business within the United States during the tax year is subject to tax under Code Secs. 11 and 59A on its taxable income that is effectively connected with the conduct of a U.S. trade or business (Code Sec. 882(a)(1), as amended by the 2017 Tax Cuts Act). In addition, for purposes of the rules allowing a corporation to apply for a quick refund of an overpayment of estimated tax and the rules for estimated tax payments by corporations, income tax liability also includes the Code Sec. 59A base erosion tax (Code Sec. 6425(c)(1)(A) and Code Sec. 6655(g)(1)(A), (e)(2)(A) and (e)(2)(B), as amended by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section apply to base erosion payments (as defined in Code Sec. 59A(d), as added by the Tax Cuts and Jobs Act of 2017) paid or accrued in tax years beginning after December 31, 2017 (Act Sec. 14401(e) of the 2017 Tax Cuts Act).

¶755 Limits on Income Shifting Through Intangible Property Transfers

NEW LAW EXPLAINED

Intangible property definition modified and allowable valuation methods clarified.— The scope of the statutory definition of intangible property is revised to include goodwill, going concern value, and workforce in place as well as a residual category of any other item the value or potential value of which is not attributable to tangible property or services of any individual. In addition, the requirement that each specific type of intangible property have substantial value independent of the services of any individual is removed so that the source or amount of value is no longer relevant in determining whether that property is within the scope of the definition (Code Sec. 936(h)(3)(B), as amended by the Tax Cuts and Jobs Act).

In addition, the new law clarifies the authority of the Secretary of the Treasury to specify the method to be used to determine the value of intangible property in the context of both Code Sec. 367(d) transfers as part of outbound restructurings of U.S. operations and Code Sec. 482 intercompany pricing allocations by authorizing the use of the aggregate basis valuation and the application of the realistic alternative principle. Specifically, the Secretary will require (i) the valuation of transfers of intangible property, including intangible property transferred with other property or services, on an aggregate basis, or (ii) the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers (Code Sec. 367(d)(2)(D), as added by the 2017 Tax Cuts Act; Code Sec. 482, as amended by the 2017 Tax Cuts Act). In the Code Sec. 367(d)(2) context, the use of these valuation methods is required for purposes of determining if the annual amounts taken into account are commensurate with the income attributable to the intangible.

COMMENT

Accordingly, the use of the aggregate basis valuation method is required in the case of transfers of multiple intangible properties in one or more related transactions if the Secretary determines that an aggregate basis achieves a more reliable result than an asset-by-asset approach. This is consistent with the position that the additional value resulting from the interrelation of intangible assets can be properly attributed to the underlying intangible assets in the aggregate, if doing so produces a more reliable result. This approach is also consistent with the cost-sharing regulations in Reg. §1.482-7(g)(2)(iv).

COMMENT

The provision codifies the realistic alternative principle, which is based on the concept that a taxpayer would only enter into a transaction if none of its realistic alternatives were economically preferable to the transaction undertaken.

Effective date. The amendments made by this section apply to transfers in tax years beginning after December 31, 2017. Nothing in the amendment to the Code Sec. 936(h)(3)(B) definition of intangible property will be construed to create any inference with respect to the application of Code Sec. 936(h)(3) or the authority of the Secretary of the Treasury to provide regulations for such application, with respect to tax years beginning before January 1, 2018 (Act Sec. 14221(c) of the Tax Cuts and Jobs Act).

¶760 Related Party Payments Involving Hybrid Entities or Hybrid Transactions

NEW LAW EXPLAINED

Deduction for disqualified related party payments involving hybrid transactions or hybrid entities denied.—A deduction is disallowed for a disqualified related party amount paid or accrued pursuant to a hybrid transaction. A deduction is also disallowed for a disqualified related party amount paid or accrued by, or to, a hybrid entity (Reg. §267A(a), as added by the Tax Cuts and Jobs Act of 2017).

Any interest or royalty paid or accrued to a related party is a "disqualified related party amount" to the extent that under the tax law of the country where the related party is a resident for tax purposes or is subject to tax:

- the amount is not included in the income of the related party , or
- the related party is allowed a deduction for the amount (Code Sec. 267A(b)(1), as added the 2017 Tax Cust Act).

A disqualified related party amount does not include any payment that is included in the gross income of a U.S. shareholder under subpart F and Code Sec. 951(a).

A "related party" means a related person as defined under Code Sec. 954(d)(3), except that the person is related to the payor rather than a controlled foreign corporation (CFC) (Code Sec. 267A(b)(2), as added by the 2017 Tax Cuts Act). Thus, a related person includes any individual, corporation, partnership, trust, or estate, that directly or indirectly, controls or is controlled by the payor (or is controlled by the same person that controls the payor). Control is ownership of more than 50 percent (by vote or value) of the corporation's stock or more than a 50 percent (by value) of the beneficial interests in a partnership, trust or estate.

EXAMPLE

Foreign Corporation owns two U.S. subsidiaries, a C corporation and an LLC. The LLC is treated as a partnership for U.S. tax purposes and a corporation for foreign tax purposes. Interest is paid by the C corporation to the LLC. The interest payment flows through LLC to the Foreign Corporation as a dividend and is excluded from tax under foreign country tax. The payment of the interest may not be deducted by the C corporation because the payment is a disqualified related party amount. Interest is paid to the Foreign Corporation, which controls the payor C corporation and so is a related party. The amount is not included in the income of the Foreign Corporation under the tax laws of the Foreign Corporation.

Hybrid transaction. A hybrid transaction means any transaction, series of transactions, agreement, or instrument, if one or more payments are treated as interest or royalties for federal income tax purposes, but are not treated as such for purposes of the tax law of the foreign country where the recipient of the payment is resident for tax purposes or is subject to tax (Code Sec. 267A(c), as added by the 2017 Tax Cuts Act).

Hybrid entity. A hybrid entity means any entity that is either:

1) treated as fiscally transparent for federal income tax purposes, but not under the tax law of the foreign country where the entity is resident for tax purposes or is subject to tax, or
2) treated as fiscally transparent under the tax law of the foreign country where the entity is resident for tax purposes or is subject to tax, but not for federal income tax purposes (Code Sec. 267A(d), as added by the 2017 Tax Cuts Act).

Regulations. The Secretary is authorized under Code Sec. 267A to issue regulations or other guidance as necessary and appropriate to carry out this provision, including regulations or other guidance providing rules for:

1) denying deductions for conduit arrangements involving a hybrid transaction or hybrid entity;
2) the application of this provision to foreign branches;
3) applying this provision to certain structured transactions;
4) denying all or a portion of 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 percent;
5) denying all of a deduction claimed for an interest or a royalty payment if the amount is subject to a participation exemption system or other system providing for the exclusion or deduction of a substantial portion of the amount;
6) rules for determining the tax residence of a foreign entity if the foreign entity is otherwise considered a resident of more than one country or of no country;
7) exceptions to the general rule set forth in the provision; and
8) requirements for record keeping and information in addition to any requirements imposed by Code Sec. 6038A (Code Sec. 276A(e), as added by the 2017 Tax Cuts Act).

Effective date. The amendment made by this section applies to tax years beginning after December 31, 2017 (Act Sec. 14222(c) of the Tax Cuts and Jobs Act).

