KPMG

Provisions affecting banks in tax reform bills—House bill and version pending in Senate

November 29, 2017

Tax reform legislative proposals: Implications for banking and capital markets

The U.S. House of Representatives on November 16, 2017, passed the "Tax Cuts and Jobs Act" (H.R. 1) by a vote of 227 to 205. Also on November 16, the Senate Finance Committee approved its version of tax reform legislation, by a vote of 14-12. The Senate Budget Committee on November 28 voted to send reconciliation legislation to the Senate floor.

There are significant differences between H.R. 1 and the version of the tax reform bill that the Senate is considering this week. Provided below is a side-by-side comparison of the key provisions in H.R. 1 and the version of the tax reform legislation based on the bill approved by the Senate Finance Committee on November 16. This report also includes KPMG's initial observations of the potential effects for banks and their customers.

In reading this report, note that the provisions described below may be amended as the Senate takes up the tax reform bill.

Business

Corporate tax rate

H.R. 1	Finance Committee bill
– Flat 20% rate. – Effective January 1, 2018. – Reduces dividends received deduction to reflect lower corporate tax rate – current 70% deduction reduced to 50% and current 80% deduction reduced to 65%.	– Flat 20% rate. – Effective January 1, 2019. – Reduces dividends received deduction to reflect lower corporate tax rate – current 70% deduction reduced to 50% and current 80% deduction reduced to 65%.

KPMG observation

– Changes in the value of deferred taxes could impact banks' financial statements and could result in changes to banks' regulatory capital. Furthermore, banks would need to assess valuation allowance potential for carryforwards in light of a reduced rate.

– A change in the corporate tax rate could also have broader implications to banking operations as the new rates are reflected in commercial loan demand, pricing models for municipal bonds, tax credit investments, and capital markets transactions.

– While both H.R. 1 and the Finance Committee bill provide for a flat 20% rate, the Finance Committee bill delays the effective date one year until 2019. As currently written, neither proposal considers a phase-in of the 20% rate. From a financial accounting perspective, the Finance Committee bill's delayed effective date to

January 1, 2019 will require taxpayers to schedule the reversal of their deferred tax assets and liabilities.

Treatment of pass-through income

H.R. 1	Finance Committee bill

– "Business income" rate capped at 25%.
  – The rules include safeguards that are intended to limit the favorable rate of 25% to (i) passive income ("net business income") and (ii) a specified percentage (the "capital percentage") from active business activities.
  – For specified service activities, the capital percentage is assumed to be zero, and therefore generally cannot qualify to apply the favorable 25% rate.
  – Examples of "specified service activities" include financial services and brokerage services. H.R. 1 explicitly states investing, trading, or dealing in securities, partnership interests and commodities will meet the definition of specified service activities.
– Extends the holding period for certain applicable partnership interests from one year to three years.
	– An individual taxpayer can deduct 17.4% of domestic qualified business income distributed by a pass-through entity. The deduction is limited to 50% of the taxpayer's allocable or pro rata share of W-2 wages of the partnership or S corporation.
	  – The deduction is not available for "specified service trade or businesses," subject to an exception for taxpayers whose income does not exceed a specified threshold. The definition of "specified service trade or business" in the Finance Committee bill is consistent with the definition of "specified service activity" in H.R. 1.
	  – Domestic qualified business losses can be carried forward.
	  – Qualified business income does not include amounts paid as reasonable compensation or amounts allocated to a partner who is acting other than in his or her capacity as a partner for services.
	  – The deduction would expire beginning in 2026.
	– Imposes a three-year holding period requirement for qualification as long-term capital gain for certain partnership interests received in connection with services performed.

KPMG observation

– Would generally not impact corporate entities, which are instead subject to the 20%t corporate tax rate.

