[JOINT COMMITTEE PRINT]

TECHNICAL EXPLANATION, ESTIMATED REVENUE EFFECTS, DISTRIBUTIONAL ANALYSIS, AND MACROECONOMIC ANALYSIS OF THE TAX REFORM ACT OF 2014, A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE

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CONTENTS

Page

INTRODUCTION

This document[1] provides a technical explanation, estimated revenue effects, distributional analysis, and macroeconomic analysis of the Tax Reform Act of 2014, a discussion draft prepared by the Chairman of the House Committee on Ways and Means that proposes to reform the Internal Revenue Code. The Chairman of the House Committee on Ways and Means released his discussion draft on February 26, 2014.[2]

This document compiles and republishes with minor typographical and content corrections the following 11 documents which were originally published on February 26, 2014:

- *Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title I – Tax Reform for Individuals* (JCX-12-14);
- *Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title II – Alternative Minimum Tax Repeal* (JCX-13-14);
- *Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title III – Business Tax Reform* (JCX-14-14);
- *Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title IV – Participation Exemption System for the Taxation of Foreign Income* (JCX-15-14);
- *Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title V – Tax Exempt Entities* (JCX-16-14);
- *Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title VI – Tax Administration and Compliance* (JCX-17-14);
- *Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title VII – Excise Taxes* (JCX-18-14);

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[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation, Estimated Revenue Effects, Distributional Analysis, and Macroeconomic Analysis of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code* (JCS-1-14), September 2014. This document can also be found on our website at www.jct.gov.

[2] The discussion draft is available on the Ways and Means website at http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft__022614.pdf; see also Ways and Means Committee Print, Tax Reform Act of 2014, as released on February 26, 2014, WMCP 113-6, September 2014.

- *Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title VIII – Deadwood and Technical Provisions* (JCX-19-14);
- *Estimated Revenue Effects of the "Tax Reform Act of 2014"* (JCX-20-14);[3]
- *Distributional Effects of the "Tax Reform Act of 2014"* (JCX-21-14);[4] and
- *Macroeconomic Analysis of the "Tax Reform Act of 2014"* (JCX-22-14).[5]

This document corrects the following substantive errors in the original documents.

Page 27 corrects an error in the description of the proposal that is on page 25 of JCX-12-14, relating to the American opportunity tax credit. The original stated that the inflation adjustment was for tax years beginning in 2018. The correction states that the adjustment is for taxable years beginning after 2018.

Page 271 corrects an error in the description of the proposal that is on page 132 of JCX-14-14, relating to the modification of rules for capitalization and inclusion in inventory costs of certain expenses. The original stated that the proposal repeals the exception to section 263A for farming businesses. The correction deletes this statement.

Page 480 corrects an error in the description of present law that is in footnote 1246 on page 341 of JCX-14-14, relating to the increased section 179 expensing limitation for an enterprise zone business. The original stated that for 2012 the limit is $500,000, and for taxable years beginning after 2012, the limit is $200,000. The correction states that for 2010 – 2013 the limit is $2,000,000, and for taxable years beginning after 2013, the limit is $200,000.

Pages 529 and 530 correct two errors in the description of the proposal, on pages 38 and 39 of JCX-15-14, relating to the extension and modification of the active financing exception. The description of the proposal mistakenly states that the proposal extends the exception for taxable years beginning before January 1, 2020. In fact, the proposal extends the exception for taxable years beginning before January 1, 2019. The description of the proposal mistakenly states that for an item of income subject to an effective foreign income tax rate of at least 50 percent of the maximum U.S. corporate tax rate under section 11, the proposal limits the exclusion to 50 percent. In fact, the 50-percent exclusion is for an item of income subject to an effective foreign income tax rate of less than 50 percent of the maximum U.S. corporate tax rate under section 11.

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[3] The economic analysis is presented relative to the 2013 economic and receipts baseline publish by the Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013-2023*, February 5, 2013.

[4] *Ibid.*

[5] *Ibid.*

TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014, A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE

TITLE I – TAX REFORM FOR INDIVIDUALS

A. Individual Income Tax Rate Reform

1. Simplification of individual income tax rates (secs. 1001 and 1003 of the discussion draft and secs. 1 and 2 of the Code)

Present Law

In general

To determine regular tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases.

Tax rate schedules

Separate rate schedules apply based on an individual's filing status. For 2014, the regular individual income tax rate schedules are as follows:

Table 1.–Federal Individual Income Tax Rates for 2014[6]

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $9,075	10% of the taxable income
Over $9,075 but not over $36,900	$907.50 plus 15% of the excess over $9,075
Over $36,900 but not over $89,350	$5,081.25 plus 25% of the excess over $36,900
Over $89,350 but not over $186,350	$18,193.75 plus 28% of the excess over $89,350
Over $186,350 but not over $405,100	$45,353.75 plus 33% of the excess over $186,350

[6] Sec. 3.01 of Rev. Proc. 2013-35, 2013-47 I.R.B. 537, 2013.

If taxable income is:	Then income tax equals:
Over $405,100 but not over $406,750	$117,541.25 plus 35% of the excess over $405,100
Over $406,750	$118,118.75 plus 39.6% of the excess over $406,750
Heads of Households	
Not over $12,950	10% of the taxable income
Over $12,950 but not over $49,400	$1,295 plus 15% of the excess over $12,950
Over $49,400 but not over $127,550	$6,762.50 plus 25% of the excess over $49,400
Over $127,550 but not over $206,600	$26,300 plus 28% of the excess over $127,550
Over $206,600 but not over $405,100	$48,434 plus 33% of the excess over $206,600
Over $405,100 but not over $432,200	$113,939 plus 35% of the excess over $405,100
Over $432,200	$123,424 plus 39.6% of the excess over $432,200
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $18,150	10% of the taxable income
Over $18,150 but not over $73,800	$1,815 plus 15% of the excess over $18,150
Over $73,800 but not over $148,850	$10,162.50 plus 25% of the excess over $73,800
Over $148,850 but not over $226,850	$28,925 plus 28% of the excess over $148,850
Over $226,850 but not over $405,100	$50,765 plus 33% of the excess over $226,850
Over $405,100 but not over $457,600	$109,587.50 plus 35% of the excess over $405,100
Over $457,600	$127,962.50 plus 39.6% of the excess over $457,600
Married Individuals Filing Separate Returns	
Not over $9,075	10% of the taxable income
Over $9,075 but not over $36,900	$907.50 plus 15% of the excess over $9,075
Over $36,900 but not over $74,425	$5,081.25 plus 25% of the excess over $36,900
Over $74,425 but not over $113,425	$14,462.50 plus 28% of the excess over $74,425

If taxable income is:	Then income tax equals:
Over $113,425 but not over $202,550	$25,382.50 plus 33% of the excess over $113,425
Over $202,550 but not over $228,800	$54,793.75 plus 35% of the excess over $202,550
Over $228,800	$63,981.25 plus 39.6% of the excess over $228,800
Estates and Trusts	
Not over $2,500	15% of the taxable income
Over $2,500 but not over $5,800	$375 plus 25% of the excess over $2,500
Over $5,800 but not over $8,900	$1,200 plus 28% of the excess over $5,800
Over $8,900 but not over $12,150	$2,068 plus 33% of the excess over $8,900
Over $12,150	$3,140.50 plus 39.6% of the excess over $12,150

Unearned income of children

Special rules (generally referred to as the "kiddie tax") apply to the net unearned income of certain children.[7] Generally, the kiddie tax applies to a child if: (1) the child has not reached the age of 19 by the close of the taxable year, or the child is a full-time student under the age of 24, and either of the child's parents is alive at such time; (2) the child's unearned income exceeds $2,000 (for 2014); and (3) the child does not file a joint return.[8] The kiddie tax applies regardless of whether the child may be claimed as a dependent by either or both parents. For children above age 17, the kiddie tax applies only to children whose earned income does not exceed one-half of the amount of their support.

Under these rules, the net unearned income of a child (for 2014, unearned income over $2,000) is taxed at the parents' tax rates if the parents' tax rates are higher than the tax rates of the child.[9] The remainder of a child's taxable income (i.e., earned income, plus unearned income up to $2,000 (for 2014), less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child. For these purposes, unearned income is income other than wages, salaries, professional fees, other amounts received as compensation for

[7] Sec. 1(g). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[8] Sec. 1(g)(2).

[9] Special rules apply for determining which parent's rate applies where a joint return is not filed.

personal services actually rendered, and distributions from qualified disability trusts.[10] In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.[11]

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($1,000 for 2014[12]), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.[13]

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income.[14] If the child has net capital gains or qualified dividends, these items are allocated to the parent's hypothetical taxable income according to the ratio of net unearned income to the child's total unearned income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based upon the child's net unearned income relative to the aggregate net unearned income of all of the parent's children subject to the tax.

Generally, a child must file a separate return to report his or her income.[15] In such case, items on the parents' return are not affected by the child's income, and the total tax due from the child is the greater of:

1. The sum of (a) the tax payable by the child on the child's earned income and unearned income up to $2,000 (for 2014), plus (b) the allocable parental tax on the child's unearned income, or

2. The tax on the child's income without regard to the kiddie tax provisions.[16]

Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return.[17]

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[10] Sec. 1(g)(4) and sec. 911(d)(2).

[11] Sec. 1(h).

[12] Sec. 3.02 of Rev. Proc. 2013-35, *supra*.

[13] Sec. 1(g)(4).

[14] Sec. 1(g)(3).

[15] Sec. 1(g)(6). See Form 8615, Tax for Certain Children Who Have Unearned Income.

[16] Sec. 1(g)(1).

[17] Sec. 1(g)(7).

Indexing tax provisions for inflation

Under present law, many parameters of the tax system are adjusted for inflation to protect taxpayers from the effects of rising prices. Most of the adjustments are based on annual changes in the level of the Consumer Price Index for all Urban Consumers ("CPI-U").[18] The CPI-U is an index that measures prices paid by typical urban consumers on a broad range of products, and is developed and published by the Department of Labor.

Among the inflation-indexed tax parameters are the following individual income tax amounts: (1) the regular income tax brackets; (2) the basic standard deduction; (3) the additional standard deduction for aged and blind; (4) the personal exemption amount; (5) the thresholds for the overall limitation on itemized deductions and the personal exemption phase-out; (6) the phase-in and phase-out thresholds of the earned income credit; (7) IRA contribution limits and deductible amounts; and (8) the saver's credit.

Description of Proposal

Modification of rates

In general

The proposal replaces the individual income tax rate structure with a new rate structure. The new rate structure generally has three rates, 10 percent, 25 percent and 35 percent, with the 35-percent rate composed of the 25-percent rate imposed on taxable income in excess of the 25-percent rate bracket threshold and an additional 10 percent tax on modified adjusted gross income (modified "AGI") in excess of $450,000 for joint returns ($400,000 for all other filers). The 25-percent rate bracket begins at taxable income of $71,200 for joint returns and surviving spouses ($35,600 for other individuals).[19] Estates and trusts have only two rate brackets: a 25-percent bracket and 35-percent bracket, with the 35-percent rate composed of a 25 percent rate on taxable income and an additional 10 percent rate on modified AGI in excess of $12,000. Modified AGI is described in more detail below.

The benefit of the 10-percent rate, as measured against the 25-percent rate on taxable income, is phased out if an individual's modified AGI exceeds a threshold of $300,000 for joint filers and surviving spouses ($250,000 for any other individual other than trusts and estates). For taxpayers whose modified AGI exceeds these thresholds, the benefit amounts to $10,680 for joint filers and $5,340 for all other filers. The benefit amount is phased out at a five-percent rate, and is thus fully phased out at modified AGI of $513,600 (in the case of joint filers) or $356,800 (in the case of other individual taxpayers) above the threshold amount.

The bracket thresholds, and the threshold at which the benefit of the 10-percent rate begins to be phased out, are all adjusted for inflation using a base year of 2013, and then rounded

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[18] Sec. 1(f)(5).

[19] The proposal repeals head of household filing status.

to the next lowest multiple of $100 in future years. Unlike present law (which uses a measure of the consumer price index for all-urban consumers), the new inflation adjustment uses the chained consumer price index for all-urban consumers.

For purposes of the 35-percent bracket and the phaseout of the benefit of the 10-percent bracket, modified AGI is defined as AGI increased by:

(i) any amount excluded from income under sections 911 (related to exclusions from income for citizens or residents of the United States living abroad), 931, and 933;

(ii) any amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax (less any amounts disallowed as a deduction for investment interest with respect to tax-exempt interest,[20] and amortizable bond premiums on tax-exempt bonds[21]);

(iii) any amount excluded by the taxpayer as a cost of employer-sponsored health coverage;

(iv) amounts paid by a self-employed individual for health insurance deducted under section 162(l);

(v) pre-tax contributions to tax-favored defined contribution retirement plans;

(vi) deductible health savings account ("HSA") contributions; and

(vii) excluded Social Security and tier I railroad retirement benefits; and

reduced by

(i) charitable contributions to the extent eligible for a deduction under section 170, but only if the taxpayer itemizes his or her deductions; and

(ii) qualified domestic manufacturing income.

Qualified domestic manufacturing income

For these purposes, qualified domestic manufacturing income is equal to domestic manufacturing gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; and (2) other expenses, losses, or deductions which are properly allocable to those receipts.

Domestic manufacturing gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any lease, rental, license, sale, exchange, or other disposition of tangible

[20] See the description of section 3124 of the discussion draft, "Prevention of arbitrage of deductible interest expense and tax-exempt interest income."

[21] Sec. 171(a)(2).

personal property that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States;[22] or (2) in the case of a taxpayer engaged in the active conduct of a construction trade or business, construction of real property performed in the United States by a taxpayer in the ordinary course of such trade or business if such real property is placed in service after December 31, 2014.