¶765 Surrogate Foreign Corporation Dividends

NEW LAW EXPLAINED

Dividends from surrogate foreign corporations excluded from reduced rate.—Surrogate foreign corporations that are not treated as domestic corporations under Code Sec. 7874(b) are excluded from the meaning of qualified foreign corporation (Code Sec. 1(h)(11)(C)(iii), as amended by the Tax Cuts and Jobs Act). Generally, a surrogate foreign corporation is a foreign corporation that: (1) acquires (after March 4, 2003) substantially all of the properties held by a U.S. corporation, (2) after the acquisition the U.S. corporation's former shareholders own at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation and (3) the expanded affiliated group does not have substantial business activities in the country where the entity is organized or created compared to the total business activities of the expanded affiliated group (Code Sec. 7874(a)(2)(B)). Therefore, dividends paid after December 22, 2017, by surrogate foreign corporations that are not treated as domestic corporations under Code Sec. 7874(b), do not qualify as qualified dividend income under Code Sec. 1(h)(11)(B)(i) Code Sec. 1(h)(11)(C)(iii), as amended by the 2017 Tax Cuts Act). As such, dividends paid to shareholders after December 22, 2017, by surrogate foreign corporations that are not treated as domestic corporations under Code Sec. 7874(b) are ineligible for the reduced tax rate applicable to qualified dividends.

COMMENT

The Senate Budget Committee's explanation of the tax reform bill states that while reduced tax rates on dividends are meant to encourage equity investments, the Committee does not believe that investments in surrogate foreign corporations fits within this parameter (JCX-56R-17)

Effective date. The amendments made by this section apply to dividends paid after December 22, 2017, the date of enactment (Act Sec. 14223(b) of the Tax Cuts and Jobs Act of 2017).

¶770 Stock Compensation Excise Tax on Insiders in Expatriated Corporations

NEW LAW EXPLAINED

Excise tax on stock compensation of insiders in expatriated corporations increased.—The excise tax rate on stock compensation received by insiders in an expatriated corporation is increased from 15 percent to 20 percent, effective on the date of enactment for corporations that first become expatriated after that date. (Code Sec. 4985(a)(1), as amended by the Tax Cuts and Jobs Act).

Effective date. The amendment made by this section applies to corporations first becoming expatriated corporations after December 22, 22017 the date of enactment of this Act (Act Sec. 13604(b) of the Tax Cuts and Jobs Act).

OTHER INTERNATIONAL REFORMS

¶775 Insurance Business Exception to the Passive Foreign Investment Company Rules

NEW LAW EXPLAINED

Insurance business exception to PFIC rules modified.—The insurance business exception to the definition of passive income for the passive foreign investment company (PFIC) rules is modified for tax years beginning after December 31, 2017 (Code Sec. 1297(b)(2)(B), as amended by the Tax Cuts and Jobs Act). The test based on whether a corporation is predominantly engaged in an insurance business is replaced with a test based on the amount of the corporation's insurance liabilities (Code Sec. 1297(f)(1), as added by the 2017 Tax Cuts Act; Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Except as provided in regulations, the term "passive income" does not include any income derived in the active conduct of an insurance business by a qualifying insurance corporation (Code Sec. 1297(b)(2)(B), as amended by the 2017 Tax Cuts Act). With respect to any tax year, a "qualifying insurance corporation" is a foreign corporation that:

1) would be subject to tax under subchapter L of the Internal Revenue Code if the corporation were a domestic corporation; and
2) has applicable insurance liabilities that are more than 25 percent of its total assets, determined on the basis of the insurance liabilities and total assets reported on the corporation's applicable financial statement for the last year ending with or within the tax year (Code Sec. 1297(f)(1), as added by the 2017 Tax Cuts Act).

A foreign corporation that fails to qualify as an insurance corporation because it does not have applicable insurance liabilities that are more than 25 percent of its total assets can apply an alternative facts and circumstances test (see "Alternative facts and circumstances test", below).

Insurance liabilities, financial statement, insurance regulatory body defined. For purposes of the insurance business test, the "applicable insurance liabilities" of any life insurance or property and casualty insurance business are its:

1) loss and loss adjustment expenses; and
2) reserves, other than deficiency, contingency, or unearned premium reserves, for both life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks (Code Sec. 1297(f)(3), as added by the 2017 Tax Cuts Act).

The amount of any applicable insurance liability cannot exceed the lesser of such amount: (1) as reported to the applicable insurance regulatory body in the applicable financial statement (or, if less, the amount required by applicable law or regulation), or (2) as determined under regulations (Code Sec. 1297(f)(3)(B), as added by the 2017 Tax Cuts Act).

COMMENT

In determining an insurance company's applicable insurance liabilities, its reserves include loss reserves for property and casualty, life, and health insurance contracts and annuity contracts. However, unearned premium reserves with respect to any type of risk are not treated as applicable insurance liabilities (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

A corporation's "applicable financial statement" is a statement for financial reporting purposes that:

- is made on the basis of generally accepted accounting principles;
- is made on the basis of international financial reporting standards, if there is no statement that is made on the basis of generally accepted accounting principles; or
- unless otherwise provided in regulations, is the annual statement that must be filed with the applicable insurance regulatory body, if there is no statement that is made on the basis of generally accepted accounting principles or international financial reporting standards (Code Sec. 1297(f)(4)(A), as added by the 2017 Tax Cuts Act).

An "applicable insurance regulatory body" is the entity established by law to license, authorize or regulate an insurance business and to which the business files its applicable financial statement (Code Sec. 1297(f)(4)(B), as added by the 2017 Tax Cuts Act).

Alternative facts and circumstances test. If a corporation fails to qualify as a qualified insurance corporation solely because the percentage of its applicable insurance liabilities is 25 percent or less of its total assets, a U.S. person that owns stock in the corporation can elect to apply an alternative facts and circumstances test. Under the alternative facts and circumstances test, the U.S. person can elect to treat the stock as stock of a qualifying insurance corporation if:

(1) the percentage of the corporation's applicable insurance liabilities is at least 10 percent of its total assets; and

(2) based on the applicable facts and circumstances, the corporation is predominantly engaged in an insurance business and its failure to meet the more-than-25-percent threshold is due solely to run-off related or rating-related circumstances involving such insurance business (Code Sec. 1297(f)(2), as added by the 2017 Tax Cuts Act).

The applicable facts and circumstances for (2), above, would be determined under regulations to be provided by the IRS. Some of the facts and circumstances that tend to show that a corporation may not be predominantly engaged in an insurance business include a small number of insured risks with low likelihood but large potential costs; workers focused to a greater degree on investment activities than underwriting activities; and low loss exposure (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

A company is in "runoff" if it is not taking on new insurance business (and consequently has little or no premium income), and is using its remaining assets to pay off claims with respect to pre-existing insurance risks on its books (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 14501(c) of the Tax Cuts and Jobs Act).

¶780 Interest Expense Allocation and Apportionment

NEW LAW EXPLAINED

Fair market value method of interest expense allocation and apportionment eliminated.— Taxpayers may no longer use the fair market value method to allocate and apportion interest expense. All allocations and apportionments of interest expense must be determined using the adjusted basis of the assets. The use of gross income to allocate and apportion interest expense continues to be disallowed (Code Sec. 864(e)(2), as amended by the Tax Cuts and Jobs Act).

COMMENT

Use of the fair market value method required that certain documentation and information requirements be met (Rev. Proc. 2003-37). Use of this method was also more likely to result in disputes with the IRS. Electing the fair market value method, however, could result in an increase in foreign source taxable income, and therefore, foreign tax credit limitation, particularly if U.S. based assets have higher appreciated values than foreign assets. Use of the adjusted tax basis method, requires that assets located outside of the United States be depreciated using the alternative depreciation system (ADS) under Code Sec. 168(g). This method results in slower depreciation than that allowed under the Modified Accelerated Recovery System (MACRS), the method used for assets located in the United States. As a result, more interest expense is allocated to foreign source income, which can reduce foreign source taxable income and the taxpayer's foreign tax credit limitation. An election to use the alternative tax book value method under Reg. §1.861-9(i) allows a taxpayer to use the straight-line method, conventions and recovery periods for tangible property.