- Changes in the taxation of pass-through income could impact tax planning for a bank's wealth management clients.
- The proposal to increase the holding period for certain partnership interests is generally consistent across H.R. 1 and the Finance Committee bill and appears intended to address the long-debated tax treatment of carried interests. Rather than treating amounts failing the three-year test as ordinary income (as has been the typical re-characterization under prior versions of proposed carried interest legislation), proposed section 1061 would treat such gain as short-term capital gain.
- The carried interest exception for applicable partnership interest held by a corporation resolves significant controversy that arose in connection with earlier versions of carried interest legislation as a result of subjecting corporations (which were not rate sensitive) to the complexities and other onerous provisions of carried interest legislation. The current proposal would resolve this controversy by excluding corporations that hold partnership interests from the proposed rules.
- Tax commentators have questioned the effectiveness of the proposed holding period increase, as taxpayers benefitting from the carried interest provision frequently hold investments for longer than three years.

Net interest expense deduction limitation

H.R. 1	Finance Committee bill
– Disallows **net** interest expense deductions in excess of 30% of "adjusted taxable income" (calculation similar to EBITDA). – Five-year carryforward of disallowed net interest expense. – Does not apply to businesses with average gross receipts of $25 million or less and businesses in certain industries (e.g., real property businesses, regulated utility businesses). – Net interest expense is computed at the tax filer level (e.g., at the consolidated group or partnership level).	– Disallows **net** interest expense deductions in excess of 30% of "adjusted taxable income". Unlike H.R. 1, the Finance Committee bill continues to include deductions for depreciation, amortization, and depletion in the definition of adjusted taxable income. – Indefinite carryforward of disallowed net interest expense. – Does not apply to businesses with average gross receipts of $15 million or less and businesses in certain industries (e.g., regulated utility businesses). – For certain real property businesses, taxpayers can elect to exclude interest expense from the limitation. If the taxpayer makes this election, it is subject to special cost recovery rules (see below under "Cost recovery").

	– Net interest expense is computed at the tax filer level (e.g., at the consolidated group).

KPMG observation

- Due to the proposed application of the limitation on net interest expense (and on a consolidated group basis), there could be less of a direct impact on the tax liabilities of banking groups compared to other industries.
- As proposed, the net interest limitation could potentially negatively impact banks with captive mortgage REITs. Net Interest expense is calculated at the filer level, and REITs are not includable in the consolidated group filing. Thus, the consolidated group would be replacing interest income (now recognized at the captive REIT level) with dividend income received from the captive REIT.
- While H.R. 1 would exclude real property businesses from the scope of its net interest expense limitation, the Finance Committee bill would require an election by certain real property businesses to opt out of the limitation.
- Under both proposals, only taxable interest income would be included in the computation of net business interest expense. Thus, investments in tax-free municipal bonds would not increase a taxpayer's interest expense capacity. This may impact the value and after-tax yield of municipal bond investments for taxpayer subject to the proposed limitation.
- Banks will likely need to change underwriting models in commercial lending to account for potential non-deductibility of some interest expense.
- Banks could see an impact on loan demand by product (e.g., higher after-tax cost for commercial borrowers in certain industries due to interest expense limitation). Bank could also see potential changes in competitors if non-financials seek to generate interest income to offset interest expense.
- There could be an increased market interest in new products to move interest income between taxpayers, or provide non-debt financing (e.g., preferred equity or partnership interests).
- The proposed limitation on interest expense may increase customers' preferences for leasing versus financing capital purchases.
- The small business exclusions provided for in H.R. 1 ($25 million threshold) and the Finance Committee bill ($15 million threshold), as well as the exclusion of certain industries, mean certain borrowers would not be affected.
- Neither proposal includes a grandfathering provision for existing debt, which could potentially lead bank customers to prematurely retire existing debt.
- Customers potentially subject to the proposal may consider borrowing through offshore foreign entities where the interest deductions could be more valuable via a deduction in the foreign jurisdiction.

- The proposed limitation could have a negative impact on leasing companies that finance their operations through debt if they are subject to the net interest expense disallowance. On the other hand, banks may see an increase in demand for leasing services because they may be less concerned about interest expense capacity.