Under the proposal, tangible personal property does not include computer software[23] or any motion picture films, video tapes, or sound recordings.[24]

However, domestic manufacturing gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed, or rented by the taxpayer for use by any related person. Further, domestic manufacturing gross receipts do not include any gross receipts of the taxpayer that are derived from the sale of food or beverages prepared by the taxpayer at a retail establishment; that are derived from the transmission or distribution of electricity, natural gas, or potable water; and that are derived from the lease, rental, license, sale, exchange, or other disposition of land. Domestic manufacturing gross receipts also do not include any gross receipts which are properly allocable to the taxpayer's net earnings from self employment,[25] or any amount attributable to a qualified change in method of accounting[26] and/or any other change in method of accounting required by the discussion draft.[27]

A special rule for government contracts provides that property that is manufactured or produced by the taxpayer pursuant to a contract with the Federal Government is considered to be domestic manufacturing gross receipts even if title or risk of loss is transferred to the Federal Government before the manufacture or production of such property is complete to the extent required by the Federal Acquisition Regulation.

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[22] When used in the Code in a geographical sense, the term "United States" generally includes only the States and the District of Columbia. However, in determining domestic manufacturing gross receipts, in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term "United States" includes the Commonwealth of Puerto Rico, but only if all of the taxpayer's Puerto Rico-sourced gross receipts are taxable under the Federal income tax for individuals or corporations.

[23] It is intended that any lease, rental, license, sale, exchange, or other disposition of computer software, regardless of the method (*e.g.*, provided via a tangible medium, downloaded from the internet, accessed on the cloud, or any similar transaction) is excluded from the definition of "domestic manufacturing gross receipts."

[24] "Sound recordings" are any works resulting from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material (*e.g.*, discs, tapes, or other phonorecordings) in which such sounds are embodied. Sec. 168(f)(4).

[25] For a discussion of net earnings from self-employment, see the description of section 3621 of the discussion draft, "Ordinary income treatment in the case of partnership interests held in connection with performance of services."

[26] For a discussion of a qualified change in method of accounting, see the description of section 3301 of the discussion draft, "Limitation on use of cash method of accounting."

[27] See, *e.g.*, section 3310 of the discussion draft, "Repeal of last-in, first-out method of inventory."

With respect to the domestic manufacturing income of a partnership or S corporation, each partner or shareholder generally will take into account such person's allocable share of the components of the calculation (including domestic manufacturing gross receipts; the cost of goods sold allocable to such receipts; and other expenses, losses, or deductions properly allocable to such receipts) from the partnership or S corporation. For a trust or estate, the components of the calculation are apportioned between (and among) the beneficiaries and the fiduciary under regulations prescribed by the Secretary. However, in the case of a publicly traded partnership described in section 7704(c), each partner shall not take into account any allocable share of the aforementioned components of the calculation.

A phase-in is provided for taxable years beginning before January 1, 2017: for any taxable year beginning in 2015, only 33 percent of a taxpayer's qualified domestic manufacturing income reduces AGI; and for any taxable year beginning in 2016, only 67 percent of a taxpayer's qualified domestic manufacturing income reduces AGI.

Simplification of tax on unearned income of children

The proposal simplifies the "kiddie tax" by effectively applying the rates applicable to trusts to the net unearned income of a child to whom the proposal applies. Specifically, the amount of taxable income taxed at a 10-percent rate may not exceed the amount of taxable income in excess of the net unearned income of the child. The amount of taxable income taxed at rates below 35 percent may not exceed sum of (1) the taxable income in excess of the net unearned income of the child plus (2) the amount of taxable income not in excess of the 35-percent bracket threshold in the case of a trust.

The following examples illustrate the application of the proposal:

Example 1.–Assume a child to whom the "kiddie tax" applies has $60,000 taxable income (and modified AGI) of which $50,000 is net unearned income. Assume the 25-percent bracket threshold amount for the taxable year is $35,600 for an unmarried taxpayer (other than a child subject to the "kiddie tax"), and the 35-percent bracket threshold for a trust is $12,000.

The child's 25-percent bracket threshold is $10,000 ($60,000 less $50,000) and 35-percent bracket threshold is $22,000 ($10,000 plus $12,000). Thus, $10,000 is taxed at a 10-percent rate, $12,000 is taxed at a 25-percent rate, and $38,000 is taxed at a 35-percent rate.

Example 2.–Assume the same facts as in Example 1 except that the amount of the child's net unearned income is $20,000 (rather than $50,000).

The child's 25-percent bracket threshold is $35,600 and 35-percent bracket threshold is $52,000 ($40,000 ($60,000 less $20,000) plus $12,000). Thus, $35,600 is taxed at a 10-percent rate, $16,400 is taxed at a 25-percent rate, and $8,000 is taxed at a 35-percent rate.

Replacing CPI-U with chained CPI-U

The proposal requires the use of the chained CPI-U ("C-CPI-U") to index tax parameters currently indexed by the CPI-U. The C-CPI-U is developed and published by the Department of

Labor, and differs from the CPI-U in that it accounts for the ability of individuals to alter their consumption patterns in response to relative price changes.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

2. Deduction for capital gains and dividends of individuals (sec. 1002 of the discussion draft and sec. 169 of the Code)

Present Law

In general

In the case of an individual, estate, or trust, any adjusted net capital gain which otherwise would be taxed at the 10- or 15-percent rate is not taxed. Any adjusted net capital gain which otherwise would be taxed at rates over 15-percent and below 39.6 percent is taxed at a 15-percent rate. Any adjusted net capital gain which otherwise would be taxed at a 39.6-percent rate is taxed at a 20-percent rate.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

In addition, a tax is imposed on net investment income in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income, which includes gains and dividends, or the excess of modified adjusted gross income over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in the case of any other individual.

Definitions

Net capital gain

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Adjusted net capital gain

The "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

Qualified dividend income

Adjusted net capital gain is increased by the amount of qualified dividend income.

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits. Qualified dividends generally includes dividends received from domestic corporations and qualified foreign corporations. The term "qualified foreign corporation" includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Dividends received from a corporation that is a passive foreign investment company (as defined in section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company ("RIC") for any taxable year in which the qualified dividend income received by the RIC is less than 95 percent of its gross income (as specially computed) may not exceed the sum of (1) the qualified dividend income of the RIC for the taxable year and (2) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of qualified dividend income that may be paid by a real estate investment trust ("REIT") for any taxable year may not exceed the sum of (1) the qualified dividend income of the REIT for the taxable year, (2) an amount equal to the excess of the income subject to the taxes imposed by section 857(b)(1) and the regulations prescribed under section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, and (3) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

Dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; or deductible dividends paid on employer securities are not qualified dividend income.

28-percent rate gain

The term "28-percent rate gain" means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof) and the amount of gain equal to the additional amount of gain that would be excluded from gross income under section 1202 (relating to certain small business stock) if the percentage limitations of section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.

Unrecaptured section 1250 gain

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 (relating to certain property used in a trade or business) applies may not exceed the net section 1231 gain for the year.

Description of Proposal

The proposal repeals the present-law maximum tax rates for capital gain and dividends. The proposal provides a deduction in computing adjusted gross income equal to 40 percent of the adjusted net capital gain of an individual.

Adjusted net capital gain means net capital gain reduced (but not below zero) by the net collectibles gain and increased by the qualified dividend income.

The 3.8 percent tax on net investment income is not affected by the proposal.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

B. Simplification of Tax Benefits for Families

1. Standard deduction (sec. 1101 of the discussion draft and sec. 63 of the Code)

Present Law

Under present law, a taxpayer may reduce his adjusted gross income ("AGI") by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2014, the amount of the standard deduction is $6,200 for single individuals and married individuals filing separate returns, $9,100 for heads of households, and $12,400 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.[28] The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

In lieu of taking the applicable standard deduction, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income, sales taxes), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 10 percent of AGI (7.5 percent for certain taxpayers over age 65)), casualty and theft losses (in excess of $100 per loss and in excess of 10 percent of AGI), and certain miscellaneous expenses (in excess of two percent of AGI).

Description of Proposal

The proposal increases the standard deduction for taxpayers across all filing statuses. Under the proposal, the amount of the standard deduction is $22,000 for married individuals filing a joint return and $11,000 for all other taxpayers (the proposal eliminates head of household filing status). The amount of the standard deduction is indexed for inflation using the chained consumer price index for all-urban consumers.[29]

The proposal also provides that the amount of the standard deduction is phased out by 20 percent of every dollar that a taxpayer's modified AGI exceeds $513,600[30] for joint filers ($356,800 for all other filers).[31] Thus, using the nominal values, the standard deduction will be completely phased out when a taxpayer's modified AGI reaches $623,600 in the case of a joint

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[28] For 2014, the additional amount is $1,200 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,650. An individual who qualifies as both blind and elderly is entitled to two additional standard deductions, for a total additional amount (for 2014) of $2,400 or $3,300, as applicable.

[29] The standard deduction amounts are set at 2013 levels. Thus, in 2015 the amounts of the standard deduction will be $11,000 and $22,000, plus an adjustment for two years of inflation.

[30] The phaseout threshold amounts are set at 2013 levels. Thus, in 2015 the threshold amounts will be $513,600 for joint filers ($356,800 for all other filers), plus an adjustment for two years of inflation.

[31] For a description of modified AGI, see the description of section 1001 of the proposal.

return (and $411,800 in any other case). The threshold amount at which the phaseout begins is indexed for inflation.[32]

To provide parity with those who itemize their deductions, the proposal also provides for a phaseout of $22,000 of itemized deductions, in the case of joint filers ($11,000 for all other filers) over the same modified AGI range. Thus, if a joint filer had $40,000 in itemized deductions, this amount would be reduced to $18,000 (*i.e.*, the $22,000 value of the standard deduction would be phased out) as the taxpayer's modified AGI went from $513,600 to $623,600.

The proposal eliminates the additional standard deduction for the aged and the blind.

The proposal provides for an additional above-the-line deduction for unmarried individuals with at least one qualifying child. These individuals are entitled to an additional deduction of $5,500 (indexed for inflation).[33] This additional deduction is phased out for every dollar by which a taxpayer's AGI exceeds $30,000 (this threshold is adjusted for inflation).

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

2. Increase and expansion of child tax credit (sec. 1102 of the discussion draft and sec. 24 of the Code)

Present Law

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is $1,000. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income ("AGI") over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. For purposes of this limitation, modified AGI includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against both the regular tax and the alternative minimum tax ("AMT"). To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is

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[32] The phaseout thresholds are set at 2013 levels. Thus, in 2015 the phaseout thresholds will be the nominal amounts above, plus an adjustment for two years of inflation.

[33] The additional standard deduction amount is set at 2013 levels. Thus, in 2015 the $5,500 amount will be adjusted based on two years of inflation.

eligible for a refundable credit[34] (the "additional child tax credit") equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). Prior to the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA"), the threshold dollar amount was $10,000 and was indexed for inflation. Under the ARRA, the threshold amount was lowered to $3,000 (the $3,000 amount is not indexed). The $3,000 threshold is currently scheduled to expire for taxable years beginning after December 31, 2017, after which the threshold reverts to the indexed $10,000 amount ($13,600 for 2014).

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's Social Security taxes exceed the taxpayer's earned income credit ("EIC").

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. At the taxpayer's election, combat pay may be treated as earned income for these purposes. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

Any credit or refund allowed or made to an individual under this provision (including to any resident of a U.S. possession) is not taken into account as income and is not be taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

Description of Proposal

The proposal increases the child tax credit to $1,500 per qualifying child and raises the age limit by one year to include qualifying children under age 18 ($500 for other qualifying dependents).[35] The proposal generally retains the present-law definition of dependent. However, the definition of a qualifying child is limited to individuals who are citizens or nationals of the United States. The credit amounts are indexed for inflation.[36]

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[34] The refundable credit may not exceed the maximum credit per child of $1,000.

[35] For a description of the modifications to the definition of a qualifying child, see the description of section 1104 of the discussion draft.

[36] The credit amounts are set at 2013 levels. Thus, in 2015 the credit amounts will be $500 and $1,500, plus an adjustment for two years of inflation.

The credit is phased out for higher-income individuals. Specifically, a taxpayer's child tax credit is reduced at a rate of five percent of the taxpayer's modified AGI as exceeds $623,600[37] for joint filers ($411,800 for other filers).[38] These thresholds are indexed for inflation.[39]

The child tax credit is partially refundable against the individual's income tax liability. The refundable portion is limited to the lesser of: (1) the child tax credit otherwise allowed, or (2) 25 percent of the taxpayer's earned income. Earned income is defined as a taxpayer's wages, salaries, tips and other employee compensation includible in gross income for the taxable year, plus the taxpayer's net earnings from self-employment income for the taxable year (determined with regard to the deduction allowed to the taxpayer by section 164(f)). For purposes of calculating a taxpayer's refundable child credit, for taxable years beginning prior to 2018, a taxpayer must reduce earned income by $3,000 (but not below zero). Additionally, the proposal provides that a taxpayer is not allowed the refundable child tax credit for a taxable year in which the taxpayer excludes any amount from gross income under section 911 (relating to the exclusion of foreign earned income).

The proposal requires that the taxpayer include the name and taxpayer identification number of each qualifying child and dependent on the tax return for each taxable year. In the case of a refundable child tax credit the taxpayer must include the taxpayer's Social Security number on the tax return for the taxable year (in the case of a joint return either spouse's Social Security number will suffice). The Internal Revenue Service may assess a deficiency in tax arising from the failure to include the Social Security number on the tax return as a mathematical or clerical error.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

3. Modification of earned income tax credit (sec. 1103 of the discussion draft and sec. 32 of the Code)

Present Law

In general

Low- and moderate-income workers may be eligible for the refundable earned income credit ("EIC"). Eligibility for the EIC is based on earned income, adjusted gross income

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[37] The phaseout threshold amounts are set at 2013 levels. Thus, in 2015 the threshold amounts will be $623,600 for joint filers ($411,800 for all other filers), plus an adjustment for two years of inflation.

[38] See the description of section 1001 of the discussion draft for a description of modified AGI.

[39] The phaseout thresholds are indexed using 2013 as the base year. Thus, in 2015 the phaseout thresholds will be $627,500, plus an adjustment for the change in the average chained consumer price index between August 31, 2013 and August 31, 2014.