Effective date. The amendment made by this section applies to tax years beginning after December 31, 2017 (Act Sec. 14502(b) of the Tax Cuts and Jobs Act).

CHAPTER 8. EXEMPT ORGANIZATIONS, EXCISE TAXES, BONDS, AND OTHER PROVISIONS TAX-EXEMPT ORGANIZATIONS

¶805 Unrelated Business Taxable Income Separately Computed for Each Trade or Business Activity

NEW LAW EXPLAINED

Unrelated business taxable income must be separately calculated for each unrelated business.—A special rule has been added for exempt organizations that have unrelated business taxable income from operating more than one unrelated business. For all purposes including the calculating of any net operating loss deduction, the unrelated business taxable income of each trade or business will be determined separately and without regard to Code Sec. 512(b)(12), which generally permits a specific deduction of $1,000 (Code Sec. 512(a)(6)(A), as added by the Tax Cuts and Jobs Act).

The unrelated business taxable income of the exempt organization having more than one unrelated trade or business will be the sum of the unrelated business taxable income of those unrelated businesses, less the specific deduction permitted by Code Sec. 512(b)(12) (Code Sec. 512(a)(6)(B), as added by the 2017 Tax Cuts Act). However, such total cannot be less than zero (Code Sec. 512(a)(6)(C), as added by the 2017 Tax Cuts Act).

The effects of the new rule are to prevent a deduction from one unrelated trade or business from offsetting income from another unrelated business in the same tax year, and to prevent the specific $1,000 deduction from being claimed more than once in a tax year regardless of how many unrelated businesses an exempt organization may have (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466). It does not, however, prevent the carryover of unused deductions to subsequent tax years if they were previously permitted and so long as they are utilized by the same unrelated business that generated such deduction. A transition rule provides that net operating losses arising in tax years beginning before January 1, 2018, that are carried over to tax years beginning on or after January 1, 2018, will not be subject to this requirement (Act Sec. 13702(b)(2) of the 2017 Tax Cuts Act).

Effective date. This provision applies generally to tax years beginning after December 31, 2017 (Act Sec. 13702(b)(1) of the Tax Cuts and Jobs Act). For any NOL carryovers from tax years beginning before January 1, 2018, Code Sec. 512(a)(6)(A) will not apply to such NOL and the unrelated business taxable income of the exempt organization (after application of Code Sec. 512(a)(6)(B)) will be reduced by the amount of the NOL (Act Sec. 13702(b)(2) of the 2017 Tax Cuts Act).

¶807 Unrelated Business Taxable Income Increased by Certain Fringe Benefit Expenses

NEW LAW EXPLAINED

Disallowed fringe benefits treated as additions to unrelated income.—The unrelated business taxable income (UBTI) of an exempt organization will be increased by the nondeductible amount of certain fringe benefit expenses incurred by the organization in that tax year, effective for amounts paid or incurred after December 31, 2017 (Code Sec. 512(a)(7), as added by the Tax Cuts and Jobs Act). These fringe benefits are expenses for which a deduction is not available due to Code Sec. 274, and specifically include:

- any qualified transportation fringe, as defined in Code Sec. 132(f);
- any parking facility used in connection with qualified parking, as defined in Code Sec. 132(f)(5)(C); and
- any on-premises athletic facility, as defined in Code Sec. 132(j)(4)(B).

To the extent the amount paid or incurred is directly connected with an unrelated trade or business that is regularly carried on by the organization, such amounts will *not* increase an organization's UBTI (Code Sec. 512(a)(7), as added by the 2017 Tax Cuts Act). Thus, the increases to UBTI for disallowed fringe benefits are for expenses paid or incurred by the organization that are not associated with any unrelated business of the organization.

COMMENT

The increase in UBTI for certain fringe benefits is an *addition to* UBTI, rather than a change in the normal calculation of UBTI.

Regulations and other guidance. The IRS is directed to issue regulations or other guidance that may be necessary or appropriate to carry out the purposes of the rule on fringe benefit expenses, such as guidance on the appropriate allocation of depreciation and other costs of facilities used for parking or for on-premises athletic facilities (Code Sec. 512(a)(7), as added by the 2017 Tax Cuts Act).

Effective date. The amendment made by this provision applies to amounts paid or incurred after December 31, 2017 (Act Sec. 13703(b) of the Tax Cuts and Jobs Act).

¶810 Excise Tax on Excess Tax-Exempt Organization Executive Compensation

NEW LAW EXPLAINED

Excise tax applies to remuneration of highly-compensated exempt organization executives.—A tax-exempt organization will be liable within a tax year for a 21 percent excise tax (equal to the maximum corporate tax rate on income) on the sum of:

- "remuneration" paid to a covered employee in excess of $1 million (not including any excess parachute payment) by an "applicable tax-exempt organization", and
- any excess parachute payments made to a covered employee by that tax-exempt organization (Code Sec. 4960, as added by the Tax Cuts and Jobs Act of 2017).

It should be noted that an exempt organization can be liable for this tax even when a covered employee's remuneration is less than $1 million if there is an excess parachute payment.

For purposes of this excise tax, there is a new definition for parachute payments that is limited to the payment of compensation to a covered employee when such payment is contingent on:

- the employee's separation from employment with the tax-exempt employer, and
- the aggregate present value of the compensation payments being equal or in excess of an amount equal to three times the base amount (Code Sec. 4960(c)(5)(B), as added by the 2017 Tax Cuts Act).

The base amount is determined under Code Sec. 280G(b)(3). However, certain payments are excluded from calculating the aggregate present value, including:

- payments under qualified plans, as described in Code Sec. 280G(b)(6));
- payments made to or under a tax-deferred annuity contract as described in Code Sec. 403(b), or the deferred compensation plan of a government employer as described in Code Sec. 457(b);
- payments to a doctor, nurse, or veterinarian for the performance of medical or veterinarian professional services; and
- payments to an individual who is not a highly compensated employee as defined in Code Sec. 414(q) (Code Sec. 4960(c)(5)(C), as added by the 2017 Tax Cuts Act).

In addition, compensation will be considered to be paid when no substantial risk of forfeiture (as defined in Code Sec. 457(f)(3)(B)) exists (Code Sec. 4960(a), as added by the 2017 Tax Cuts Act). Therefore, such compensation may be considered paid when fully vested even if not yet actually paid.

An "applicable tax-exempt organization" is one that is exempt from taxation under Code Sec. 501(a), a farmers' cooperative under Code Sec. 521(b)(1), a political organization described in Code Sec. 527(e)(1), or an organization that has income excluded from taxation under Code Sec. 115(1) (Code Sec. 4960(c)(1), as added by the 2017 Tax Cuts Act).

For purposes of this provision, a "covered employee" includes any current or former employee of the applicable tax-exempt organization that is one of the five highest compensated employees for the current tax year, or a covered employee of the organization (or any predecessor organization) for any preceding tax year that began after December 31, 2016 (Code Sec. 4960(c)(2), as added by the 2017 Tax Cuts Act).

"Remuneration" generally means wages, as defined in Code Sec. 3401(a). Remuneration, for purposes of this section, specifically includes amounts required to be included in income by Code Sec. 457(f), but does not include:

- any designated Roth contribution under Code Sec. 402A(c); or
- any remuneration paid to a licensed medical professional (doctor, nurse, or veterinarian) for the performance of medical or veterinary services (Code Sec. 4960(c)(3), as added by the 2017 Tax Cuts Act).