Immediate expensing of qualified capital investments

H.R. 1	Finance Committee bill

– 100% expensing of qualified property acquired or placed in service between September 27, 2017 and January 1, 2023.
– Property must only be new to taxpayer (i.e., applies to "used" property acquired by taxpayer).
– Excludes property used in a real property trades or businesses.
	– Generally consistent with H.R. 1, however, the Finance Committee bill proposal generally only applies to new property.
	– Nonresidential real, residential rental, and qualified improvement property amendment.
	  – In a separate proposal, the recovery period for nonresidential real and residential rental property is shortened to 25 years.
	  – "Qualified improvement property" subject to a 10-year recovery period.
	  – Real property businesses that have elected out of the interest limitation rule must use the ADS method to depreciate nonresidential real property, residential rental property, and qualified improvement property.

KPMG observation

- Immediate expensing would likely result in an increased deferred tax liability, as GAAP would continue to depreciate the cost of the investment over the useful life. This increase in deferred tax liability may improve banks' regulatory capital.
- Immediate expensing could impact assets that banks hold in leasing portfolios. A timing benefit could exist in the case of "true leases" because the bank would be treated as the owner of the property and therefore receive the tax benefits of immediate expensing.

Like-kind exchange limitation

H.R. 1	Finance Committee bill
– Limits the deferral of gain under the like-kind exchange rules to exchanges of real property.	– Generally consistent with H.R. 1.

KPMG observation

- For tangible personal property, repeal of like-kind rules could impact a bank's leasing portfolio and affect the after tax return on assets from the leasing business. However, the proposed allowance for full expensing may offset the negative impact of eliminating the gain deferral.
- Limiting the applicability of like-kind exchange rules could limit or eliminate the market for like-kind exchange qualified intermediary (QI) services.

Deduction for FDIC premiums limitation

H.R. 1	Finance Committee bill
– Phases out deduction for FDIC premiums for banks with total consolidated assets between $10 billion and $50 billion and eliminates deduction for banks with total consolidated assets over $50 billion. Calculation must take into account the assets of the expanded affiliated group.	– Generally consistent with H.R. 1.

KPMG observation

- Banks preparing to cross the $10 billion or $50 billion asset threshold should consider the impact of losing this tax benefit in addition to the increased regulatory requirements imposed on the bank.
- The limitation or disallowance could result in a new permanent adjustment to a bank's financial statements.

Cost basis of specified securities

H.R. 1	Finance Committee bill
– Not addressed.	– Requires taxpayers to use the first-in first-out method to determine cost basis of specified securities sold, exchanged, or otherwise disposed of on or after January 1, 2018 (i.e., repeals specific identification method). – Retains the rule allowing the average basis method for certain securities (e.g., stock of a RIC). – RICS are exempt from needing to apply the first-in first-out rule.

KPMG observation

- The change proposed in the Finance Committee bill may be unfavorable for taxpayers who currently use the specific identification method, as those taxpayers would no longer have the ability to specifically identify securities in order to minimize taxable gain on a sale. Instead, taxpayers other than RICs would be limited to using the FIFO method, except for RIC stock with respect to which taxpayers may still elect to use an average-cost-basis method.
- Preventing taxpayers from using a specific identification method could mean that taxpayers (i) may have gain on a sale that they may not have had if they could have identified higher basis shares as being sold, (ii) may have long-term loss on a sale which may have been short-term loss if they could have identified shares held for a shorter timeframe as being sold, or (iii) may have loss on a sale subject to the wash sales rules instead of gain on the sale if lower basis shares were specifically identified.
- In addition, brokers have invested substantial time and money into their cost basis reporting systems, including to accommodate the specific identification method. While the Finance Committee bill proposal's elimination of the specific identification method ostensibly simplifies cost basis reporting, it would require efforts by brokers to "turn off" specific identification for "specified securities" as an available method to determine cost basis and to communicate this change to clients. A potential complicating factor worth noting is that not all securities are treated as "specified securities" under current IRS regulations, including debt instruments subject to section 1272(a)(6), short-term obligations described in section 1272(a)(2)(C) and certain derivatives.