("AGI"), investment income, filing status, number of children, and immigration and work status in the United States. The amount of the EIC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The EIC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the beginning of the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EIC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $3,350 (for 2014). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income that is not self-employment income (if greater than zero).

The EIC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

Filing status

An unmarried individual may claim the EIC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EIC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EIC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year, and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of qualifying children and amount of the earned income credit

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children. The values below are for 2014.[40]

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to $6,480, resulting in a maximum credit of $496. The maximum is available for those with incomes between $6,480 and $8,110 ($13,540

[40] All income thresholds are indexed for inflation annually.

if married filing jointly). At that point, the credit begins to phase out at a rate of 7.65 percent of earnings above that threshold, resulting in a $0 credit at $14,590 of earnings ($20,020 if married filing jointly).

Taxpayers with one qualifying child may claim a credit of 34 percent of their earnings up to $9,720, resulting in a maximum credit of $3,305. The maximum credit is available for those with earnings between $9,720 and $17,830 ($23,260 if married filing jointly). At that point, the credit begins to phase out at a rate of 15.98 percent of earnings above this threshold, phasing out completely at $38,511 of earnings ($43,941 if married filing jointly).

Taxpayers with two qualifying children may claim a credit of 40 percent of earnings up to $13,650, resulting in a maximum credit of $5,460. The maximum credit is available for those with earnings between $13,650 and $17,830 ($23,260 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above that threshold, and is completely phased out at $43,756 of earnings ($49,186 if married filing jointly).

A temporary provision recently extended by the American Taxpayer Relief Act of 2012 ("ATRA")[41] allows taxpayers with three or more qualifying children to claim the EIC at an increased rate of 45 percent for taxable years before 2018. Thus, in 2014 taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to $13,650, resulting in a maximum credit of $6,143. The maximum credit is available for those with earnings between $13,650 and $17,830 ($23,260 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above that threshold, and is completely phased out at $46,997 of earnings ($52,427 if married filing jointly).

A temporary provision recently extended by the ATRA increases the phase-out thresholds for married couples to an amount $5,000 (indexed for inflation from 2009)[42] above that for other filers. The increase is $5,430 for 2014. This increase expires for taxable years beginning after December 31, 2017.

Description of Proposal

The proposal modifies the EIC. Under the proposal, certain low-income taxpayers are entitled to a credit equal to the amount of the individual's employment-related taxes for the taxable year. The maximum credit for a taxpayer with two or more qualifying children is $3,000 ($4,000 for those who file joint returns). For taxpayers with one qualifying child,[43] the maximum credit is $2,400 (regardless of filing status). For taxpayers with no qualifying children, the maximum credit is $100 ($200 for those who file joint returns). For individuals who pay Federal Insurance Contributions Act ("FICA") or Railroad Retirement Tax Act

[41] Pub. L. No. 112-240.

[42] A technical correction may be necessary to reflect that the $5,000 amount is indexed.

[43] For a description of changes to the definition of a qualifying child, see the description of section 1104 of the discussion draft.

("RRTA") taxes under section 3101 or 3201, respectively, the credit is first credited against the employee share of such taxes, but may not reduce the employee share of such taxes below zero.[44] Any section 32 credit available to be applied against income tax is reduced by the amount of any credit applied against the taxes imposed by section 3101 or 3201.

For these purposes, employment-related taxes with respect to any taxpayer for any taxable year is the sum of: (1) the employee share and the employer share of FICA tax on the taxpayer's wages received during the calendar year in which the taxable year begins; (2) any RRTA tax imposed (*i.e.*, on employees, employers, and employee representatives) on compensation received by the taxpayer during the calendar year in which the taxable year begins; and (3) any Self-Employment Contributions Act ("SECA") tax imposed on the self-employment income of the taxpayer for the taxable year. For these purposes, the definition of wages is the same as used for FICA tax purposes in section 3121(a) and the definition of compensation is the same as used for Railroad Retirement Tax purposes in section 3231(e). In the case of taxpayers with no qualifying children, for purposes of the credit, employment-related taxes are defined as the employee share of FICA or RRTA taxes, or, in the case of any SECA tax imposed on the taxpayer, one-half of such amount.

In the case of taxpayers with qualifying children, the credit is phased-down by the sum of: (1) 19 percent of the taxpayer's AGI over $27,000 in the case of taxpayers filing a joint return ($20,000 for all other filers); and (2) 100 percent of the taxpayer's investment income as exceeds $3,300. The definition of investment income for these purposes is unchanged from present law.[45] For taxpayers with no qualifying children, the credit is phased down by the sum of (1) 19 percent of the taxpayer's AGI over $13,000 in the case of taxpayers filing a joint return ($8,000 for all other filers), and (2) 100 percent of the taxpayer's investment income as exceeds $3,300.

For tax years beginning prior to 2018, taxpayers with qualifying children are allowed an EIC for up to 200 percent of employment-related taxes, subject to the applicable maximum credit. For tax years beginning prior to 2018, the applicable maximum credit for taxpayers with two or more children is $4,000, regardless of filing status (that is, the maximum credit is increased by $1,000 for taxpayers with two or more children who do not file a joint return), and the maximum applicable credit for taxpayers with one child is increased by $600, to $3,000.

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[44] The credit is not taken into account in determining the amount of FICA or RRTA tax required to be withheld from an employee's wages or compensation, rather, it is generally taken as a credit on an individual's income tax return.

[45] For these purposes, investment income means the sum of (1) interest or dividends received in the taxable year; (2) tax-exempt interest received or accrued during the taxable year; (3) net income derived for rents or royalties during the taxable year, not received in the ordinary course of a trade or business; (4) net capital gain income for the taxable year; and (5) net income derived from passive activities during the taxable year.

Both the maximum amount of the credit and income thresholds for the phaseout of the credit are indexed for inflation.[46]

No credit is allowed unless the taxpayer includes on the tax return for the taxable year the taxpayer's Social Security number. In the case of taxpayers filing a joint return, this identification requirement will be satisfied if the Social Security number of either spouse is included on the tax return. Additionally, a child shall not be considered a qualifying child for purposes of the credit unless the return includes the name, age and Social Security number of that child. The Secretary of the Treasury or his designee may prescribe other methods for satisfying the second identification requirement.

The proposal also requires the Secretary of the Treasury (or the Secretary's designee) to submit a report to Congress within 180 days of the date of enactment, making recommendations regarding the best method for providing for advance payment of the EIC. The recommendations in the report shall seek to 1) provide for the payment of the EIC as promptly as is feasible, and 2) minimize any administrative burdens on employers and the IRS.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

4. Repeal of deduction for personal exemptions (sec. 1104 of the discussion draft and sec. 151 of the Code)

Present Law

Under present law, in determining taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2014, the amount deductible for each personal exemption is $3,950. This amount is indexed annually for inflation.

Withholding rules

Under present law, the amount of tax required to be withheld by employers from a taxpayer's wages is based in part on the number of withholding exemptions a taxpayer claims on his Form W-4. An employee is entitled to the following exemptions: (1) an exemption for himself, unless he allowed to be claimed as a dependent of another person; (2) an exemption to which the employee's spouse would be entitled, if that spouse does not file a Form W-4 for that taxable year claiming an exemption described in (1); (3) an exemption for each individual who is a dependent (but only if the employee's spouse has not also claimed such a withholding exemption on a Form W-4); (4) additional withholding allowances (taking into account estimated

[46] Both the maximum credit value and the phaseout thresholds are set at 2013 levels. Thus, in 2015 the maximum credit values and phaseout thresholds will be the nominal amounts described above, plus an adjustment for two years of inflation.

itemized deductions, estimated tax credits, and additional deductions as provided by the Secretary of the Treasury); and (5) a standard deduction allowance.

Filing requirements

Under present law, an unmarried individual is required to file a tax return for the taxable year if in that year the individual had income which equals or exceeds the exemption amount plus the standard deduction applicable to such individual (*i.e.*, single, head of household, or surviving spouse). An individual entitled to file a joint return is required to do so unless that individual's gross income, when combined with the individual's spouse's gross income for the taxable year, is less than the sum of twice the exemption amount plus the basic standard deduction applicable to a joint return, provided that such individual and his spouse, at the close of the taxable year, had the same household as their home.

Qualifying Children

Present law contains numerous provisions, including the dependency exemption, that provide benefits for taxpayers with children. In general, a child is a qualifying child of a taxpayer (and thus eligible for these benefits) if the child satisfies each of three tests: (1) the child has the same principal place of abode as the taxpayer for more than one half the taxable year; (2) the child has a specified relationship to the taxpayer; and (3) the child has not yet attained a specified age. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

Under the *residency test*, a child must have the same principal place of abode as the taxpayer for more than one half of the taxable year. Special rules apply in the case of divorced or separated parents. The *relationship test* requires that the individual is the taxpayer's son, daughter, stepchild, foster child, or a descendant of any of them (for example, the taxpayer's grandchild). Additionally, the child can be the taxpayer's brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them (for example, the taxpayer's niece or nephew).[47]

The *age test* varies depending upon the tax benefit involved. In general, a child must be under age 19 (or under age 24 in the case of a full-time student) in order to be a qualifying child. In general, no age limit applies with respect to individuals who are totally and permanently disabled at any time during the calendar year. There are exceptions to these general rules. Two notable exceptions are: (1) a child must be under age 13 (if he or she is not disabled) for purposes of the dependent care credit and (2) a child must be under age 17 (whether or not disabled) for purposes of the child credit.

[47] For purposes of determining whether an adopted child is treated as a child by blood, an adopted child qualifies if he or she is an individual who is legally adopted by the taxpayer, or an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer. A foster child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction is treated as the taxpayer's child.

Description of Proposal

The proposal repeals the deduction for personal exemptions.

The proposal modifies the requirements for those who are required to file a tax return. In the case of an individual who is not married, such individual is required to file a tax return if the taxpayer's gross income for the taxable year exceeds the applicable standard deduction. Married individuals are required to file a return if that individual's gross income, when combined with the individual's spouse's gross income for the taxable year, is more than the standard deduction applicable to a joint return, provided that: (i) such individual and his spouse, at the close of the taxable year, had the same household as their home; (ii) the individual's spouse does not make a separate return; and (iii) neither the individual nor his spouse is a dependent of another taxpayer and has income (other than earned income) in excess of $500.

The proposal modifies the age test for a qualifying child. Under the proposal, a child may only be a qualifying child if that child has not attained the age of 18 as of the close of the calendar year in which the taxable year of the taxpayer begins. Under the proposal, as under present law, there is no age test for an individual who is permanently and totally disabled.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

C. Simplification of Education Benefits

1. American opportunity tax credit (sec. 1201 of the discussion draft and sec. 25A of the Code)

Present Law

Hope credit and American Opportunity credit

For taxable years beginning before 2009 and after 2017, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to $1,950 (estimated 2014 level) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.[48] The Hope credit rate is 100 percent on the first $1,300 of qualified tuition and related expenses, and 50 percent on the next $1,300 of qualified tuition and related expenses. These dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of $100. Thus, for example, a taxpayer who incurs $1,300 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income ("AGI") phaseout described below) for a $1,300 Hope credit. If a taxpayer incurs $2,600 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a $1,950 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $55,000 and $65,000 ($110,000 and $130,000 for married taxpayers filing a joint return) for 2014, based on inflation adjustments determined by the staff of the Joint Committee on Taxation. The beginning points of the AGI phaseout ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of $1,000. The size of the phaseout ranges for single and married taxpayers are always $10,000 and $20,000 respectively.

A taxpayer may not claim the Hope credit if the qualified tuition and related expenses for the enrollment or attendance of a student, if such student has been convicted of a Federal or State felony offense consisting of the possession or distribution of a controlled substance before the end of the taxable year.[49]

For taxable years beginning after December 31, 2008, individual taxpayers are eligible to claim the American Opportunity credit, which refers to modifications to the Hope credit that apply for taxable years 2009 through 2017.[50] The maximum allowable modified credit is $2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses,

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[48] Sec. 25A(a)(1).

[49] Sec. 25A(b)(2)(D).

[50] Sec. 25A(i).

and 25 percent on the next $2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials. Forty percent of a taxpayer's otherwise allowable modified credit is refundable. The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

Lifetime learning credit

Individual taxpayers may be eligible to claim a nonrefundable credit, the Lifetime Learning credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. Up to $10,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (*i.e.*, the maximum credit per taxpayer return is $2,000). In contrast with the Hope credit, the maximum credit amount is not indexed for inflation.

In contrast to the Hope and American Opportunity tax credits, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years.[51] Also in contrast to the Hope and American Opportunity tax credits, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return does not vary based on the number of students in the taxpayer's family—that is, the Hope credit is computed on a per student basis while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $55,000 and $65,000 ($110,000 and $130,000 for married taxpayers filing a joint return) in 2014, based on inflation adjustments determined by the staff of the Joint Committee on Taxation. These phaseout ranges are the same as those for the Hope credit as it applies for tax years beginning before 2009, and are similarly indexed for inflation.

Reporting requirements

Section 6050S imposes reporting requirements, related to higher education tax benefits, on eligible educational institutions if the institution receives payments for qualified tuition and related expenses with respect to any individual for any calendar year. The information an institution subject to the reporting requirements is required to provide includes providing either the aggregate amount of payments received or the aggregate amount billed for qualified tuition and related expenses during the calendar year period.[52]

Description of Proposal

The proposal permanently replaces the Hope credit with the American Opportunity credit and also modifies the American Opportunity credit. As under present law, the credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses, and 25 percent on the next

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[51] Sec. 25A(a)(2).

[52] Sec. 6050S(b)(2)(B)(i).

$2,000 of qualified tuition and related expenses, for a maximum credit of $2,500. Under the proposal, the taxpayer's credit for the first $1,500 of qualified tuition and related expenses is refundable.

The proposal lowers the phaseout range of the credit. The credit phases out for joint filers with modified AGI between $86,000 and $126,000, and for all other filers with modified AGI between $43,000 and $63,000. Both the credit amounts and the phaseout ranges are indexed for inflation for taxable years beginning after 2018.

The proposal repeals the provision that denies the credit with respect to qualified tuition and related expenses for the enrollment or attendance of any student who has been convicted of a felony offense consisting of the possession or distribution of a controlled substance.