The remuneration of a covered employee includes not only compensation paid by an applicable tax-exempt organization in a tax year, but also any compensation paid to that employee for employment by any related organization of the applicable tax-exempt organization in that same tax year. Related organizations include any person or government agency that, during the tax year:

- controls, or is controlled by, the organization;
- is controlled by one or more persons that control the organization;
- is a supported organization, as defined in Code Sec. 509(f)(3), of the organization;
- is a supporting organization, as defined in Code Sec. 509(a)(3), of the organization; or
- establishes, maintains, or makes contributions to an applicable tax-exempt organization that is a voluntary employees' beneficiary association (VEBA), as defined in Code Sec. 501(c)(9) (Code Sec. 4960(c)(4), as added by the 2017 Tax Cuts Act).

Any remuneration that is not deductible due to the $1 million limit on deductible compensation under Code Sec. 162(m) is not included in determining the total remuneration of a covered employee (Code Sec. 4960(c)(6), as added by the 2017 Tax Cuts Act). When remuneration from more than one employer is included in determining the tax imposed by Code Sec. 4960(a), each employer will be liable for its respective percentage of the total tax debt according to the percentage of income it paid into the employee's aggregate remuneration from all employers (Code Sec. 4960(c)(4), as added by the 2017 Tax Cuts Act).

Effective date. This provision applies to tax years beginning after December 31, 2017 (Act Sec. 13602(c) of the Tax Cuts and Jobs Act of 2017).

¶815 Excise Tax Based on Investment Income of Private Colleges and Universities

NEW LAW EXPLAINED

Net investment income of private colleges and universities taxed.—A new Internal Revenue Code section imposes a tax on the net investment income of certain private colleges and universities in tax years beginning after December 31, 2017 (Code Sec. 4968 as added by the Tax Cuts and Jobs Act of 2017). For this purpose, net investment income is defined by reference to Code Sec. 4940(c) which defines it for purposes of the excise tax applicable to private foundations.

Subject to this excise tax will be "applicable educational institutions," defined as eligible educational institutions (as described in Code Sec. 25A(f)(2)) that:

- have at least 500 students during the preceding tax year, of which more than 50 percent are located in the United States,
- are private educational institutions and not state colleges and universities described in Code Sec. 511(a)(2)(B), and
- have assets with an aggregate fair market value of at least $500,000 per student (not including assets used directly in carrying out the institution's exempt purpose) as measured at the end of the preceding tax year.

For these purposes, the number of students of an institution is based on the daily average number of full-time students attending the institution, with part-time students being taken into account on a full-time student equivalent basis.

The assets and net investment income of any related organization are treated as assets and net investment income of the applicable educational institution. Related organizations include any organization that:

- controls, or is controlled by, an applicable education institution;
- is controlled by one or more persons who also control that educational institution; or
- is either a supported organization (as defined in Code Sec. 509(f)(3)) or a organization described in Code Sec. 509(a)(3) in regards to the educational institution during the applicable tax year.

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 13701(c) of the Tax Cuts and Jobs Act of 2017).

EXCISE TAXES ON ALCOHOL AND TRANSPORTATION

¶820 Aircraft Management Services

NEW LAW EXPLAINED

Payments for aircraft management services excluded from air transportation excise taxes.— Amounts paid by an aircraft owner to a provider of aircraft management services related to maintenance and support of the owner's aircraft or flights on the owner's aircraft are not subject to the excise tax on the air transportation of passengers under Code Sec. 4261 or the excise tax on the air transportation of property under Code Sec. 4271 (Code Sec. 4261(e)(5)(A), as added by the Tax Cuts and Jobs Act of 2017).

Exempt aircraft management services include (Code Sec. 4261(e)(5)(B), as added by the 2017 Tax Cuts Act):

- assisting an aircraft owner with administrative and support services, such as scheduling, flight planning, and weather forecasting;
- obtaining insurance;
- maintenance, storage, and fueling of aircraft;
- hiring, training, and provision of pilots and crew;
- establishing and complying with safety standards; and
- other services necessary to support flights operated by an aircraft owner.

An aircraft lessee is treated as an aircraft owner for exemption purposes unless the aircraft is leased under a disqualified lease. A "disqualified lease" is a lease from a person providing aircraft management services with respect to the aircraft (or from a related person to the person providing the services) if the lease is for a term of 31 days or less (Code Sec. 4261(e)(5)(C), as added by the 2017 Tax Cuts Act).

The exclusion for aircraft management services applies on a pro rata basis if only a portion of the payment is attributable to aircraft management services (Code Sec. 4261(e)(5)(D), as added by the 2017 Tax Cuts Act). Excise tax must be collected on that portion paid attributable to flights on aircraft not owned by the aircraft owner.

Effective date. The amendment made by this section apply to amounts paid after December 22, 2017, the date of enactment of the Act (Act Sec. 13822(b) of the Tax Cuts and Jobs Act of 2017).

¶825 Production Period for Beer, Wine and Distilled Spirits

NEW LAW EXPLAINED

Aging period excluded from production period for beer, wine and distilled spirits.—The aging period for beer, wine, and distilled spirits are excluded from the production period for purposes of the UNICAP interest capitalization rules (Code Sec. 263A(f)(4) as added by the 2017 Tax Cuts Act). Thus, producers of beer, wine and distilled spirits are able to deduct interest expenses (subject to any other applicable limitation) attributable to a shorter production period. Spirits that are unfit for use for beverages purposes are excluded.

Effective date. This provision applies to interest costs paid or accrued after December 31, 2017 (Act Sec. 13801(c), of the Tax Cuts and Jobs Act of 2017).

¶830 Beer Excise Tax Rate Reduced

NEW LAW EXPLAINED

The excise tax rate on beer is reduced.—The rate of tax on beer is lowered to $16 per barrel on the first six million barrels brewed by the brewer or imported by the importer (Code Sec. 5051(a)(1), as amended by the Tax Cuts and Jobs Act of 2017). Beer brewed or imported in excess of the six million barrel limit continues to be taxed at $18 per barrel. Small brewers are taxed at a different rate: $3.50 per barrel on the first 60,000 barrels domestically produced, and $16 per barrel on any further barrels produced (Code Sec. 5051(a)(2)(A), as amended by the 2017 Tax Cuts Act). In the case of a controlled group of brewers, both the six million barrel limitation, and the two million barrel limitation to qualify as a small brewer, are applied at the level of the controlled group.

For barrels of beer that have been brewed or produced outside of the United States and imported into the United States, the reduced tax rate may be assigned by the brewer to any importer of such barrels pursuant to certain regulatory requirements (Code Sec. 5051(a)(4), as added by the 2017 Tax Cuts Act). These requirements will include:

- a limitation to ensure that the number of barrels of beer for which the reduced tax rate has been assigned by a brewer to any importer does not exceed the number of barrels produced by that brewer during the calendar year which were imported into the United States by the importer;
- procedures that allow a brewer and an importer to elect whether to receive the reduced tax rate;
- requirements that the brewer provide any information that is needed to assign the reduced tax rate; and
- procedures that allow the eligibility of the brewer and the importer for the reduced tax rate to be revoked if the brewer provided erroneous or fraudulent information which was material in qualifying for the reduced rate.

Any importer making an election to receive the reduced tax rate shall be deemed to be a member of the controlled group of the brewer, within the meaning of Code Sec. 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in Code Sec. 1563(a) (Code Sec. 5051(a)(5)(A), as added by the 2017 Tax Cuts Act). Foreign corporations may be members of the controlled group (Code Sec. 5051(a)(5)(B), as added by the 2017 Tax Cuts Act).