Corporate AMT repeal

H.R. 1	Finance Committee bill
– Repeals corporate AMT. – Credit carryforwards partially refundable in years 2019, 2020 and 2021; fully refundable by 2022.	– Generally consistent with H.R 1. However, credit carryforwards partially refundable in years 2018, 2019, and 2020; fully refundable by 2021 (i.e., one year earlier than H.R. 1).

KPMG observation

– Repealing the corporate AMT would eliminate some of the complexity in U.S. corporate taxation.

– For taxpayers with significant corporate AMT credit carryovers, the proposed rules would allow the full use of the credits to reduce or eliminate regular tax liability, and to obtain tax refunds to the extent the AMT credit carryovers exceed such tax liability. Although the carryover proposals are substantially similar, the Finance Committee bill would accelerate the refund schedule by one year compared to H.R. 1.

Income recognition

H.R. 1	Finance Committee bill

– Not addressed.	– Requires taxpayers to recognize taxable income no later than the year the income is included in an applicable financial statement.
	  – Exception for long-term contract income.
	  – These rules would apply prior to applying the OID rules.
	– Application of these rules is a change in taxpayers' method of accounting and appears to require a 481(a) adjustment.

KPMG observation

– The Finance Committee bill proposal appears to largely eliminate taxpayers' ability to defer fee and interchange income recognized on credit card portfolios.

– The Finance Committee bill makes a broad reference to "part V of subchapter P" (i.e., "Special Rules for Bonds and Other Debt Instruments"), which presumably is intended to make clear that this proposal will apply to original issue discount (OID), and in particular would apply to credit card portfolios. However, part V of subchapter P also

includes rules for the tax treatment of stripped bonds (section 1286), which apply to the excess servicing on originated mortgage services rights (OMSRs). When an OMSR is created (through the sale of the underlying mortgage), gain is frequently recognized for financial accounting purposes, but not recognized for tax purposes (under current law). However, the gain is only a timing benefit (i.e., results in a deferred tax liability) that will reverse over the life of the servicing right. Thus, many in the industry are concerned this rule may now require servicers to accelerate income associated with their OMSRs.

NOL modifications

H.R. 1	Finance Committee bill
– Limited to 90% of taxable income. – Generally repeals carrybacks. – Indefinite carryforward, indexed for inflation. – Effective for NOLs arising in tax years beginning after 2017 (but 90% limitation applies to pre-existing NOLs).	– Generally consistent with H.R. 1, except no indexation of NOL carryforward amounts and the 90% limitation does not apply to NOLs from years prior to 2018. – Further reduces the limitation from 90% of taxable income to 80%of taxable income beginning in 2023.

KPMG observation

– The proposals would require corporations to track NOLs arising in tax years beginning before December 31, 2017, separately from those arising after December 31, 2017, as only the latter NOLs would be eligible for the indefinite carryover (under H.R. 1 and Finance Committee bill) and the annual percentage increase (under H.R. 1).

– The proposed changes to the NOL carryover provisions could favorably impact bank earnings from (i) the inflation indexing and (ii) the indefinite carryforward potentially changing the valuation allowance analysis.

– The proposed changes could also impact a bank's regulatory capital calculations, especially in a bank's stress testing calculations. Since NOLs could no longer be carried back under the proposal, all NOLs would be subject to the unfavorable capital treatment for NOL carryforwards.

Reform of business credits

H.R. 1	Finance Committee bill
– Retains research and development credit (R&D). – Retains low income housing tax credit (LIHTC).	– Retains current rules for R&D, NMTC, and energy tax credits. – LIHTC is largely maintained, while modifying certain aspects of the LIHTC regime, and renaming the

- Terminates new markets tax credits (NMTC).
  - Investors will continue to claim credit for existing NMTC investments.
- Repeals historic rehabilitation tax credit (HTC).
  - Transition rule qualifies expenditures for a period of 2 years for property owned or leased at December 31, 2017.
- Modifies energy production tax credit (PTC).
- Modifies energy investment tax credit (ITC).

credit the "Affordable Housing Tax Credit".