The proposal contains a provision that coordinates the credit with Pell Grants, such that Pell Grant amounts are deemed to first apply to expenses other than the qualified tuition and related expenses that are eligible for the credit. Thus, for purposes of calculating the credit, qualified tuition and related expenses are reduced by Pell Grant amounts only to the extent the Pell Grant exceeds the cost of college attendance (other than qualified tuition and related expenses).

The proposal modifies present-law reporting requirements, such that an eligible institution may only report the aggregate amount of tuition received with respect to any individual during the calendar year period. Additionally, the proposal adds a requirement that any taxpayer claiming the credit must include on the tax return the Employer Identification Number of any institution to whom qualified tuition was paid.

The proposal repeals the Lifetime Learning credit.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

2. Expansion of Pell grant exclusion from gross income (sec. 1202 of the discussion draft and sec. 117 of the Code)

Present Law

Present law provides an exclusion from gross income and wages for amounts received as a qualified scholarship by an individual who is a candidate for a degree at a qualifying educational organization.[53] Generally, the exclusion does not apply to amounts received by a student that represent payment for teaching, research, or other services by the student as a condition for receiving the scholarship.

[53] Secs. 117(a), 3121(a)(20).

In general, a qualified scholarship is any amount received by such an individual as a scholarship or fellowship grant if the amount is used for qualified tuition and related expenses. Qualified tuition and related expenses include tuition and fees required for enrollment or attendance, or for fees, books, supplies, and equipment required for courses of instruction, at the qualifying educational organization. This definition does not include regular living expenses, such as room and board. A qualifying educational organization is an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

Description of Proposal

The proposal modifies the exclusion for qualified scholarships by providing that Federal Pell Grants under section 401 of the Higher Education Act of 1965[54] are excluded from gross income, without regard to whether the grant is used for qualified tuition and related expenses.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

3. Repeal of exclusion of income from United States savings bonds used to pay higher education expenses (sec. 1203 of the discussion draft and sec. 135 of the Code)

Present Law

Interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[55] Qualified higher education expenses include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain eligible higher educational institutions. The amount of qualified higher education expenses taken into account for purposes of the exclusion is reduced by the amount of such expenses taken into account in determining the Hope, American Opportunity, or Lifetime Learning credits claimed by any taxpayer, or taken into account in determining an exclusion from gross income for a distribution from a qualified tuition program or a Coverdell education savings account, with respect to a particular student for the taxable year.

The exclusion is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 2014, the exclusion is phased out for taxpayers with modified AGI between $76,000 and $91,000 ($113,950 and $143,950 for married taxpayers filing a joint return). To prevent taxpayers from effectively avoiding the income phaseout limitation through the purchase of bonds directly in the child's

[54] 20 U.S.C. sec. 1070(a).

[55] Sec. 135.

name, the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Description of Proposal

The proposal repeals the exclusion of interest earned on U.S. Series EE savings bonds described above.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

4. Repeal of deduction for interest on education loans (sec. 1204 of the discussion draft and sec. 221 of the Code)

Present Law

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit.[56] Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.[57]

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending on at least a half-time basis (1) eligible educational institutions, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. The cost of attendance is reduced by any amount excluded from gross income under the exclusions for qualified scholarships and tuition reductions, employer-provided educational assistance, interest earned on education savings bonds, qualified tuition programs, and Coverdell education savings accounts, as well as the amount of certain other scholarships and similar payments.

The maximum allowable deduction per year is $2,500.[58] For 2014, the deduction is phased out ratably for taxpayers with AGI between $65,000 and $80,000 ($130,000 and $160,000 for married taxpayers filing a joint return). The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of $5,000.

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[56] Sec. 221.

[57] Sec. 221(c).

[58] Sec. 221(b)(1).

Description of Proposal

The proposal repeals the deduction for interest on education loans.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

5. Repeal of deduction for qualified tuition and related expenses (sec. 1205 of the discussion draft and sec. 222 of the Code)

Present Law

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.[59] Qualified tuition includes tuition and fees required for the enrollment or attendance by the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution. The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic term beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is $4,000 for an individual whose AGI for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for other individuals whose AGI does not exceed $80,000 ($160,000 in the case of a joint return).[60] No deduction is allowed for an individual whose AGI exceeds the relevant AGI limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2013.

Description of Proposal

The proposal repeals the deduction for qualified tuition and related expenses.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2013.

[59] Sec. 222(a).

[60] Sec. 222(b)(2)(B).

6. No new contributions to Coverdell education savings accounts (sec. 1206 of the discussion draft and sec. 530 of the Code)

Present Law

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.[61] Annual contributions to Coverdell education savings accounts may not exceed $2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between $95,000 and $110,000 ($190,000 and $220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.[62] However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (*i.e.*, the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.[63]

Tax-free (and free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include qualified elementary and secondary expenses and qualified higher education expenses. Such qualified education expenses generally include only out-of-pocket expenses. They do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income.

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[61] Sec. 530.

[62] In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by section 511.

[63] This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

The term qualified elementary and secondary school expenses, means expenses for: (1) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law; (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (3) the purchase of any computer technology or equipment (as defined in section 170(e)(6)(F)(i)) or internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

The term qualified higher education expenses includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis.[64] Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.[65]

Description of Proposal

The proposal provides that, except in the case of rollover contributions from another Coverdell account, no contributions to Coverdell education savings accounts shall be accepted by such an account after December 31, 2014. Additionally, the proposal provides that qualified tuition programs[66] may accept rollover distributions from a Coverdell education savings account on a tax-free basis after December 31, 2014.

Effective Date

The proposal is effective for contributions and distributions made after December 31, 2014.

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[64] Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

[65] Sec. 530(b)(2)(B).

[66] Sec. 529.

7. Repeal of exclusion for discharge of student loan indebtedness (sec. 1207 of the discussion draft and sec. 108(f) of the Code)

Present Law

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.[67]

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses. The loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) 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, or (4) 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.

In addition, an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of such loans made or refinanced by educational organizations (or refinancing loans made by certain tax-exempt organizations), cancellation of the student loan must be contingent upon the student working in an occupation or area with unmet needs and such work must be performed for, or under the direction of, a tax-exempt charitable organization or a governmental entity.

Finally, an individual's gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program or certain State loan repayment programs.

Description of Proposal

The proposal repeals the above-described exclusion from income for student loan forgiveness.

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[67] Sec. 108(f).

Effective Date

The proposal applies to amounts discharged after December 31, 2014.

8. Repeal of exclusion for qualified tuition reductions (sec. 1208 of the discussion draft and sec. 117(d) of the Code)

Present Law

Present law provides an exclusion from gross income and wages for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations.[68] The exclusion does not apply to any amount received by a student that represents payment for teaching, research or other services by the student required as a condition for receiving the tuition reduction.[69]

Description of Proposal

The proposal repeals the exclusion for qualified tuition reductions.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

9. Repeal of exclusion for education assistance programs (sec. 1209 of the discussion draft and sec. 127 of the Code)

Present Law

If certain requirements are satisfied, up to $5,250 annually of educational assistance provided by an employer to an employee is excludable from gross income for income tax purposes and from wages for employment tax purposes.[70] This exclusion applies to both graduate and undergraduate courses. For the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer.[71]

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[68] Sec. 117(d).

[69] The exclusion applies with respect to highly compensated employees only if such tuition reductions are available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification established by the employer, such that the benefit does not discriminate in favor of highly compensated employees.

[70] Secs. 127, 3121(a)(18).

[71] The employer's educational assistance program must not discriminate in favor of highly compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of

For purposes of the exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include (1) tools or supplies that may be retained by the employee after completion of a course, (2) meals, lodging, or transportation, and (3) any education involving sports, games, or hobbies. The exclusion for employer-provided educational assistance applies only with respect to education provided to the employee (*i.e.*, it does not apply to education provided to the spouse or a child of the employee).

Description of Proposal

The proposal repeals the exclusion for income attributable to an education assistance program.

Effective Date

The proposal is effective for amounts paid or incurred in taxable years beginning after December 31, 2014.

10. Repeal of exception to 10-percent penalty for higher education (sec. 1210 of the discussion draft and sec. 72(t) of the Code)

Present Law

The Code imposes an early distribution tax on distributions made from qualified retirement plans, section 403(b) plans and individual retirement accounts ("IRAs") before an employee (or an IRA owner) attains age 59½ unless an exception applies.[72] The tax is equal to 10 percent of the amount of the distribution that is includible in gross income.[73] One of the exceptions to the early distribution tax is for distributions from IRAs used for qualified higher education expenses.[74]

Description of Proposal

The proposal repeals the exception from the 10-percent early distribution tax that applies to distributions from IRAs that are made before age 59½ and used for qualified higher education expenses.

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individuals consisting of more-than-five-percent owners of the employer and the spouses or dependents of such more-than-five-percent owners.

[72] Sec. 72(t).

[73] The 10-percent tax is in addition to the taxes that would otherwise be due on distribution.

[74] Sec. 72(t)(2)(E) and (7).

Effective Date

The proposal applies to distributions after December 31, 2014.

D. Repeal of Certain Credits for Individuals

1. Repeal of dependent care credit (sec. 1301 of the discussion draft and sec. 21 of the Code)

Present Law

A taxpayer who maintains a household that includes one or more qualifying individuals may claim a nonrefundable credit against income tax liability for up to 35 percent of a limited amount of employment-related dependent care expenses. Eligible child and dependent care expenses related to employment are limited to $3,000 if there is one qualifying individual or $6,000 if there are two or more qualifying individuals. Thus, the maximum credit is $1,050 if there is one qualifying individual and $2,100 if there are two or more qualifying individuals. The applicable dollar limit is reduced by any amount excluded from income under an employer-provided dependent care assistance plan. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each $2,000 (or fraction thereof) of AGI above $15,000. Thus, for taxpayers with adjusted gross income above $43,000, the credit rate is 20 percent. The phase-out point and the amount of expenses eligible for the credit are not indexed for inflation.

Generally, a qualifying individual is: (1) a qualifying child of the taxpayer under the age of 13 for whom the taxpayer may claim a dependency exemption, or (2) a dependent or spouse of the taxpayer if the dependent or spouse is physically or mentally incapacitated, and shares the same principal place of abode with the taxpayer for over one half the year. Married taxpayers must file a joint return in order to claim the credit.

Description of Proposal

The proposal repeals the credit for dependent care expenses.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

2. Repeal of credit for adoption expenses (sec. 1302 of the discussion draft and sec. 23 of the Code)

Present Law

In general

A tax credit is allowed for qualified adoption expenses paid or incurred by a taxpayer subject to a maximum credit amount per eligible child.[75] An eligible child is an individual who: (1) has not attained age 18; or (2) is physically or mentally incapable of caring for himself or herself. The maximum credit is applied per child rather than per year. Therefore, while

[75] Sec. 36C.

qualified adoption expenses may be incurred in one or more taxable years, the tax credit per adoption of an eligible child may not exceed the maximum credit.

For taxable years beginning in 2014, the maximum credit amount is $13,190, and the credit is phased out ratably for taxpayers with modified adjusted gross income ("AGI") above a certain amount. In 2014, the phase out range begins at modified AGI of $197,880, with no credit allowed for taxpayers with a modified AGI of $237,880. Modified AGI is the sum of the taxpayer's AGI plus amounts excluded from income under sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands and residents of Puerto Rico, respectively).

Special needs adoptions

In the case of a special needs adoption finalized during a taxable year, the taxpayer may claim as an adoption credit the amount of the maximum credit minus the aggregate qualified adoption expenses with respect to that adoption for all prior taxable years. A special needs child is an eligible child who is a citizen or resident of the United States whom a State has determined: (1) cannot or should not be returned to the home of the birth parents; and (2) has a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions, or physical, mental, or emotional handicaps) because of which the child cannot be placed with adoptive parents without adoption assistance.

Qualified adoption expenses

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys fees, and other expenses that are: (1) directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer; (2) not incurred in violation of State or Federal law, or in carrying out any surrogate parenting arrangement; (3) not for the adoption of the child of the taxpayer's spouse; and (4) not reimbursed (*e.g.*, by an employer).

Description of Proposal

The proposal repeals the credit for adoption expenses.

Effective Date

The proposal applies to amounts paid or incurred after December 31, 2014.

3. Nonbusiness energy property credit (sec.1303 of the discussion draft and sec. 25C of the Code)

Present Law

Credits in varying amounts are allowed through 2013 for certain (1) insulation, (2) energy efficient window, doors, skylights, and roofs, (3) advanced main air circulating fans, (4) natural gas, propane, or oil furnace or hot water boilers, (5) electric heat pump, natural gas, propane, or oil water heaters, (6) central air conditions, or (7) wood stoves. The maximum total credit is $500 for all taxable years.

Description of Proposal

The proposal repeals the nonbusiness energy property credit.

Effective Date

The proposal is effective for property placed in service after December 31, 2013.

4. Credit for residential energy efficient property (sec. 1304 of the discussion draft and sec. 25D of the Code)

Present Law

A thirty percent credit is available through 2016 for residential (1) solar water heating or solar electric property, (2) small wind property, (3) geothermal heat pump property, and (4) fuel cell property placed in service.

Description of Proposal

The proposal repeals the credit.

Effective Date

The proposal applies to property placed in service after December 31, 2014.

5. Repeal of credits for alternative fuel vehicles and alternative fuel refueling property (secs. 1305 through 1308 of the discussion draft and secs. 30, 30B, 30C, and 30D of the Code)

Present Law

Fuel cell vehicles (sec. 30B)

A credit is available through 2014 for new vehicles propelled by chemically combining oxygen with hydrogen and creating electricity. The base credit is $4,000 for vehicles weighing 8,500 pounds or less. Heavier vehicles can get up to a $40,000 credit, depending on their weight. An additional $1,000 to $4,000 credit is available to cars and light trucks to the extent their fuel economy exceeds the 2002 base fuel economy set forth in the Code.