Under rules to be issued, two or more entities (whether or not under common control) that produce beer marketed under a similar brand, license, franchise, or other arrangement are treated as a single taxpayer for purposes of the beer excise tax (Code Sec. 5051(a)(5)(C), as added by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section apply to beer removed after December 31, 2017 (Act Sec. 13802(e), of the Tax Cuts and Jobs Act of 2017).

Expiration date. The provision expires for beer removed after December 31, 2019.

¶835 Transfer of Beer Between Bonded Facilities

NEW LAW EXPLAINED

Requirements relaxed for transfer of beer between bonded facilities.—The Code Sec. 5414 shared ownership requirement is relaxed. Specifically, a brewer may transfer beer from one bonded brewery to another without incurring tax, provided that:

- the breweries are owned by the same person;
- one brewery owns a controlling interest in the other or the same person or persons have a controlling interest in both breweries; or
- the proprietors of the transferring and receiving premises are independent of each other, and the transferor has divested itself of all interest in the transferred beer, and the transferee has accepted responsibility for payment of the tax (Code Sec. 5414, as amended by the Tax Cuts and Jobs Act of 2017).

For purposes of transferring the tax liability (last item above), relief from liability is effective from the time the beer is removed from the transferor's bonded premises, or from the time the transferor divests itself of all interest in the transferred beer, whichever is later.

Effective date. The amendments made by this section apply to any calendar quarters beginning after December 31, 2017 (Act Sec. 13803(c) of the Tax Cuts and Jobs Act of 2017).

Expiration date. The provision expires for calendar quarters beginning after December 31, 2019.

¶840 Wine Excise Tax Rate Reduced

NEW LAW EXPLAINED

Tax Credit Reduces Wine Excise Tax Rate.— For wine removed after December 31, 2017 and before January 1, 2020, the credit against the wine excise tax for small domestic producers is modified by removing the 250,000 wine gallon domestic production limitation. This makes the credit available for all wine producers and importers (Code Sec. 5041(c), as amended by the Tax Cuts and Jobs Act of 2017). Sparkling wine producers and importers are now also eligible for the credit. With respect to wine produced in, or imported into, the United States during a calendar year, the credit amount is:

- on the first 30,000 wine gallons of wine, $1 per wine gallon;
- on the next 100,000 wine gallons of wine (after the first 30,000 gallons), 90¢ per wine gallon;
- on the next 620,000 wine gallons of wine (after the first 130,000 gallons), 53.5¢ per wine gallon.

With respect to hard cider, the credit amount is:

- on the first 30,000 wine gallons of hard cider, 6.2¢ per wine gallon;
- on the next 100,000 wine gallons of hard cider (after the first 30,000 gallons), 5.6¢ per wine gallon;
- on the next 620,000 wine gallons of hard cider (after the first 130,000 gallons), 3.3¢ per wine gallon.

COMMENT

Note that Act Sec. 13805 of the 2017 Tax Cuts Act increases the wine alcohol content level of the first two excise tax tiers from 14 percent alcohol to 16 percent alcohol for still wines.

For wine gallons of wine that have been produced outside of the United States and imported into the United States, the tax credit allowable may be assigned by the "foreign producer" to any electing importer of those wine gallons under regulatory requirements to be established. These requirement include:

- a limitation to ensure that the number of wine gallons of wine for which the tax credit has been assigned by a foreign producer: (i) to any importer does not exceed the number of wine gallons of wine produced by the foreign producer, during the calendar year, that were imported into the United States by the importer; and (ii) to all importers does not exceed the 750,000 wine gallons of wine to which the tax credit applies;
- procedures that allow the election of a foreign producer to assign, and an importer to receive, the tax credit;
- requirements that the foreign producer provide any information determined to be necessary and appropriate for purposes of assigning the tax credit; and
- procedures that allow the eligibility of the foreign producer and the importer for the tax credit to be revoked if the foreign producer provides erroneous or fraudulent information that is deemed to be material for qualifying for the reduced tax rate.

Any importer making an election to receive the reduced tax rate will deemed to be a member of the controlled group of the winemaker, within the meaning of Code Sec. 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in Code Sec. 1563(a). Members of the controlled group may include foreign corporations.

Effective date. The amendments made by this section apply to wine removed after December 31, 2017 (Act Sec. 13804(d), of the Tax Cuts and Jobs Act of 2017).

Expiration date. The provision expires for wine removed in calendar quarters beginning after December 31, 2019.

¶845 Alcohol Content Level of Wine Adjusted

NEW LAW EXPLAINED

Alcohol content level of wine adjusted for application of excise taxes.— Alcohol-by-volume levels of the first two tiers of the excise tax on wine are modified by changing 14 percent to 16 percent. Therefore, a wine producer or importer may produce or import "still wine" (nonsparkling) that has an alcohol-by-volume level of up to 16 percent, and remain subject to the lowest rate of $1.07 per wine gallon (Code Sec. 5041(b) as amended by the Tax Cuts and Jobs Act of 2017).

Effective date. The amendment made by this section applies to wine removed after December 31, 2017 (Act Sec. 13805(b), of the Tax Cuts and Jobs Act of 2017).

Expiration date. The provision does not apply to wine removed after December 31, 2019.

¶850 Taxation of Mead and Certain Carbonated Wines

NEW LAW EXPLAINED

Mead and certain carbonated wines taxed as still wines.—Mead and certain carbonated wines are taxed at the lowest rate applicable to "still wine" of $1.07 per wine gallon (Code Sec. 5041(h), as added by the Tax Cuts and Jobs Act of 2017).

> **COMMENT**
>
> Note that Act Sec. 13805 of the 2017 Tax Cuts Act increases the wine alcohol content level of the first two excise tax tiers from 14 percent alcohol to 16 percent alcohol for still wines.

"Mead" is defined as a wine that contains not more than 0.64 grams of carbon dioxide per hundred milliliters of wine, which is derived solely from honey and water, contains no fruit product or fruit flavoring, and contains less than 8.5 percent alcohol-by-volume (Code Sec. 5041(h)(2)(A), as added by the 2017 Tax Cuts Act). The sparkling wines eligible to be taxed at the lowest rate as "low alcohol by volume wine" are those wines that contain not more than 0.64 grams of carbon dioxide per hundred milliliters of wine, which are derived primarily from grapes or grape juice concentrate and water, which contain no fruit product or fruit flavoring other than grape, and which contain less than 8.5 percent alcohol by volume (Code Sec. 5041(h)(2)(B), as added by the 2017 Tax Cuts Act).

Effective date. The amendment made by this section applies to wine removed after December 31, 2017 (Act Sec. 13806(b) of the Tax Cuts and Jobs Act of 2017).

Expiration date. The provision does not apply to wine removed after December 31, 2019.

¶855 Distilled Spirits Excise Tax Rate Reduced

NEW LAW EXPLAINED

Distilled spirits excise tax rate reduced.—A tiered tax rate for distilled spirits is created for tax years 2018 and 2019 (Code Sec. 5001(c)(1), as added by the Tax Cuts and Jobs Act of 2017). The tiers are as follows:

- $2.70 per proof gallon on the first 100,000 proof gallons of distilled spirits;
- $13.34 for all proof gallons on the next 22,130,000 (after the first 100,000 proof gallons); and
- $13.50 for amounts over 22,230,000 proof gallons.

Rules have been added to prevent members of the same controlled group from receiving the lower rate on more than 100,000 proof gallons of distilled spirits. Note that two or more entities (whether under common control or not) that produce distilled spirits marketed under a similar brand, franchise, license, or other arrangement are treated as a single taxpayer (Code Sec. 5001(c)(2), as added by the 2017 Tax Cuts Act). Importers of distilled spirits are also eligible for the lower rates (Code Sec. 5001(c)(3), as added by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section apply to distilled spirits removed after December 31, 2017 (Act Sec. 13807(d), of the Tax Cuts and Jobs Act of 2017).