- Repeals historic rehabilitation tax credit (HTC) for most buildings. Credit is retained for certified historic structures (i.e., structures listed on the historic register). The credit for certified historic structures is claimed ratably over 5 years.
  - Transition rule for HTC similar to H.R. 1.

KPMG observation

- Although the LIHTC credit would be retained, the net benefit of such investments would be reduced as a result of the lower proposed corporate tax rate. The after tax yield, which depends in part on the losses passed through from the investment, would be reduced by the lower tax rate. As a result, banks may need to consider whether existing investments should be impaired for financial accounting purposes.
- The market for credits could be impacted by a reduction in tax capacity resulting from lower rates.
- Many LIHTC investments were historically funded by private activity bonds, the elimination of which in H.R. 1 could impact the availability of financing for these investments.
- The research credit would be retained under both proposals.
- Under H.R. 1, the energy production tax credit would be modified to repeal the inflation adjustment for certain electricity and refined coal, and clarify that the construction of any facility, modification, improvement, addition, or other property is determined based on "a continuous program of construction". The Finance Committee bill does not address the energy production credit.
- Under H.R. 1, the energy investment credit alters the pre-existing expiration dates and phase-out schedules for different properties. Additionally, as with the energy production credit, the H.R. 1 would clarify that the construction of any facility, modification, improvement, addition, or other property is determined based on "a continuous program of construction".
- Banks with investments in current rehabilitation tax credit projects may still receive some near-term benefit under a proposed transition rule that would allow credit for

qualified rehabilitation expenditures on buildings owned or leased as of December 31, 2017.

- Although the NMTC would be repealed under H.R. 1 for years after December 31, 2017, banks would be allowed to continue claiming the credit on existing NMTC projects. In addition, the lower corporate rate might increase the yield of the investments (i.e., gain from the section 45D(h) basis adjustment would be taxed at a lower rate).
- Banks historically satisfying Community Reinvestment Act (CRA) requirements through tax credits that are repealed under the proposals may need to find alternative investments to satisfy their CRA requirements.
- A reduction in the number of credits available (due to a repeal or modification of HTC and/or NMTC) could drive up the price of LIHTC investments (and other remaining CRA investments).

Municipal lending

H.R. 1	Finance Committee bill
– Terminates private activity bonds, advance refunding bonds, and tax credit bonds. – Retains tax exempt status of other municipal bond interest.	– Terminates advance refunding bonds. – Appears to retain tax exempt status of private activity bonds, tax credit bonds, and other qualifying municipal bonds.

KPMG observation

- Neither H.R. 1 nor the Finance Committee bill mentions any modifications to the interest expense disallowance rules under section 265.
- The lower proposed tax rates may reduce the value of tax-exempt investments. However, there may be countervailing factors, such as a potential reduction in the amount of CRA investments available (due to the repeal of certain social credits discussed above) that might otherwise increase the value of municipal investments. In addition, the net interest expense limitation imposed on borrowers could reduce supply of fixed income investments (i.e., fewer corporate bonds in the market), and such reduced supply could increase the value of tax-exempt bonds.
- For municipal bonds that are otherwise repealed, such bonds issued on or before December 31, 2017 would remain tax-exempt under a grandfathering rule.
- The repeal of advance refunding bonds could remove some flexibility for municipalities to reduce their cost of borrowing by preventing the municipalities from taking advantage of lower interest rates before outstanding bonds may be called otherwise. This could negatively impact pricing of municipal bonds as well as municipalities' appetite to issue new bonds in general.

Limitation on excessive employee remuneration

H.R. 1	Finance Committee bill
– Repeals exceptions for commissions and performance-based compensation to the $1 million deduction limitation. – Expands the definition of "publicly held corporation" – "Covered employees" would be redefined to include the principal financial officer. – Provides that once an employee is treated as a covered employee, the individual remains a covered employee as long as the individual receives remuneration from the corporation.	– Generally consistent with H.R. 1. – Unlike H.R. 1, the proposal would include a transition rule such that the limitation would generally not apply to remuneration under a binding contract in place as of November 2, 2017.