Plug-in electric-drive motor vehicles (secs. 30 and 30D)

A credit is available for new four-wheeled vehicles (excluding low speed vehicles and vehicles weighing 14,000 pounds or more) propelled by a battery with at least 4 kilowatt-hours of electricity that can be charged from an external source. The base credit is $2,500 plus $417 for each kilowatt-hour of additional battery capacity in excess of 4 kilowatt-hours (for a maximum credit of $7,500). Qualified vehicles are subject to a 200,000 vehicle-per-manufacturer limitation.

A 10-percent credit up to $2,500 is available for vehicles acquired before 2012 that otherwise qualify for the above credit but for the fact that they have limited speed. A similar 10-percent credit is available for two- and three-wheeled vehicles acquired before 2014 that have a battery capacity of at least 2.5 kilowatt-hours and are capable of achieving a speed of 45 miles per hour or greater. The 10-percent credits are not subject to the 200,000 vehicle-per-manufacturer limitation.

Credit for alternative fuel refueling property (sec. 30C)

A 30-percent credit is available through 2013 (2014 for hydrogen refueling property) for property that dispenses alternative fuels, including ethanol, biodiesel, natural gas, hydrogen, and electricity. The credit may not exceed $30,000 per location for business property and $1,000 for property installed at a principal residence.

Description of Proposal

The proposal repeals the credits for fuel cell and plug-in electric drive motor vehicles. The proposal also repeals the credit for alternative fuel refueling property.

Effective Date

For fuel cell vehicles, the proposal applies to property purchased after December 31, 2014. In the case of low speed plug-in electric vehicles, the proposal applies to vehicles acquired after December 31, 2011. For other plug-in electric vehicles, the proposal applies to vehicles acquired after December 31, 2014. For alternative fuel refueling property, the proposal applies to property placed in service after December 31, 2014.

6. Repeal of credit for health insurance costs of eligible individuals (sec. 1309 of the discussion draft and sec. 35 of the Code)

Present Law

In the case of an eligible individual, for months beginning before January 1, 2014, a refundable tax credit is provided for a portion (currently 72.5 percent) of the individual's premiums for qualified health insurance of the individual and qualifying family members[76] for each eligible coverage month beginning in the taxable year. The credit is commonly referred to as the health coverage tax credit ("HCTC"). The credit is available only with respect to amounts

[76] Qualifying family members are the individual's spouse and any dependent for whom the individual is entitled to claim a dependency exemption. Any individual who has certain specified coverage is not a qualifying family member.

paid by the individual and is available on an advance basis once a qualified health insurance costs credit eligibility certificate is in effect.[77]

Eligibility for the credit is determined on a monthly basis. In general, an eligible coverage month is any month if the month begins before January 1, 2014, and, as of the first day of the month, the individual (1) is an eligible individual, (2) is covered by qualified health insurance, (3) does not have other specified coverage, and (4) is not imprisoned under Federal, State, or local authority. In the case of a joint return, the eligibility requirements are met if at least one spouse satisfies the requirements.

An eligible individual is an individual who is (1) an eligible Trade Adjustment Assistance ("TAA") recipient, (2) an eligible alternative TAA recipient, or (3) an eligible Pension Benefit Guaranty Corporation ("PBGC") pension recipient. In general, an individual is an eligible TAA recipient for a month if the individual (1) receives for any day of the month a trade readjustment allowance under the Trade Act of 1974 or would be eligible to receive such an allowance but for the requirement that the individual exhaust unemployment benefits before being eligible to receive an allowance and (2) with respect to such allowance, is covered under a required certification.[78] An individual is an eligible alternative TAA recipient for a month if the individual participates in a certain program under the Trade Act of 1974 and receives a related benefit for the month. Generally, an individual is a PBGC pension recipient for any month if the individual (1) is age 55 or over as of the first day of the month and (2) receives a benefit, any portion of which is paid by the PBGC. A person who may be claimed as a dependent on another person's tax return is not an eligible individual. In addition, an otherwise eligible individual is not eligible for the credit for a month if, as of the first day of the month, the individual has certain specified coverage, such as certain employer-provided coverage or coverage under certain governmental health programs.

Description of Proposal

The proposal repeals the health coverage tax credit in accordance with expiration of the credit for months beginning after December 31, 2013.

Effective Date

The proposal is effective for months beginning after December 31, 2013.

[77] Sec. 7527.

[78] The eligibility rules and conditions for such a trade readjustment allowance are specified in chapter 2 of title II of the Trade Act of 1974. Among other requirements, payment of a trade readjustment allowance is conditioned on the individual enrolling in certain training programs or receiving a waiver of training requirements. The required certification is issued under subchapter A or D of chapter 2 of title II of the Trade Act of 1974.

7. Repeal of first time homebuyer credit (sec. 1310 of the discussion draft and sec. 36 of the Code)

Present and Prior Law

Under present law, there is no credit for the purchase of a home. Prior law provided an individual who is a first-time homebuyer a refundable tax credit equal up to a maximum of \$8,000 (\$4,000 for a married individual filing separately) or 10 percent of the purchase price of a principal residence purchased after April 9, 2008. The credit expired for purchases after July 1, 2010 (July 1, 2011 for certain individuals on qualified official extended duty outside of the United States).

Description of Proposal

The proposal repeals section the first time homebuyer credit. Credit recapture provisions continue to apply to residences purchased before July 1, 2011.

Effective Date

The proposal applies to residences purchased after June 30, 2011.

E. Deductions, Exclusions, and Certain Other Provisions

1. Exclusion of gain from sale of a principal residence (sec. 1401 of the discussion draft and sec. 121 of the Code)

Present Law

A taxpayer who is an individual may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the date of the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances, is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

The exclusion under this provision may not be claimed for more than one sale or exchange during any two-year period.

Description of Proposal

The proposal extends the length of time a taxpayer must own and use a residence to qualify for this exclusion. Specifically, the exclusion is available only if the taxpayer has owned and used the residence as a principal residence for at least five of the eight years ending on the date of the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the five years that the ownership and use requirements are met.

The proposal limits the exclusion so that the exclusion may not apply to more than one sale or exchange during any five-year period.

The proposal phases-out the exclusion by one dollar for every dollar a taxpayer's AGI exceeds $250,000 ($500,000 if married filing a joint return).

Effective Date

The proposal applies to sales and exchanges after December 31, 2014.

2. Mortgage interest (sec. 1402 of the discussion draft and sec. 163 of the Code)

Present Law

As a general matter, personal interest is not deductible.[79] Qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations.[80] Qualified residence interest means interest paid or accrued during the taxable year on either acquisition indebtedness or home equity indebtedness. A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

Acquisition indebtedness

Acquisition indebtedness is indebtedness that is incurred in acquiring, constructing or substantially improving a qualified residence of the taxpayer and which secures the residence. The maximum amount treated as acquisition indebtedness is $1 million ($500,000 in the case of a married person filing a separate return).

Acquisition indebtedness also includes indebtedness from the refinancing of other acquisition indebtedness but only to the extent of the amount (and term) of the refinanced indebtedness. Thus, for example, if the taxpayer incurs $200,000 of acquisition indebtedness to acquire a principal residence and pays down the debt to $150,000, the taxpayer's acquisition indebtedness with respect to the residence cannot thereafter be increased above $150,000 (except by indebtedness incurred to substantially improve the residence).

Interest on acquisition indebtedness is allowable in computing alternative minimum taxable income. However, in the case of a second residence, the acquisition indebtedness may only be incurred with respect to a house, apartment, condominium, or a mobile home that is not used on a transient basis.

Home equity indebtedness

Home equity indebtedness is indebtedness (other than acquisition indebtedness) secured by a qualified residence.

The amount of home equity indebtedness may not exceed $100,000 ($50,000 in the case of a married individual filing a separate return) and may not exceed the fair market value of the residence reduced by the acquisition indebtedness.

Interest on home equity indebtedness is not deductible in computing alternative minimum taxable income.

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[79] Sec. 163(h)(1).

[80] Sec. 163(h)(2)(D) and (h)(3).

Interest on qualifying home equity indebtedness is deductible, regardless of how the proceeds of the indebtedness are used. For example, personal expenditures may include health costs and education expenses for the taxpayer's family members or any other personal expenses such as vacations, furniture, or automobiles. A taxpayer and a mortgage company can contract for the home equity indebtedness loan proceeds to be transferred to the taxpayer in a lump sum payment (e.g., a traditional mortgage), a series of payments (*e.g.*, a reverse mortgage), or the lender may extend the borrower a line of credit up to a fixed limit over the term of the loan (*e.g.*, a home equity line of credit).

Thus, the aggregate limitation on the total amount of a taxpayer's acquisition indebtedness and home equity indebtedness with respect to a taxpayer's principal residence and a second residence that may give rise to deductible interest is $1,100,000 ($550,000, for married persons filing a separate return).

Reporting requirements

Any person who, in the course of a trade or business during a calendar year, received from an individual $600 or more of interest during a calendar year on an obligation secured by real property (such as mortgage interest) must file an information return with the IRS and must provide a copy of that return to the payor. The information return generally must include the name, address, and taxpayer identification number of the individual from whom the interest was received, and the amount of the interest and points received for the calendar year.

Description of Proposal

The proposal modifies the limitations on the amount of indebtedness that may be treated as acquisition indebtedness with respect to which interest payments are deductible. The proposal is phased in. The maximum amount of indebtedness treated as acquisition indebtedness incurred in 2015 is $875,000; in 2016 is $750,000; in 2017 is $625,000; and in 2018 and thereafter, is $500,000. In the case of a married person filing a separate return the maximum amounts are half these amounts.

Under the proposal, interest paid on home equity indebtedness incurred after 2014 is not treated as qualified residence interest, and thus is not deductible.

The proposal does not change the treatment of interest on qualified residence indebtedness incurred before 2015.

Special rules apply in the case of indebtedness from refinancing existing qualified residence indebtedness. Specifically, present law continues to apply to any indebtedness incurred on or after January 1, 2015, to refinance qualified residence indebtedness incurred before that date to the extent the amount of the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness. Thus, the maximum dollar amount that may be treated as qualified indebtedness will not decrease by reason of a refinancing.

The proposal modifies the reporting requirements with respect to taxpayers who, in the course of a trade or business during a calendar year, received from an individual $600 or more of interest during a calendar year on an obligation secured by real property (such as mortgage interest). In addition to the present-law reporting requirements, the proposal requires that taxpayers report both the amount of outstanding principal on the mortgage as of the beginning of the calendar year and the date of origination of the mortgage.

Effective Date

The modification of the limitations on the deductibility of interest applies to interest paid or accrued on indebtedness incurred after December 31, 2014. The modification of the reporting requirements applies to returns and statements for calendar years after 2014.

3. Charitable contributions (sec. 1403 of the discussion draft and sec. 170 of the Code)

Present Law

In general

The Internal Revenue Code allows taxpayers to reduce their income tax liability by taking deductions for contributions to certain organizations, including charities, Federal, State, local and Indian tribal governments, and certain other organizations.

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.*, an organization or entity described in section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.*, not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.[81] Fourth, the transfer must be of money or property—contributions of services are not deductible.[82] Finally, the transfer must be substantiated and in the proper form.

As also discussed below, special rules limit a taxpayer's charitable contributions in a given year to a percentage of income, and those rules, in part, turn on whether the organization receiving the contributions is a public charity or a private foundation. Other special rules determine the deductible value of contributed property for each type of property.

[81] Sec. 170(a)(1).

[82] For example, the value of time spent volunteering for a charitable organization is not deductible. Incidental expenses such as mileage, supplies, or other expenses incurred while volunteering for a charitable organization, however, may be deductible.

Contributions of partial interests in property

In general

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration.[83] This rule of nondeductibility, often referred to as the partial interest rule, generally prohibits a charitable deduction for contributions of income interests, remainder interests, or rights to use property.

A charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.[84] For this purpose, a future interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization that has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property."[85]

A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.[86] For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.[87] A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.[88]

Other exceptions to the partial interest rule are provided for, among other interests: (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds; (2) present interests in the form of a guaranteed annuity or a fixed

[83] Secs. 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).

[84] Sec. 170(a)(3).

[85] Treas. Reg. sec. 1.170A-5(a)(4). Treasury regulations provide that section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, has "no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year." Treas. Reg. sec. 1.170A-5(a)(2).

[86] Sec. 170(f)(3)(B)(ii).

[87] Treas. Reg. sec. 1.170A-7(b)(1).

[88] Treas. Reg. sec. 1.170A-7(b)(1).

percentage of the annual value of the property; (3) a remainder interest in a personal residence or farm; and (4) qualified conservation contributions.

Qualified conservation contributions

Qualified conservation contributions are not subject to the partial interest rule, which generally bars deductions for charitable contributions of partial interests in property.[89] A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property (generally, a conservation easement). Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Percentage limits on charitable contributions

Individual taxpayers

Charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's adjusted gross income ("AGI") for a taxable year, disregarding any net operating loss carryback to the year under section 172.[90] In general, more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

More specifically, the deduction for charitable contributions by an individual taxpayer of cash and property that is not appreciated to a charitable organization described in section 170(b)(1)(A) (public charities, private foundations other than nonoperating private foundations, and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to nonoperating private foundations generally may be deducted up to the lesser of 30 percent of the taxpayer's contribution base or the excess of (i) 50 percent of the contribution base over (ii) the amount of contributions subject to the 50 percent limitation.

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[89] Secs. 170(f)(3)(B)(iii) and 170(h).

[90] Sec. 170(b)(1)(G).

Contributions of appreciated capital gain property to public charities and other organizations described in section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's contribution base (after taking into account contributions other than contributions of capital gain property). An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to nonoperating private foundations are deductible up to the lesser of 20 percent of the taxpayer's contribution base or the excess of (i) 30 percent of the contribution base over (ii) the amount of contributions subject to the 30 percent limitation.

Finally, more favorable percentage limits sometimes apply to contributions to the donee charity than to contributions that are for the use of the donee charity. Contributions of capital gain property for the use of public charities and other organizations described in section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's contribution base.[91] In contrast to property contributed directly to a charitable organization, property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization.[92] Charitable contributions of income interests (where deductible) also generally are treated as contributions for the use of the donee organization.