Expiration date. The provision does not apply to distilled spirits removed after December 31, 2019.

¶860 Transfer of Bulk Distilled Spirits

NEW LAW EXPLAINED

Transfer of distilled spirits in non-bulk containers allowed.—Distillers are allowed to transfer spirits in approved containers other than bulk containers in bond without payment of tax (Code Sec. 5212, as amended by the Tax Cuts and Jobs Act of 2017).

Effective date. The amendment made by this section applies to distilled spirits transferred in bond after December 31, 2017 (Act Sec. 13808(b) of the Tax Cuts and Jobs Act of 2017).

Expiration date. The provision does not apply to distilled spirits transferred in bond after December 31, 2019.

BONDS

¶870 Advance Refunding Bonds

NEW LAW EXPLAINED

Exclusion eliminated for interest on advance refunding bonds.—Interest paid on advance refunding bonds issued after December 31, 2017, is not excludable from gross income (Code Sec. 149(d), as amended by the Tax Cuts and Jobs Act).

Effective date. The amendments apply to advance refunding bonds issued after December 31, 2017 (Act Sec. 13532 of the Tax Cuts and Jobs Act).

¶875 Tax Credit Bonds

NEW LAW EXPLAINED

New tax credit bonds cannot be issued after 2017.—Tax credit bond provisions are repealed and new tax credit bonds cannot be issued after December 31, 2017 (Code Secs. 54, 54A, 54B, Code Sec. 54C, 54D54E, 54F, 54AA and 6431, stricken by the Tax Cut and Jobs Act of 2017).

COMMENT

Holders and issuers will continue receiving tax credits and payments for tax credit bonds already issued (House Committee Report for the Tax Cuts and Jobs Act of 2017 (H.R. Rep. No. 115-409)).

Effective date. This provision applies to bonds issued after December 31, 2017 (Act Sec.13404(d) of the Tax Cut and Jobs Act of 2017).

TAX PRACTICE AND PROCEDURE

¶880 Time Limits to File Suit and Return Property for Wrongful Levies

NEW LAW EXPLAINED

Time Limits for Wrongful Levy Civil Suits and the Return of Property Increased.— The time period for bringing a civil action in district court for wrongfully levied property is extended to two years from the date of levy (Code Sec. 6532(c), as amended by the Tax Cuts and Jobs Act). Additionally, the time period that the IRS has to return monetary proceeds from the sale of wrongfully levied property is also extended to two years (Code Sec. 6343(b), as amended by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section apply to levies made after December 22, 2017, the date of enactment, and levies made on or before December 22, 2017, if the nine-month period has not expired under Code Secs. 6343(b) (without regard to this section) as of such date (Act Sec. 11071 of the Tax Cuts and Jobs Act).

CHAPTER 9. TAXATION OF INSURANCE COMPANIES

¶905 Net Operating Losses for Life Insurance Companies

NEW LAW EXPLAINED

Operations loss deduction eliminated and replaced by NOL deduction.—The operations loss deduction (OLD) for life insurance companies is repealed for losses arising in tax years beginning after December 31, 2017, including the carryforward, carryback, and special business transition rules (Code Secs. 805(a)(5) and 810, stricken by the Tax Cuts and Jobs Act)). Instead, life insurance companies are subject to the same rules for net operating losses (NOL) as other corporations and insurance companies under Code Sec. 172, including carryforward periods as other corporations (see ¶515) (Code Sec. 805(b), as amended by the 2017 Tax Cuts Act). There are numerous references to the OLD of a life insurance company throughout the Code. The new law removes these references and in most cases replaces them with a reference to the NOL deduction.

Taxable income limitation on dividends received deductions. In determining the amount of a life insurance company's 70 percent deduction for dividends received from a domestic corporation (Code Sec. 243(a)(1)) and deduction for dividends received from a foreign corporation (Code Sec. 245), the limit on the aggregate amount of deductions allowed (Code Sec. 246) is based on the applicable percentage of taxable income computed without regard to the NOL deduction (Code Sec. 805(a)(4)(B)(ii), as amended by the 2017 Tax Cuts Act). Previously, taxable income of the life insurance company for this purpose was determined without regard to the operations loss deduction.

Charitable deduction limitation. The 10 percent of taxable income limit on a life insurance company's charitable contribution deduction is determined without regard to the company's NOL deduction instead of the OLD (Code Sec. 805(b)(2)(A)(iv), as amended by the 2017 Tax Cuts Act).

Transitions between life insurance status and non-life insurance status. The rule which allows a life-insurance company that becomes a non-life insurance company to deduct operations losses from a prior life insurance year as an NOL in a later non-life insurance year is repealed (Code Sec. 844, stricken by the 2017 Tax Cuts Act). The rule also allowed a non-life insurance company that becomes a life insurance company to deduct the amount of an NOL carryover from a prior non-life insurance company year as an operations loss in a later life insurance year.

> **COMMENT**
>
> The rule is no longer necessary since life insurance and non-life insurance company's will both deduct NOLs going forward.

Successor corporation's treatment of acquired life insurance corporation's operations losses. A successor (acquiring) corporation takes limited carryovers of a predecessor (distributor or transferor) corporation's tax benefits, privileges, elective rights, and obligations in certain corporate acquisitions involving tax-free liquidations of subsidiaries or reorganizations (Code Sec. 381(a)). The manner in which an operation loss carryback or carryover of an acquired life insurance company is handled by a successor corporation is governed by the rules for OLDs. Since OLDs are repealed, this rule is also repealed (Code Sec. 381(d), stricken by the 2017 Tax Cuts Act).

Subpart F income calculation. In the case of a controlled foreign life insurance corporation, "Subpart F Income" includes insurance income (Code Sec. 952(a)(1)). Under the new law, insurance income is determined without regard to the NOL deduction. Previously, insurance income was determined without regard to the operations loss deduction (Code Sec. 953(b)(1)(B), as amended by the 2017 Tax Cuts Act).

Recoveries of foreign expropriation losses. Special rules limit the tax on the recovery of a foreign expropriation loss by a life insurance company and other corporations to the benefit previously received in deducting the loss. Foreign expropriation losses are losses sustained by reason of expropriation, intervention, seizure, or similar taking of property by a foreign government (Code Sec. 1351). If this provision applies, special adjustments must be made to NOLs, and in the case of a life insurance

company, operations losses. The reference to operations losses is removed (Code Sec. 1351(i)(3), as amended by the 2017 Tax Cuts Act).

CAUTION NOTE

The repeal of the OLD rules puts the operating losses of life insurance companies on equal footing with other corporations. Thus, the NOL of a life insurance company may not be carried back and may be carried forward indefinitely. Non-life insurance companies, however, are allowed to carry a net operating loss back two years and forward 20 years (Code Sec. 172(b)(1)(C), as added by the Tax Cuts and Jobs Act). See ¶515 for a detailed discussion of changes made to the NOL.

Effective date. The amendments made by this section apply to losses arising in tax years beginning after December 31, 2017 (Act Sec. 13511(c) of the Tax Cuts and Jobs Act of 2017).

¶910 Small Life Insurance Company Deduction

NEW LAW EXPLAINED

The small life insurance company deduction is repealed.— The small life insurance company deduction is repealed effective for tax years beginning after December 31, 2017 (Code Sec. 806, struck by the Tax Cut and Jobs Act).