KPMG observation

– The performance-based exception, while complex, is an often-used exception to link compensation to performance and provide a greater deduction to a publicly traded corporation. Nonetheless, the repeal may allow banks greater flexibility in structuring executive compensation plans because they may no longer feel obligated to comply with the "performance-based" requirements.

– The proposed change to the definition of covered employee is now aligned with the definition used by the SEC. This has been a long discussed change as the different definitions generate some confusion.

– Expanding the definition to apply after officers retire is also a major change, and it is not completely clear how the deduction would work after a change in control.

Non-deductibility of fines and penalties

H.R. 1	Finance Committee bill
– Not addressed.	– Would expand the non-deductibility of fines and penalties to disallow a deduction for "any otherwise deductible amount paid or incurred to or at the direction of a government or specified nongovernmental entity" with regard to violations or investigations.

KPMG observation

- Based on prior guidance, the IRS has indicated that FINRA meets the definition of a "corporation serving as an agency or instrumentality of the government" for the purposes of generally disallowing a deduction for fines under the current section 162(f). (While this is the IRS position, there are currently differing viewpoints on this issue.) The proposal would expand the non-deductibility to certain amounts paid to non-governmental entities exercising self-regulatory powers either (i) in connection with a qualified board or exchange or (ii) as part of performing an "essential government function."

Deduction for domestic production activities

H.R. 1	Finance Committee bill
– Repeals deduction for domestic production activities under section 199.	– Generally consistent with H.R. 1.

Modifies deduction for meals and entertainment expenses

H.R. 1	Finance Committee bill
– Eliminates 50% deduction for entertainment expenses, but retains the deduction for business meals.	– Generally consistent with H.R. 1. – Additionally, disallows an employer's deduction for expenses associated with certain meals provided for the convenience of the employer.

International

Territorial taxation

H.R. 1	Finance Committee bill

– Creates a 100% exemption for dividends received from 10% owned foreign corporations.
– Generally repeals section 956 for corporate shareholders.
– Mandatory repatriation for post-1986 accumulated earnings and profits (E&P) of foreign subsidiaries.
  – Taxes cash and cash equivalents at 14%.
	– Generally consistent with H.R. 1 on foreign dividends received deduction.
	– Mandatory repatriation for post-1986 accumulated E&P of foreign subsidiaries.
	  – Generally allows taxpayers to recognize a deduction to arrive at tax rates of 10% for repatriated income attributable to cash assets and 5% for repatriated income derived from all other sources.

H.R. 1	Finance Committee bill
– Taxes all remaining E&P at 7% (i.e., E&P reinvested in the foreign subsidiary's business). – Provides an election to pay tax liability over an 8-year period in equal installments.	– Provides an election to pay tax liability over an 8-year period in weighted installments, increasing during the later years.

KPMG observation

- It is important for banks to analyze E&P positions for both financial statement reporting and evaluating tax planning opportunities.
- The shift to a territorial tax system could also raise issues with transfer pricing and ASC 740-30 (formerly APB 23) assertions.
- Banking operations could also be impacted in a variety of ways including potential changes to cash management services that banks offer to their U.S. multinational clients, and bank deposits as cash is repatriated.
- Because banking operations may result in a greater proportion of banks' E&P being held in cash, compared to other industries, banks may be generally subject to a higher effective rate under the mandatory repatriation proposals than other industries.