[91] Under a special, temporary provision that was effective for contributions made in taxable years beginning before January 1, 2014, certain qualified conservation contributions (generally, conservation easements), qualify for more generous contribution limits and carryforward periods.

[92] *Rockefeller v. Commissioner*, 676 F.2d 35, 39 (2d Cir. 1982).

Table 2.–Charitable Contribution Percentage Limits For Individual Taxpayers[93]

	Ordinary Income Property and Cash	Capital Gain Property to the Recipient[94]	Capital Gain Property for the use of the Recipient
Public Charities, Private Operating Foundations, and Private Distributing Foundations	50%	30%[95]	20%
Nonoperating Private Foundations	30%	20%	20%

Corporate taxpayers

A corporation generally may deduct charitable contributions up to 10 percent of the corporation's taxable income for the year.[96] For this purpose, taxable income is determined without regard to: (1) the charitable contributions deduction; (2) any net operating loss carryback to the taxable year; (3) deductions for dividends received; (4) deductions for dividends paid on certain preferred stock of public utilities; and (5) any capital loss carryback to the taxable year.[97]

Carryforwards of excess contributions

Charitable contributions that exceed the applicable percentage limit generally may be carried forward for up to five years.[98] In general, contributions carried over from a prior year are taken into account after contributions for the current year that are subject to the same percentage

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[93] Percentages shown are the percentage of an individual's contribution base.

[94] Capital gain property contributed to public charities, private operating foundations, or private distributing foundations will be subject to the 50-percent limitation if the donor elects to reduce the fair market value of the property by the amount that would have been long-term capital gain if the property had been sold.

[95] Under a special, temporary provision that was effective for contributions made in taxable years beginning before January 1, 2014, certain qualified conservation contributions to public charities (generally, conservation easements), qualify for more generous contribution limits. In general, the 30-percent limit applicable to contributions of capital gain property is increased to 100 percent if the individual making the qualified conservation contribution is a qualified farmer or rancher or to 50 percent if the individual is not a qualified farmer or rancher.

[96] Sec. 170(b)(2)(A).

[97] Sec. 170(b)(2)(C). Under a special, temporary provision, certain qualified conservation contributions (generally, conservation easements), qualify for more generous contribution limits and carryforward periods.

[98] Sec. 170(d).

limit. Excess contributions made for the use of (rather than to) an organization generally may not be carried forward.

Temporary rule for qualified conservation contributions

Under a temporary provision that was effective for contributions made in taxable years beginning before January 1, 2014,[99] preferential percentage limits and carryforward rules apply for qualified conservation contributions. In general, under the temporary provision, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions. Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) (generally, public charities) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions. Individuals are allowed to carry forward any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.[100]

A qualified farmer or rancher means a taxpayer whose gross income from the trade or business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

Valuation of charitable contributions

In general

For purposes of the income tax charitable deduction, the value of property contributed to charity may be limited to the fair market value of the property, the donor's tax basis in the property, or in some cases a different amount.

Charitable contributions of cash are deductible in the amount contributed, subject to the percentage limits discussed above. In addition, a taxpayer generally may deduct the full fair

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[99] Sec. 170(b)(1)(E).

[100] Sec. 170(b)(2)(B).

market value of long-term capital gain property contributed to charity.[101] Contributions of tangible personal property also generally are deductible at fair market value if the use by the recipient charitable organization is related to its tax-exempt purpose.

In certain other cases, however, section 170(e) limits the deductible value of the contribution of appreciated property to the donor's tax basis in the property. This limitation of the property's deductible value to basis generally applies, for example, for: (1) contributions of inventory or other ordinary income or short-term capital gain property;[102] (2) contributions of tangible personal property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose;[103] and (3) contributions to or for the use of a private foundation (other than certain private operating foundations).[104]

For contributions of qualified appreciated stock, the above-described rule that limits the value of property contributed to or for the use of a private nonoperating foundation to the taxpayer's basis in the property does not apply; therefore, subject to certain limits, contributions of qualified appreciated stock to a nonoperating private foundation may be deducted at fair market value.[105] Qualified appreciated stock is stock that is capital gain property and for which (as of the date of the contribution) market quotations are readily available on an established securities market.[106] A contribution of qualified appreciated stock (when increased by the aggregate amount of all prior such contributions by the donor of stock in the corporation) generally does not include a contribution of stock to the extent the amount of the stock contributed exceeds 10 percent (in value) of all of the outstanding stock of the corporation.[107]

Contributions of property with a fair market value that is less than the donor's tax basis generally are deductible at the fair market value of the property.

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[101] Capital gain property means any capital asset or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Sec. 170(e)(1)(A).

[102] Sec. 170(e). Special rules, discussed below, apply for certain contributions of inventory and other property.

[103] Sec. 170(e)(1)(B)(i)(I).

[104] Sec. 170(e)(1)(B)(ii). Certain contributions of patents or other intellectual property also generally are limited to the donor's basis in the property. Sec. 170(e)(1)(B)(iii). However, a special rule permits additional charitable deductions beyond the donor's tax basis in certain situations.

[105] Sec. 170(e)(5).

[106] Sec. 170(e)(5)(B).

[107] Sec. 170(e)(5)(C).

Enhanced deduction rules for certain contributions of inventory and other property

Although most charitable contributions of property are valued at fair market value or the donor's tax basis in the property, certain statutorily described contributions of appreciated inventory and other property qualify for an enhanced deduction valuation that exceeds the donor's tax basis in the property, but which is less than the fair market value of the property.

As discussed above, a taxpayer's deduction for charitable contributions of inventory property generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less, the fair market value of the property. For certain contributions of inventory, however, C corporations (but not other taxpayers) may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (*i.e.*, basis plus one-half of fair market value in excess of basis) or (2) two times basis.[108] To be eligible for the enhanced deduction value, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.[109] Contributions to organizations that are not described in section 501(c)(3), such as governmental entities, do not qualify for this enhanced deduction.

To use the enhanced deduction provision, the taxpayer must establish that the fair market value of the donated item exceeds basis.

Under a temporary provision that was effective for contributions made before January 1, 2014, any taxpayer engaged in a trade or business, whether or not a C corporation, is eligible to claim the enhanced deduction for certain donations of food inventory.[110] Another expired provision (effective for contributions made before January 1, 2012) allowed an enhanced charitable deduction for certain contributions of book inventory.[111]

Selected statutory rules for specific types of contributions

Special statutory rules limit the deductible value (and impose enhanced reporting obligations on donors) of charitable contributions of certain types of property, including vehicles, intellectual property, and clothing and household items. Each of these rules was enacted in response to concerns that some taxpayers did not accurately report – and in many instances overstated – the value of the property for purposes of claiming a charitable deduction.

[108] Sec. 170(e)(3).

[109] Sec. 170(e)(3)(A)(i)-(iii).

[110] Sec. 170(e)(3)(C).

[111] Sec. 170(e)(3)(D).

Vehicles.—Under present law, the amount of deduction for charitable contributions of vehicles (generally including automobiles, boats, and airplanes for which the claimed value exceeds $500 and excluding inventory property) depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction may not exceed the gross proceeds received from the sale. In other situations, a fair market value deduction may be allowed.

Patents and other intellectual property.—If a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory)[112] to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property.[113] In addition, the taxpayer generally is permitted to deduct, as a charitable contribution, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed intellectual property. For this purpose, qualified donee income includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).[114]

Clothing and household items.—Charitable contributions of clothing and household items generally are subject to the charitable deduction rules applicable to tangible personal property. If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is limited to basis. In most situations, however, clothing and household items have a fair market value that is less than the taxpayer's basis in the property. Because property with a fair market value less than basis generally is deductible at the property's fair market value, taxpayers generally may deduct only the fair market value of most contributions of clothing or household items, regardless of whether the property is used for exempt or unrelated purposes by the donee organization. Furthermore, a special rule generally provides that no deduction is allowed for a charitable contribution of clothing or a household item unless the item is in good used or better condition. The Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments. Notwithstanding the general rule, a charitable contribution of clothing or household items not in good used or better condition with a claimed value of more than $500 may be deducted if the taxpayer

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[112] Under present and prior law, certain copyrights are not considered capital assets, such that the charitable deduction for such copyrights generally is limited to the taxpayer's basis. See sec. 1221(a)(3), 1231(b)(1)(C).

[113] Sec. 170(e)(1)(B)(iii).

[114] The present-law rules allowing additional charitable deductions for qualified donee income were enacted as part of the American Jobs Creation Act of 2004, and are effective for contributions made after June 3, 2004. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, pp. 457-461.

includes with the taxpayer's return a qualified appraisal with respect to the property.[115] Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and certain collections are excluded from the special rules described in the preceding paragraph.[116]

College athletic seating rights.—In general, where a taxpayer receives or expects to receive a substantial return benefit for a payment to charity, the payment is not deductible as a charitable contribution. However, special rules apply to certain payments to institutions of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event. Specifically, the payor may treat 80 percent of a payment as a charitable contribution where: (1) the amount is paid to or for the benefit of an institution of higher education (as defined in section 3304(f)) described in section (b)(1)(A)(ii) (generally, a school with a regular faculty and curriculum and meeting certain other requirements), and (2) such amount would be allowable as a charitable deduction but for the fact that the taxpayer receives (directly or indirectly) as a result of the payment the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution.[117]

Description of Proposal

The proposal makes the following modifications to present law.

Two-percent floor on charitable deduction for individuals

The proposal imposes a two-percent floor on charitable contributions by taxpayers who are individuals. Specifically, the amount of an individual's charitable contributions for a taxable year (determined without regard to excess contributions carried over from a prior year under section 170(d)) are reduced by two percent of the taxpayer's contribution base for the taxable year.

The two-percent reduction is applied in the following order: (1) first, to charitable contributions to which paragraph 170(b)(1)(B) applies (generally, contributions subject to a 25-percent limitation, as reduced under the proposal); (2) second, to qualified conservation contributions; and (3) third, to charitable contributions to which paragraph 170(b)(1)(A) applies (generally, other contributions subject to a 40-percent limitation, as reduced under the proposal).

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[115] As is discussed above, the charitable contribution substantiation rules generally require a qualified appraisal where the claimed value of a contribution is more than $5,000.

[116] The special rules concerning the deductibility of clothing and household items were enacted as part of the Pension Protection Act of 2006, P.L. 109-280 (August 17, 2006), and are effective for contributions made after August 17, 2006. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 109th Congress* (JCS-1-07), January 17, 2007, pp. 597-600.

[117] Sec. 170(l).

Extension of time for individuals to make charitable contributions

The proposal permits individuals to elect to deduct for a taxable year charitable contributions made after the close of the taxable year but not later than the due date (determined without regard to extensions) for the individual's income tax return for the taxable year. The election must be made at the time of the filing of the tax return in the manner provided by the Secretary. For example, if a calendar year taxpayer makes a charitable contribution on February 15, 2015, the individual may elect to treat the contribution as having been made during 2014. The election must be made at the time of the filing of the 2014 income tax return in the manner prescribed by the Secretary.

Deduction for contributions of appreciated property generally limited to basis

Under the proposal a charitable contribution of property generally is reduced by the amount of gain that would have been realized if the property contributed had been sold by the taxpayer for its fair market value (determined at the time of the contribution). In other words, the proposal generally limits a charitable contribution of appreciated property to the taxpayer's basis in the property.

The proposal provides that contributions of certain property are reduced only by the amount of gain that would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market (determined at the time of the contribution). In other words, the amount of such contributions of property need only be reduced by the amount of any short-term capital gain or ordinary income, resulting in more preferential treatment for such property relative to other property under the proposal. These contributions include:

1. Contributions of tangible personal property if the use of the property by the donee organization is related to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in section 170(c));

2. Qualified conservation contributions described in section 170(h)(1);

3. Contributions of inventory and similar property that qualify for an enhanced charitable contribution deduction under present law[118];

4. Contributions of scientific property used for research that qualify for an enhanced deduction under present law[119]; and

[118] Sec. 170(e)(3). The proposal repeals the expired provisions that provided an enhanced deduction for certain contributions of food and book inventory.

[119] Sec. 170(e)(4).

5. Contributions of qualified appreciated stock (generally limited to 10 percent of the outstanding stock of a corporation), as described in present-law sections 170(e)(5)(B) and (C), to an organization described in section 170(c).

The special rules of present law continue to apply in determining whether the sale of certain property would result in a long-term gain.

Modifications to income-based percentage limits and repeal of separate, lower percentage limits for contributions of capital gain property

The proposal reduces the income-based percentage limit described in section 170(b)(1)(A) for certain charitable contributions by an individual taxpayer of cash and property that is not appreciated to public charities and certain other organizations from 50 percent to 40 percent. The proposal reduces the percentage limit for certain charitable contributions by an individual taxpayer to nonoperating private foundations from 30 percent to 25 percent.

The proposal repeals the provisions that provide lower percentage limitations on contributions of capital gain property (section 170(b)(1)(C), which generally imposes a 30-percent limit on charitable contributions of capital gain property to public charities and certain other organizations, and 170(b)(1)(D), which generally imposes a 20-percent limit on charitable contributions of capital gain property to nonoperating private foundations and certain other organizations). Thus, all contributions generally qualify for the more preferential 40- and 25-percent limitations, respectively, of sections 170(b)(1)(A) and 170(b)(1)(B), as amended.

Qualified conservation contributions

The proposal extends and makes permanent the special rules for qualified conservation contributions that provide for increased charitable contribution percentage limits and extended carryforward periods for excess contributions.

Golf course easements

The proposal modifies the definition of a qualified real property interest that may be treated as a qualified conservation contribution under section 170(h) generally to exclude golf course property. Specifically, an interest in real property is not treated as a qualified real property interest if (at the time of the contribution of such interest) the property is, or is intended to be, used as a golf course. As a result, charitable contributions of conservation easements on golf course property will not: (1) be excepted from the "partial interest" rule that generally denies a charitable deduction for a contribution of a partial interest in property, and (2) qualify for the preferential percentage limit and carryforward rules that generally apply to qualified conservation contributions.