Effective date. The amendments made by this section applies to tax years beginning after December 31, 2017 (Act Sec. 13512(c) of the Tax Cut and Jobs Act).

¶915 Adjustment in Computing Life Insurance Company Reserves

NEW LAW EXPLAINED

Computation of life insurance tax reserves revised.—For tax years beginning after December 31, 2017, life insurance reserves for any contract are generally determined as the greater of: (1) the net surrender value of the contract, or (2) 92.81-percent of the reserve computed under the tax reserve method, as prescribed by the National Association of Insurance Commissioners (NAIC) at the time when the reserve is determined (Code Sec. 807(d)(1)(A) and (d)(2), as added by the Tax Cuts and Jobs Act) and Code Sec. 807(d)(3), as amended by the 2017 Tax Cuts Act).

For a variable contract, the amount of life insurance reserves for a contract equals the sum of: (1) the greater of the net surrender value of the contract, or the portion of the reserve that is separately accounted for under Code Sec. 817, plus (2) 92.81-percent of the excess of the reserve determined using the tax reserve method over the amount in (1) (Code Sec. 807(d)(1)(B), as amended by the 2017 Tax Cuts Act).

A statutory cap applies, providing that the amount of the reserves cannot exceed the amount that would be taken into account with respect to the contract in determining statutory reserves (Code Sec. 807(d)(1)(C), as added by the 2017 Tax Cuts Act). In addition, in determining any reserve under Subchapter L (Insurance Companies), no amount or item can be taken into account more than once (Code Sec. 807(d)(1)(D), as added by the 2017 Tax Cuts Act).

A special provision regarding the amount of the reserve for supplemental benefits that are not qualified supplemental benefits is eliminated (Code Sec. 807(e)(3), prior to redesignation as (e)(2) and amendment by the 2017 Tax Cuts Act). Also eliminated is language that required the life insurance reserve for any qualified supplemental benefit to be the reserve taken into account for purposes of the annual statement approved by the NAIC (Code Sec. 807(e)(2), as redesignated and amended by the 2017 Tax Cuts Act).

The IRS is directed to issue rules requiring reporting with respect to the opening balance and closing balance of reserves and also the method of computing reserves for purposes of determining income (Code Sec. 807(e)(6), as added by the 2017 Tax Cuts Act).

Under transitional rules for existing contracts, the difference in reserve amounts under the old and new methods is taken into account as a deduction or as income over an eight-year period (Act Sec. 13517(c)(2) and (c)(3) of the 2017 Tax Cuts Act).

Change in method of computing reserves treated as change in accounting method. The special 10-year spread provision for a life insurance company that changes its method of computing reserves is eliminated. Instead, for a life insurance company that changes its method of computing reserves, income or loss resulting from the change is taken into account under Code Sec. 481 (i.e., with a one-year or four-year adjustment period), as an adjustment attributable to a change in the method of accounting. The change is treated as initiated by the taxpayer and made with the IRS's consent (Code Sec. 807(f), as amended by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section shall apply to taxable years beginning after December 31, 2017 (Act Secs. 13513(b) and 13517(c) of the Tax Cuts and Jobs Act of 2017).

¶920 Life Insurance Proration Rules for Determining the Dividends Received Deduction

NEW LAW EXPLAINED

Simplification of life insurance proration rules.—The Tax Cuts and Jobs Act of 2017) simplifies the life insurance company proration rules required for reducing deductions, including dividends received deductions and reserve deductions with respect to untaxed income. For purposes of the life insurance company proration rule, the company's share is fixed at 70 percent and the policyholder's share is defined as 30 percent (Code Sec. 812, as amended by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section shall apply to tax years beginning after December 31, 2017 (Act Sec. 13518(c) of the Tax Cuts and Jobs Act of 2017).

¶925 Proration Rule for Property and Casualty Insurance Companies

NEW LAW EXPLAINED

Proration rule for reduction of losses modified.— Effective for tax years beginning after 2017, the proration rule for reduction of losses incurred by property and casualty insurance companies is modified to replace the 15 percent reduction with a reduction equal to 5.25 percent divided by the highest corporate income tax rate under Code Sec. 11(b) (Code Sec. 832(b)(5)(B), as amended by the Tax Cuts and Jobs Act)).

> **COMMENT**
>
> The top corporate tax rate is 21 percent for tax years beginning after 2017, so the percentage reduction is 25 percent under the modified proration rule. See ¶305 for a discussion of the new corporate income tax rate.

Effective date. The amendment made by this section applies to tax years beginning after December 31, 2017 (Act Sec. 13515(b) of the Tax Cuts and Jobs Act).

¶930 Discounting Rules for Property and Casualty Insurance Companies

NEW LAW EXPLAINED

Rate of interest used to discount unpaid losses.—The interest rate used to discount unpaid losses is the annual rate determined by the Treasury Department based on the corporate bond yield curve as defined in Code Sec. 430(h)(2)(D)(i), but determined using a 60-month period instead of a 24-month period (Code Sec. 846(c)(2), as amended by the Tax Cuts and Jobs Act). This change applies to tax years beginning after December 31, 2017.

COMMENT

The "corporate bond yield curve" reflects the average of monthly yields on investment grade corporate bonds that are in the top three rating levels.

Computational rules for loss payment patterns. The period for determining certain loss payment patterns is extended and the additional five-year period for long-tail lines of business, and special rules for international and reinsurance lines of business are removed for tax years beginning after December 31, 2017. There are two loss payment patterns—a 10-year loss payment pattern that applies to auto liability, other liability, medical malpractice, workers' compensation and multiple peril lines of business and a general three-year loss payment pattern that applies to all other lines of business (Code Sec. 846(d)(3)).

There is a 14-year extension available to 10-year lines of business that applies for tax years beginning after December 31, 2017. The amount of the losses that were previously paid in the 10th year following an accident year, are treated as paid in the 10th year and each subsequent year in an amount equal to the average of the amounts paid in the 7th, 8th, and 9th years. To the extent these unpaid losses have not been treated as paid before the 24-5th year after the accident year, they are treated as paid in that 24th year (Code Sec. 846(d)(3)(B)(ii)(II), as amended by the 2017 Tax Cuts Act)

PLANNING NOTE

For the first tax year beginning after December 31, 2017, certain unpaid losses and expenses unpaid at the end of the preceding tax year will be determined as if the amendments to Code Sec. 846 had applied to the unpaid losses and expenses. The interest rate and loss payment pattern applicable to accident years ending with calendar year 2018 will apply. Any adjustment will be taken into account ratably in the first tax year and the seven succeeding tax years. For following tax years, the amendments will be applied by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 2018 (Act Sec. 13523(e) of the 2017 Tax Cuts Act).

Historical payment pattern election repeal.—The election permitting a taxpayer to use its own historical loss payment pattern for all its lines of business is repealed. All taxpayers will now use an aggregate industry-experience based loss payment pattern (Code Sec. 846(e), as stricken by the 2017 Tax Cuts Act).

Effective date. The amendments made by this section apply to tax years beginning after December 31, 2017 (Act Sec. 13523(c) of the Tax Cuts and Jobs Act).

¶935 Capitalization of Certain Policy Acquisition Expenses of Insurance Companies

NEW LAW EXPLAINED

Amortization period for specified policy acquisition expenses extended. —The amortization period for specified policy acquisition expenses is extended from a 120-month period to 180-month period beginning with the first month in the second half of the tax year (Code Sec. 848(a)(2), as amended by the Tax Cuts and Jobs Act). The special rule providing for 60-month amortization of the first $5 million of specified policy acquisition expenses, with a phase out, is not changed (Code Sec. 848(b)).