Base erosion

H.R. 1	Finance Committee bill

– Limits net interest expense deduction of a U.S. corporation that is a member of an international financial reporting group.
  – For net interest expense limitation purposes, an "international financial reporting group" is a group comprised of at least one domestic corporation and at least one foreign corporation engaged in a U.S. trade or business, and which prepares consolidated financial statements. The group must report average annual group gross receipts greater than $100 million, for a rolling three-year period.
  – Limitation is based on a U.S. corporation's EBITDA compared
	– Limits net interest expense deduction of a U.S. corporation that is a member of a worldwide affiliated group.
	  – For net interest expense limitation purposes, the "worldwide affiliated group" is generally the same as the current section 1504 affiliated group, except the ownership threshold is reduced to 50%, and the restriction on inclusion of a foreign corporation is disregarded.
	  – Limitation is based on net interest expense of the domestic corporation multiplied by the "debt-to-equity differential percentage" of the worldwide affiliated group.

H.R. 1	Finance Committee bill

to the financial reporting group's EBITDA.
– Introduces a 20% excise tax on certain payments made by a U.S. corporation to a related foreign corporation, unless an election is made to treat such payments as effectively connected income.
– Taxes U.S. parent of one or more foreign subsidiaries on 50% of the U.S. parent's foreign "high returns", regardless of whether those earnings are repatriated.
  – A number of exceptions apply to this rule.
	– Debt-to-equity differential percentage compares debt-to-equity ratio of the U.S. group members to debt-to-equity ratio of the worldwide group.
	– Minimum tax of 10%, effective 2018, and 12.5%, effective 2026, imposed on taxpayers with base erosion payments. The minimum tax is intended to address similar issues as the excise tax in H.R. 1, but with a very different mechanic.
	  – The tax is calculated on the excess of the taxpayer's modified taxable income over regular taxable income.
	  – Modified taxable income is calculated without regard to deductible payments made to foreign related parties (subject to certain exceptions).
	  – Only applies to corporations (excluding RICs, REITs, and S Corps) with gross receipts of at least $500 million and a base erosion percentage of at least 4% (base erosion percentage equals base erosion deductions divided by total deductions of the taxpayer).
	– Denies a deduction for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity.
	– U.S. shareholder must pay current tax on CFC income above a deemed return on intangible assets, subject to certain exclusions. U.S. shareholders may also recognize a deduction associated with such income, which essentially results in the income

H.R. 1	Finance Committee bill
	being taxed at a rate of 10% through 2025. Beginning in 2026, the deduction would be reduced to result in an effective rate of 12.5%.

KPMG observation

- As proposed in H.R. 1, the excise tax would effectively deny the benefit of a deduction for covered payments, unless the foreign recipient elects to treat the payment as ECI and as income attributable to a permanent establishment for tax treaty purposes. SIFMA issued a November 2, 2017, comment letter on selected provisions of the proposed legislation, addressing the perceived issues with this proposal.
- Because of the deemed paid foreign tax credit under H.R. 1, a U.S. parent generally would be indifferent to the tax on foreign high returns when the effective tax rate on the underlying income is at least 12.5% (ignoring base and timing differences). Without a carryforward or other mitigating provision, it is possible that U.S. shareholders whose CFCs generally are subject to significant foreign taxes may owe residual U.S. tax in a given year if income is recognized for U.S. tax purposes but not foreign tax purposes.
- The proposals to limit net interest limitation would apply in addition to the general net interest expense limitation discussed above. Whichever provision would deny the greater amount of interest deductions would apply to the affected U.S. corporation, and the amount denied would be permitted as a carryforward (for five years under H.R. 1, or indefinitely under the Finance Committee bill).
- The proposals focus on excessive leverage, but would allow the U.S. entity to have 10% more leverage than the worldwide group. A similar proposal was included in former Representative Camp's 2014 tax reform proposal.

Individual[1]

Ordinary income rates

H.R. 1	Finance Committee bill
– Consolidates seven tax brackets into four. – Retains highest tax bracket of 39.6%.	– Modifies seven tax brackets. – Lowers highest tax bracket to 38.6%.

[1] All individual proposals under the Finance Committee bill discussed in this document would generally expire beginning in 2026, except the repeal of the individual mandate under the Affordable Care Act.