College athletic event seating rights

The proposal repeals section 170(l), which generally provides that a taxpayer may deduct 80 percent of certain payments to institutions of higher education in exchange for which the taxpayer receives the right to purchase tickets or seating at an athletic event of such an institution.

Contributions of intellectual property

The proposal repeals section 170(m), under which certain donee income from intellectual property is treated as an additional charitable contribution.

Effective Date

The proposal generally is effective for contributions made in taxable years beginning after December 31, 2014.

The permanent extension of the special rules for qualified conservation contributions is effective for contributions made in taxable years beginning after December 31, 2013.

4. Denial of deduction for expenses attributable to the trade or business of being an employee (sec. 1404 of the discussion draft and sec. 62(a)(2) and new sec. 262A of the Code)

Present Law

In general, business expenses incurred by an employee are deductible, but only as an itemized deduction and only to the extent the expenses exceed two percent of adjusted gross income.[120] However, in the case of certain employees and certain expenses, a deduction may be taken in determining adjusted gross income (referred to as an "above-the-line" deduction), including expenses of qualified performing artists, expenses of State or local government officials performing services on a fee basis, expenses of eligible educators (applicable under present law for taxable years beginning after 2001 and before 2014), and expenses of members of a reserve component of the Armed Forces.[121]

A working condition fringe provided to an employee is excluded from the employee's income and wages.[122] For this purpose, a working condition fringe means property or services provided to an employee to the extent that, if the employee paid for the property or service, the payment would be deductible as a business expense or depreciation.

Description of Proposal

Under the proposal, business expenses incurred by an employee are not deductible, other than expenses that are deductible in determining adjusted gross income (that is, above-the-line deductions). In addition, the proposal repeals the provisions allowing above-the-line deductions for expenses of qualified performing artists and expenses of State or local government officials performing services on a fee basis. The proposal also repeals the provision allowing an above-the-line deduction for expenses of eligible educators for taxable years beginning after 2001 and

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[120] Secs. 62(a)(1) and 67.

[121] Sec. 62(a)(2)(B), (C), (D) and (E). Under section 62(a)(2)(A) and (c), certain reimbursements of employee business expenses are excluded from income.

[122] Sec. 132(a)(3) and (d).

before 2014.[123] The proposal retains the provision allowing an above-the-line deduction for expenses of members of a reserve component of the Armed Forces.[124] In addition, whether property or services provided by an employer are excluded as a working condition fringe is determined without regard to the proposal, that is, the same standard as under present law applies for this purpose.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

5. Repeal of deduction for taxes not paid or accrued in a trade or business (sec. 1405 of the discussion draft and sec. 164 of the Code)

Present Law

Individuals are permitted a deduction for certain taxes paid or accrued, whether or not incurred in a taxpayer's trade or business. These taxes are: (i) State, local real and foreign property taxes;[125] (ii) State and local personal property taxes;[126] (iii) State, local and foreign income, war profits, and excess profits taxes.[127] For taxable years beginning before 2014, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes.[128]

Property taxes may be allowed as a deduction in computing adjusted gross income if incurred in connection with property used in a trade or business; otherwise they are an itemized deduction. In the case of State and local income taxes, the deduction is an itemized deduction notwithstanding that the tax may be imposed on profits from a trade or business.[129]

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[123] As under present law, this provision does not apply for taxable years beginning in 2014.

[124] The proposal also retains the provision under which certain reimbursements of employee business expenses are excluded from income.

[125] Sec. 164(a)(1).

[126] Sec. 164(a)(2).

[127] Sec. 164(a)(3). A foreign tax credit, in lieu of a deduction, is allowable for foreign taxes if the taxpayer so elects.

[128] Sec. 164(b)(5).

[129] See H. Rep. No. 1365 to accompany Individual Income Tax Bill of 1944 (78th Cong., 2d. Sess.), reprinted at 19 C. B. 839 (1944).

Individuals also are permitted a deduction for Federal and State generation skipping transfer tax ("GST tax") imposed on certain income distributions that are included in the gross income of the distributee.[130]

In determining a taxpayer's alternative minimum taxable income, no itemized deduction for property, income, or sales tax is allowed.

Description of Proposal

The proposal provides that in the case of an individual, State, local and foreign property taxes shall be allowed as a deduction only when paid or accrued in carrying on a trade or business or an activity described in section 212 (relating to expenses for the production of income).[131]

The proposal also provides that in the case of an individual, State and local income, war profits, and excess profits taxes are not allowable as a deduction.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

6. Repeal of deduction for personal casualty losses (sec. 1406 of the discussion draft and sec. 165 of the Code)

Present Law

A taxpayer may generally claim a deduction for any loss sustained during the taxable year, not compensated by insurance or otherwise. For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft.[132] Personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.

Description of Proposal

The proposal repeals the deduction for personal casualty losses.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

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[130] Sec. 164(a)(4).

[131] The proposal does not modify the deductibility of GST tax imposed on certain income distributions.

[132] Sec. 165(c).

7. Limitation on wagering losses (sec. 1407 of the discussion draft and sec. 165(d) of the Code)

Present Law

Losses sustained during the taxable year on wagering transactions are allowed as a deduction only to the extent of the gains during the taxable year from such transactions.[133]

Description of Proposal

The proposal clarifies the scope of "losses from wagering transactions" as that term is used in section 165(d). The proposal provides that this term includes any deduction otherwise allowable under chapter 1 of the Code incurred in carrying on any wagering transaction.

The proposal 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 activity.[134] The proposal clarifies, for instance, an individual's otherwise deductible expenses in traveling to or from a casino are subject to the limitation under section 165(d).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

8. Repeal of deduction for tax preparation expenses (sec. 1408 of the discussion draft and sec. 212 of the Code)

Present Law

For regular income tax purposes, individuals are allowed an itemized deduction for expenses for the production of income. These expenses are defined as ordinary and necessary expenses paid or incurred in a taxable year: (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.[135]

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[133] Sec. 165(d).

[134] The proposal thus reverses the result reached by the Tax Court in *Ronald A. Mayo v. Commissioner*, 136 T.C. 81 (2011). In that case, the Court held that a taxpayer's expenses incurred in the conduct of the trade or business of gambling, other than the cost of wagers, were not limited by sec. 165(d), and were thus deductible under sec. 162(a).

[135] Sec. 212.

Description of Proposal

The proposal repeals the deduction for expenses in connection with the determination, collection, or refund of any tax. Expenses in the other two categories are not changed by the proposal.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

9. Repeal of deduction for medical expenses (sec. 1409 of the discussion draft and sec. 213 of the Code)

Present Law

Individuals are allowed an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceed 10 percent of adjusted gross income. However, for the years 2013, 2014, 2015 and 2016, if either the taxpayer or the taxpayer's spouse turns 65 before the end of the taxable year, the threshold is at 7.5 percent of adjusted gross income.

Description of Proposal

The proposal repeals the itemized deduction for unreimbursed medical expenses.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

10. Repeal of the disqualification of expenses for over-the-counter drugs under certain accounts and arrangements (sec. 1410 of the discussion draft and secs. 106 and 223 of the Code)

Present Law

Individual deduction for medical expenses

Expenses for medical care, not compensated for by insurance or otherwise, are deductible by an individual under the rules relating to itemized deductions to the extent the expenses exceed 10 percent of adjusted gross income ("AGI").[136] Medical care generally is defined broadly as

[136] Sec. 213(a). For taxable years beginning before January 1, 2013, the threshhold was 7.5 percent of AGI. However, the increase in the threshold from 7.5 to 10 percent of AGI does not apply until taxable years beginning after December 31, 2016, with respect to any taxpayer if the taxpayer or the taxpayer's spouse has attained age 65 before the close of the taxable year.

amounts paid for diagnoses, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure of the body.[137]

Under an explicit limitation, any amount paid during a taxable year for medicine or drugs is deductible as a medical expense only if the medicine or drug is a prescribed drug or insulin.[138] The term prescribed drug means a drug or biological which requires a prescription of a physician for its use by an individual.[139] Thus, any amount paid for medicine available without a prescription ("over-the-counter medicine") is not deductible as a medical expense, including any medicine prescribed or recommended by a physician.[140]

Exclusion for employer-provided health care

Employees are not taxed on (that is, may exclude from gross income) the value of employer-provided health coverage under an accident or health plan.[141] In addition, any reimbursements under an employer-provided accident or health plan for medical care expenses for employees, their spouses, their dependents, and adult children under age 27 generally are excludible from gross income.[142] An employer may agree to reimburse expenses for medical care of its employees (and their spouses and dependents), not covered by a health insurance plan, through a flexible spending arrangement ("FSA") which allows reimbursement not in excess of a specified dollar amount. The amounts available for reimbursement must be exclusively for reimbursement for medical care because the exclusion does not apply to amounts to which the employee would be entitled irrespective of whether he or she incurs expenses for medical care.[143]

Such dollar amount is either elected by an employee under a cafeteria plan ("Health FSA") or otherwise specified by the employer under a health reimbursement arrangement ("HRA"). Reimbursements under these arrangements are also excludible from gross income as reimbursements for medical care under employer-provided health coverage.

Health savings accounts

An individual with a high deductible health plan (and no other health plan other than a plan that provides certain permitted insurance or permitted coverage) may establish a health savings account ("HSA"). In general, HSAs provide tax-favored treatment for current medical

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[137] Sec. 213(d). There are certain limitations on the general definition including a rule that cosmetic surgery or similar procedures are generally not medical care.

[138] Sec. 213(b).

[139] Sec. 213(d)(3).

[140] Rev. Rul. 2003-58, 2003-1 CB 959.

[141] Sec 106.

[142] Sec. 105(b).

[143] Treas. Reg. sec. 1.105-2.

expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents. Thus, earnings on amounts in HSAs are not taxable.

Subject to limits,[144] contributions made to an HSA by an employer, including contributions made through a cafeteria plan through salary reduction, are excludible from income (and from wages for payroll tax purposes). Contributions made by individuals are deductible for income tax purposes, regardless of whether the individuals itemize. Distributions from an HSA that are used for qualified medical expenses are excludible from gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 20 percent. The 20-percent additional tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65). Similar rules apply for another type of medical savings arrangement called an Archer medical savings account ("Archer MSA").[145]

Medical care for excludible reimbursements

For purposes of the exclusion for reimbursements under employer-provided accident and health plans (including under Health FSAs and HRAs), and for distributions from HSAs and Archer MSAs used for qualified medical expenses, the definition of medical care is generally the same as the definition that applies for the itemized deduction for the cost of medical care. However, prior to the enactment of the Patient Protection and Affordable Care Act (referred to as the "Affordable Care Act"), [146] the limitation (applicable to the itemized deduction) that only prescription medicines or drugs and insulin are taken into account did not apply. Thus, for example, amounts paid from a Health FSA or HRA, or funds distributed from an HSA to reimburse a taxpayer for nonprescription drugs, such as nonprescription aspirin, allergy medicine, antacids, or pain relievers, were excludible from income even though, if the taxpayer paid for such amounts directly (without such reimbursement), the expenses could not be taken into account in determining the itemized deduction for medical expenses.[147]

For years beginning after December 31, 2010, the Affordable Care Act changed the definition of medical care for purposes of the exclusion for reimbursements for medical care under employer-provided accident and health plans and for distributions from HSAs and Archer

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[144] For 2014, the maximum aggregate annual contribution that can be made to an HSA is $3,300 in the case of self-only coverage and $6,550 in the case of family coverage. The annual contribution limits are increased by $1,000 for individuals who have attained age 55 by the end of the taxable year (referred to as "catch-np contributions"). Contributions, including catch-np contribntions, cannot be made once an individual is enrolled in Medicare.

[145] Sec. 220.

[146] Pub. L. No 111-148. Various provisions of the Affordable Care Act are amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152.

[147] Rev. Rul. 2003-102, 2993-2 C.B. 559, now obsolete by Rev. Rul. 2010-23, 2010-39 I.R.B. 388.

MSAs used for qualified medical expenses to require that over-the-counter medicine (other than insulin) be prescribed by a physician in order for the medicine to be medical care for these purposes.[148] Thus, under present law, a Health FSA or an HRA is only permitted to reimburse an employee for the cost of over-the-counter medicine if the medicine is prescribed by a physician and distributions from an HSA or an Archer MSA used to purchase over-the-counter medicine is not a qualified medical expense unless the medicine is prescribed by a physician.

Description of Proposal

The proposal repeals the change to the definition of medical care made by the Affordable Care Act for purposes of the exclusion for reimbursements for medical care under employer-provided accident and health plans and for distributions from HSAs or Archer MSAs used for qualified medical expenses that requires that over-the-counter medicine (other than insulin) be prescribed by a physician in order for the medicine to be medical care for these purposes. Thus, for example, amounts paid from a Health FSA or HRA, or funds distributed from an HSA or an Archer MSA to reimburse a taxpayer for nonprescription drugs, such as nonprescription aspirin, allergy medicine, antacids, or pain relievers, are excludible from income.

Effective Date

The proposal is effective with respect to expenses incurred after December 31, 2014.

11. Repeal of deduction for alimony payments and corresponding inclusion in gross income (sec. 1411 of the discussion draft and secs. 71 and 215 of the Code)

Present Law

Alimony and separate maintenance payments are deductible by the payor spouse and includible in income by the recipient spouse.[149] Child support payments are not treated as alimony.[150]

Description of Proposal

Under the proposal, alimony and separate maintenance payments are not deductible by the payor spouse. The proposal repeals sections 61(a)(8) and 71 of the Code. Those sections specified that alimony and separate maintenance payments are included in income. Thus, the intent of the proposal is to follow the rule of the Supreme Court's holding in *Gould v. Gould*,[151]

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[148] Sec. 9003 of the Affordable Care Act. Notice 2010-59, 2010-39 I.R.B. 388, provides guidance on this change to the definition of medical care for these purposes.

[149] Secs. 215(a) and 71(a).

[150] Sec. 71(c).

[151] 245 U.S. 151 (1917).

in which the Court held that such payments are not income to the recipient. The treatment of child support is not changed.