The percentages of net premiums used to determine the amount of general deductions that are treated as specified policy acquisition costs are increased (Code Sec. 848(c), as amended by the 2017 Tax Cuts Act):

- from 1.75 percent to 2.1 percent for annuity contracts;
- from 2.05 percent to 2.46 percent for group life insurance contracts; and
- from 7.7 percent to 9.24 percent for all other specified insurance contracts.

Effective date. The amendments made by this section apply to net premiums for tax years beginning after December 31, 2017 (Act Sec. 13519(c)(1)) of the 2017 Tax Cuts Act). Specified policy acquisition expenses first required to be capitalized in a tax year beginning before January 1, 2018, will continue to be allowed as a deduction ratably over the 120-month period beginning with the first month in the second half of such tax year (Act Sec. 13519(c)(2)) of the 2017 Tax Cuts Act).

¶940 Pre-1984 Policyholder Surplus Accounts

NEW LAW EXPLAINED

Eight-year phase-in of pre-1984 policyholder surplus account balances into life insurance company taxable income.— Code Sec. 815, which provides special rules for distributions to shareholders from pre-1984 policy holders surplus accounts, is repealed, applicable to tax years beginning after December 31, 2017 (Code Sec. 815, repealed by the Tax Cuts and Jobs Act). A stock life insurance company that has a balance (as of the close of the company's last tax year beginning before January 1, 2018) in an existing policyholder surplus account must include the balance in income over eight years (Act Sec. 13514(d) of the 2017 Tax Cuts Act). For the first eight tax years beginning after December 31, 2017, a life insurance company must include in its taxable income:

- life insurance taxable income for the year (Code Sec. 801), but not less than zero; plus
- 1/8th of the policyholder surplus account balance.

COMMENT

Because taxable income for the tax year cannot be less than zero, life insurance company losses are not allowed to offset the amount of the policyholders surplus account balance subject to tax.

Effective date. The amendment made by this section applies to tax years beginning after December 31, 2017 (Act Sec. 13514(c) of the Tax Cuts and Jobs Act).

¶945 Reporting Sales of Life Insurance

NEW LAW EXPLAINED

New rules for reportable sales of life insurance contracts.—New reporting requirements apply for reportable sales occurring after December 31, 2017, and for the payment of reportable death benefits after December 31, 2017 (Code Sec. 6050Y, added by the Tax Cut and Jobs Act). The exceptions to the transfer for value rules do apply to reportable policy sales for transfers after 2017 (Code Sec. 101(a)(3), added by the 2017 Tax Cut Act). The method of determining the tax basis in a life insurance contract is clarified (Code Sec. 1016(a)(1), amended by the 2017 Tax Cut Act).

A "reportable policy sale" means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract. An indirect acquisition for these purposes would include acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract (Code Sec. 101(a)(3)(B) and 6050Y(d)(2), added by the 2017 Tax Cut Act).

For transfers after December 31, 2017, the exceptions to the transfer for value rules (Code Sec. 101(a)(2)(A) and (B)) do not apply to a transfer of a life insurance contract, or any interest therein, in a reportable policy sale (Code Sec. 101(a)(3)(A), added by the 2017 Tax Cut Act). Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466).

Reporting by person acquiring a life insurance contract. Anyone who acquires a life insurance contract or any interest in a life insurance contract in a reportable policy sale during a tax year must make a return for such tax year (at such time and in such manner as the Secretary of the Treasury shall prescribe) setting forth:

- the name, address, and TIN of such person,
- the name, address, and TIN of each recipient of payment in the reportable policy sale,
- the date of such sale,
- the name of the issuer of the life insurance contract sold and the policy number of such contract, and
- the amount of each payment (Code Sec. 6050Y(a)(1), added by the 2017 Tax Cuts Act).

Anyone required to make such a return must furnish to each person named in the return a written statement showing:

- the name, address, and phone number of the information contact of the person required to make the return, and
- the information required to be shown on the return with respect to such person (except that in the case of an issuer of a life insurance contract, such statement is not required to include the amount of each payment) (Code Sec. 6050Y(a)(2), added by the 2017 Tax Cut Act).

A "payment" for these purposes means the amount of cash and the fair market value of any consideration transferred in any reportable policy sale (Code Sec. 6050Y(d)(1), added by the 2017 Tax Cut Act).

Reporting by issuer of seller's basis. Upon receipt of the written statement required under Code Sec. 6050Y(a)(2), or upon notice of a transfer of a life insurance contract to a foreign person, each issuer of a life insurance contract shall make a return setting forth:

- the name, address, and TIN of the seller who transfers any interest in such contract in such sale,
- the investment in the contract (Code Sec. 72(e)(6)) with respect to such seller, and
- the policy number of such contract (Code Sec. 6050Y(b)(1), added by the 2017 Tax Cut Act).

Every person required to make a return reporting seller's basis shall furnish to each person whose name is required to be set forth in such return a written statement showing:

- the name, address, and phone number of the information contact of the person required to make such return, and
- the information required to be shown on such return with respect to each seller whose name is required to be set forth in such return (Code Sec. 6050Y(b)(2), added by the 2017 Tax Cut Act).

An "issuer" for these purposes means any life insurance company that bears the risk with respect to a life insurance contract on the date of any required return or statement (Code Sec. 6050Y(d)(3), added by the 2017 Tax Cut Jobs Act).

In determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (Code Sec. 1016(a)(1), amended by the 2017 Tax Cut Act). This change reverses the position of the IRS in Rev. Rul. 2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract. This clarification applies retroactively to transactions entered into after August 25, 2009.

Reporting payment of death benefits. A "reportable death benefit" is any amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale (Code Sec. 6050Y(d)(4), added by the 2017 Tax Cut Jobs Act). Every person who makes a payment of reportable death benefits during any tax year shall make a return for such tax year setting forth:

- the name, address, and TIN of the person making such payment,
- the name, address, and TIN of each recipient of such payment,
- the date of each such payment,
- the gross amount of each such payment, and
- such person's estimate of the investment in the contract (as defined in Code Sec. 72(e)(6)) with respect to the buyer) (Code Sec. 6050Y(c)(1), added by the 2017 Tax Cut Act).

Every person required to make a return reporting the payment of death benefits shall furnish to each person named in the return a written statement showing:

- the name, address, and phone number of the information contact of the person required to make such return, and
- the information required to be shown on such return with respect to each recipient of payment whose name is required to be set forth in such return) (Code Sec. 6050Y(c)(2), added by the 2017 Tax Cut Act).

Effective date. The reporting provisions apply to reportable policy sales after December 31, 2017, and reportable death benefits paid after December 31, 2017; the tax basis clarification applies to transactions entered into after August 25, 2009; and the change in the scope of the transfer for value rules applies to transfers after December 31, 2017 (Act Secs. 13520(d), 13521(b), and 13522(c) of the Tax Cut and Jobs Act).

¶950 Additional Deduction and Estimated Tax for Insurance Companies

NEW LAW EXPLAINED

Additional deduction and estimated tax rules for insurance companies are repealed.—The election to pay the special estimated tax, the additional deduction, special loss discount account, special estimated tax payment, and refundable amount rules are eliminated (Code Sec. 847, struck by the Tax Cut and Jobs Act).

The entire balance of an existing account is included in income of the taxpayer for the first tax year beginning after 2017, and the entire amount of existing special estimated tax payments are applied against the amount of additional tax attributable to this inclusion. Any special estimated tax payments in excess of this amount are treated as estimated tax payments under Code Sec. 6655 (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Effective date. The amendment made by this section applies to tax years beginning after December 31, 2017 (Act Sec. 13516(b) of the Tax Cut and Jobs Act).