ACA individual mandate

H.R. 1	Finance Committee bill
– Not addressed.	– Reduces the so-called "individual mandate" under the Affordable Care Act to zero. The proposal would be effective beginning in 2019, and it would not sunset.

Retains itemized deductions for home mortgage interest and charitable contributions

H.R. 1	Finance Committee bill
– Repeals personal exemption. – Doubles standard deduction. – Eliminates most itemized deductions, including deductions for state and local income tax. – Preserves state and local property tax deduction, although deduction is capped at $10,000. – Limits home mortgage interest deduction to $500,000 of indebtedness acquired after November 2, 2017. – Includes "grandfathering" rules. Refinanced debt would be considered incurred on the same date as the original debt. – Eliminates deduction for second home mortgage and home equity indebtedness. – Modifies exclusion of gain from sale of residence.	– Repeals personal exemptions. – Doubles standard deduction. – Eliminates most itemized deductions, including deductions for state and local income tax. – Eliminates deductions for state and local property taxes unless imposed on business assets. – Retains current home mortgage interest deduction for acquisition indebtedness. – Eliminates deduction for home equity indebtedness. – Modifies exclusion of gain from sale of residence.

KPMG observation

– While retaining the deductions for home mortgage interest and charitable contributions may be significant, the elimination of the other itemized deductions would likely result in fewer taxpayers who would choose to itemize and therefore may effectively eliminate the benefit of retaining such deductions for many individuals.

- For homeowners who are unable to benefit from the home mortgage interest deduction, there would be an increase in the after-tax cost of mortgages, which could lead to a reduction in demand for, or individual size of, new mortgages.
- It will be necessary for banks to alter current underwriting models in order to account for the new limits.

Repeals estate and generation-skipping transfer taxes

H.R. 1	Finance Committee bill

– Modifies and ultimately repeals estate, and generation skipping transfer taxes.
  – Doubles estate tax exclusion to $10 million, indexed for inflation.
  – Repeals estate and generation skipping transfer taxes beginning in 2024.
  – Basis step-up retained.
	– Does not repeal estate and generation skipping transfer taxes.
	– Doubles estate tax exclusion to $10 million, indexed for inflation.

KPMG observation

- The repeal of these taxes could impact high-net worth clients and provide new opportunities for banks' wealth management operations.
- A reduction and/or repeal of estate and generation skipping transfer tax may impact the demand for products, including insurance products sold through broker subsidiaries.

Repeals the individual AMT

H.R. 1	Finance Committee bill
– Repeals individual AMT. – Credit carryforwards partially refundable in years 2019, 2020 and 2021; fully refundable by 2022.	– Generally consistent with H.R. 1.

KPMG observation

- Under current law, incentive stock options are treated as compensation at exercise for AMT purposes. The repeal of AMT would mean incentive stock option would only be subject to federal income tax when sold.

Additional observations

H.R. 1 and the Finance Committee bill share many common provisions, but diverge in significant ways as noted above. Many questions remain about what will ultimately be included in a final tax reform bill, if anything. For example, derivative reform and the treatment of debt for holders are among the items not addressed by either H.R. 1 or the Finance Committee bill. These items have been raised in previous tax reform proposals, and could still be considered by Congress.

Derivative reform

Previous tax reform proposals moved to a mark-to-market regime for derivative contracts, with any mark-to-market gains and losses recognized as ordinary income or loss. If such a proposal was enacted at a later date, the change would likely affect the investment strategies of retail and institutional investors, driving a change in demand for different investment products.

Treatment of debt for holders

Former Ways and Means Chairman's "Tax Reform Act of 2014" contained proposals for inclusion in income of market discount, as well as no gain/loss treatment of certain exchanges of debt instruments. The current proposals do not discuss debt treatment for holders.

Read KPMG's initial observations (dated November 16) of H.R. 1 as passed by the House: **House Republican Tax Reform Bill - Initial Observations on House Passed Bill**

Read KPMG's initial observations of the Finance Committee bill (dated November 18) **Senate Tax Reform Bill – Initial Observations on Finance Committee Bill**

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