Effective Date

The proposal is effective for any divorce or separation instrument executed after December 31, 2014, or for any divorce or separation instrument executed on or before December 31, 2014, and modified after that date, if the modification expressly provides that the amendments made by this section apply to such modification.

12. Repeal of deduction for moving expenses (sec. 1412 of the discussion draft and sec. 217 of the Code)

Present Law

Individuals are allowed an itemized deduction for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work.[152] Such expenses are deductible only if the move meets certain conditions related to distance from the taxpayer's previous residence and the taxpayer's status as a full-time employee in the new location.

Description of Proposal

The proposal repeals the deduction for moving expenses.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

13. Termination of deduction and exclusions for contributions to medical savings accounts (sec. 1413 of the discussion draft and secs. 106(b) and 220 of the Code)

Present Law

Archer MSAs

As of 1997, certain individuals are permitted to contribute to an Archer MSA, which is a tax-exempt trust or custodial account.[153] Within limits, contributions to an Archer MSA are deductible in determining adjusted gross income if made by an individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an individual.

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[152] Sec. 217(a).

[153] Archer MSAs were originally called medical savings accounts or MSAs.

An individual is generally eligible for an Archer MSA if the individual is covered by a high deductible health plan and no other health plan other than a plan that provides certain permitted insurance or permitted coverage. In addition, the individual either must be an employee of a small employer (generally an employer with 50 or fewer employees on average) that provides the high deductible health plan or must be self-employed or the spouse of a self-employed individual and the high deductible health plan is not provided by the employer of the individual or spouse.

For 2014, a high deductible health plan for purposes of Archer MSA eligibility is a health plan with an annual deductible of at least $2,200 and not more than $3,250 in the case of self-only coverage and at least $4,350 and not more than $6,550 in the case of family coverage. In addition, for 2014, the maximum out-of-pocket expenses with respect to allowed costs must be no more than $4,350 in the case of self-only coverage and no more than $ $8,000 in the case of family coverage. Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan. A plan does not fail to qualify as a high deductible health plan if substantially all of the coverage under the plan is certain permitted insurance or is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the annual deductible under the individual's high deductible health plan in the case of self-only coverage (65 percent of $3,250 for 2014) and 75 percent of the annual deductible in the case of family coverage (75 percent of $6,550 for 2014), but in no case more than the individual's compensation income. In addition, the maximum contribution can be made only if the individual is covered by the high deductible health plan for the full year.

Distributions from an Archer MSA for qualified medical expenses are not includible in gross income. Distributions not used for qualified medical expenses are includible in gross income and subject to an additional 20-percent tax unless an exception applies. A distribution from an Archer MSA may be rolled over on a nontaxable basis to another Archer MSA or to a health savings account and does not count against the contribution limits.

After 2007, no new contributions can be made to Archer MSAs except by or on behalf of individuals who previously had made Archer MSA contributions and employees of small employers that previously contributed to Archer MSAs (or at least 20 percent of whose employees who were previously eligible to contribute to Archer MSAs did so).

Health savings accounts

As of 2004, an individual with a high deductible health plan (and no other health plan other than a plan that provides certain permitted insurance or permitted coverage) generally may contribute to a health savings account ("HSA"), which is a tax-exempt trust or custodial account. HSAs provide similar tax-favored savings treatment as Archer MSAs. That is, within limits, contributions to an HSA are deductible in determining adjusted gross income if made by an individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an individual, and distributions for qualified medical expenses are not includible in gross income.[154] However, the rules for HSAs are in various aspects more favorable than the rules for Archer MSAs. For example, the availability of HSAs is not limited to employees of small employers or self-employed individuals and their spouses.

For 2014, a high deductible health plan for purposes of HSA eligibility is a health plan with an annual deductible of at least $1,250 in the case of self-only coverage and at least $2,500 in the case of family coverage. In addition, for 2013, the sum of the deductible and the maximum out-of-pocket expenses with respect to allowed costs must be no more than $6,350 in the case of self-only coverage and no more than $12,700 in the case of family coverage. A plan does not fail to qualify as a high deductible health plan for HSA purposes merely because it does not have a deductible for preventive care.

For 2014, the maximum aggregate annual contribution that can be made to an HSA is $3,300 in the case of self-only coverage and $6,550 in the case of family coverage. The annual contribution limits are increased by $1,000 for individuals who have attained age 55 by the end of the taxable year (referred to as "catch-up contributions"). The maximum amount that an individual make contribute is reduced by the amount of any contributions to the individual's Archer MSA and any excludable HSA contributions made by the individual's employer. In some cases, an individual may make the maximum HSA contribution, even if the individual is covered by the high deductible health plan for only part of the year. A distribution from an HSA may be rolled over on a nontaxable basis to another HSA and does not count against the contribution limits.

Description of Proposal

Under the proposal, contributions to Archer MSAs for taxable years beginning after December 31, 2014, are not deductible or excluded from income and wages.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

14. Repeal of two-percent floor on miscellaneous itemized deductions (sec. 1414 of the discussion draft aud sec. 67 of the Code)

Present Law

An individual may claim an itemized deduction for certain miscellaneous expenses only to the extent of such expenses in excess of two percent of the taxpayer's adjusted gross income.[155] Miscellaneous expenses subject to the two-percent floor include certain unreimbursed employee business expenses and expenses for the production or collection of

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[154] Secs. 106(d) and 223.

[155] Sec. 67(a).

income, for the management, conservation, or maintenance of property held for the production of income, and in connection with the determination, collection, or refund or any tax.

To be deductible, an unreimbursed employee business expense must be: (1) paid or incurred during the taxable year; (2) for carrying on the trade or business of being an employee; and (3) an ordinary and necessary business expense. Thus, unreimbursed employee business expenses are those expenses that would be deductible above the line if the employee were engaged in a trade or business (other than the trade or business of being an employee). Generally, the two-percent floor applies to unreimbursed employee business expenses after any other deduction limit (such as the 50-percent limit on expenses for business-related meals and entertainment). Unreimbursed employee expenses include such expenses as certain business and professional dues, uniform costs, home office deductions, business bad debts of an employee, employment related education expenses, licenses and regulatory fees, malpractice insurance premiums, medical examinations required by an employer, occupational taxes, publications and subscriptions, job search, employment and outplacement agency fees, and union dues and expenses.

The two-percent floor does not apply to the following itemized deductions: (1) otherwise deductible interest; (2) State and local income (or in lieu of such, State sales), real property, and certain personal property taxes; (3) casualty and theft losses; (4) gambling losses to the extent of gambling winnings; (5) charitable contributions; (6) medical expenses; (7) impairment-related work expenses of a disabled individual; (8) the estate tax on income in respect to a decedent; (9) any deduction allowable in connection with personal property used in a short sale; (10) certain adjustments occurring when a taxpayer restores amounts held under a claim of right; (11) amortizable bond premium; (12) certain terminated annuity payments; and (13) deductions in connection with cooperative housing corporations. The two-percent floor does not apply to deductions allowable to estates or trusts under sections 642(c), 651, and 661.

Description of Proposal

The proposal repeals the two-percent floor on miscellaneous itemized deductions.[156]

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

[156] The proposal repeals certain miscellaneous itemized deductions. See sec. 1404 (repeal of deduction for expenses attributable to the trade or business of being an employee), and sec. 1408 (repeal of deduction for tax preparation expenses).

15. Repeal of overall limitation on itemized deductions (sec. 1415 of the discussion draft and sec. 68 of the Code)

Present Law

The total amount of most otherwise allowable itemized deductions (other than the deductions for medical expenses, investment interest and casualty, theft or gambling losses) is limited for certain upper-income taxpayers.[157] All other limitations applicable to such deductions (such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced by three percent of the amount by which the taxpayer's adjusted gross income exceeds a threshold amount.

For 2014, the threshold amounts are $254,200 for single taxpayers, $279,650 for heads of household, $305,050 for married couples filing jointly, and $152,525 for married taxpayers filing separately. These threshold amounts are indexed for inflation. The otherwise allowable itemized deductions may not be reduced by more than 80 percent by reason of the overall limit on itemized deductions.

Description of Proposal

The proposal repeals the overall limitation on itemized deductions.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

16. Deduction for amortizable bond premium allowed in determining adjusted gross income (sec. 1416 of the discussion draft and sec. 62 of the Code)

Present Law

Under present law, a deduction for amortizable bond premium is allowed to the holder of a taxable bond acquired for more than the amount payable on maturity.[158] The deduction is an itemized deduction.[159] The amount amortizable is computed on a constant yield basis. The amount of bond premium is allocated among the interest payments received on the bond, and the allocated amount reduces the amount the of the interest payments to the extent thereof, in lieu of any deduction otherwise allowable.[160]

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[157] Sec. 68.

[158] Sec. 171(a)(1).

[159] Sec. 62.

[160] See Treas. Reg. sec. 1.171-2 for rules relating to offsetting qualified stated interest with premium.

Description of Proposal

The proposal allows the deduction for amortizable bond premium of an individual as an "above-the-line" deduction which reduces adjusted gross income.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

17. Repeal of exclusion, etc., for employee achievement awards (sec. 1417 of the discussion draft and secs. 74(c) and 274(j) of the Code)

Present Law

An employer's deduction for the cost of an employee achievement award is limited to a certain amount.[161] Employee achievement awards that are deductable by an employer (or would be deductible but for the fact that the employer is a tax-exempt organization) are excluded from an employee's gross income and wages for employment tax purposes.[162] An employee achievement award is an item of tangible personal property given to an employee in recognition of either length of service or safety achievement and presented as part of a meaningful presentation.

Description of Proposal

The proposal repeals the deduction limitation and the exclusion for employee achievement awards.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

18. Clarification of special rule for certain governmental plans (sec. 1418 of the discussion draft and sec. 105(j) of the Code)

Present Law

Reimbursements under an employer-provided accident or health plan for medical care expenses for employees, their spouses, their dependents, and adult children under age 27 are excludible from gross income.[163] However, in order for these reimbursements to be excluded from income, the plan may reimburse expenses of only the employee and the employee's spouse, dependents, and children under age 27. In the case of a deceased employee, the plan generally

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[161] Sec. 274(j).

[162] Secs. 74(c), 3121(a)(20), 3231(e)(5), 3306(b)(16), and 3401(a)(19).

[163] Sec. 105(b).

may reimburse medical expenses of only the employee's surviving spouse, dependents and children under age 27. If a plan reimburses expenses of any other beneficiary, all expense reimbursements under the plan are included in income, including reimbursements of expenses of the employee and the employee's spouse, dependents and children under age 27 (or the employee's surviving spouse, dependents and children under age 27).[164]

Under a limited exception, reimbursements under a plan do not fail to be excluded from income solely because the plan provides for reimbursements of medical expenses of a deceased employee's beneficiary, without regard to whether the beneficiary is the employee's surviving spouse, dependent, or child under age 27. In order for the exception apply, the plan must have provided, on or before January 1, 2008, for reimbursement of the medical expenses of a deceased employee's beneficiary. In addition, the plan must be funded by a medical trust (1) that is established in connection with a public retirement system, and (2) that either has been authorized by a State legislature, or has received a favorable ruling from the IRS that the trust's income is not includible in gross income by reason of the exclusion for income of a State or political subdivision.[165] This exception preserves the exclusion for reimbursements of expenses of the employee and the employee's spouse, dependents, and children under age 27 (or the employee's surviving spouse, dependents, and children under age 27). Reimbursements of expenses of other beneficiaries are included in income.

Description of Proposal

The proposal expands the exception to apply to plans funded by medical trusts in addition to those covered under present law. As expanded, the exception would apply to a plan funded by a medical trust (1) that is either established in connection with a public retirement system or established by or on behalf of a State or political subdivision thereof, and (2) that either has been authorized by a State legislature or has received a favorable ruling from the IRS that the trust's income is not includible in gross income by reason of either the exclusion for income of a State or political subdivision or the exemption from income tax for a voluntary employees' beneficiary association ("VEBA").[166] The plan would still be required to have provided, on or before January 1, 2008, for reimbursement of the medical expenses of a deceased employee's beneficiary.

The proposal also clarifies that this exception preserves the exclusion for reimbursements of expenses of the employee and the employee's spouse, dependents, and children under age 27 (or the employee's surviving spouse, dependents, and children under age 27) and that, as under present law, reimbursements of expenses of other beneficiaries are included in income.

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[164] Rev. Rul. 2006-36, 2006-2 C.B. 353. The ruling is effective for plan years beginning after December 31, 2008, in the case of plans including certain reimbursement provisions on or before August 14, 2006.

[165] This exclusion is provided under Code section 115.

[166] Tax-exempt status for a VEBA is provided under Code section 501(c)(9).

Effective Date

The proposal is effective with respect to payments made after the date of enactment of the proposal.

19. Limitation on exclusion for employer-provided housing (sec. 1419 of the discussion draft and sec. 119 of the Code)

Present Law

The value of lodging furnished to an employee, spouse, or dependents by or on behalf of an employer for the convenience of the employer (referred to as "employer-provided lodging") is excluded from the employee's gross income, but only if the employee is required to accept the lodging on the business premises of the employer as a condition of employment. The value of employer-provided lodging is also excluded from wages for employment tax purposes.[167]

Description of Proposal

The proposal limits the amount that may be excluded as employer-provided lodging. The exclusion with respect to employer-provided lodging for a taxable year may not exceed $50,000 ($25,000 in the case of a married individual filing a separate return). In addition, the exclusion does not apply to more than one residence at any given time. In the case of spouses filing a joint return, the one residence limit may be applied separately to each spouse for a period during which the spouses reside in separate residences provided in connection with their respective employments.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

20. Fringe benefits (sec. 1420 of the discussion draft and sec. 132 of the Code)

Present Law

In general

A fringe benefit that is a no-additional-cost service, qualified employee discount, or a qualified transportation fringe is excluded from an employee's gross income and wages for employment tax purposes.[168]

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[167] Secs. 3121(a)(19), 3231(e)(9), and 3306(b)(14).

[168] Secs. 132(a)(1), (a)(2), (a)(5), (b), (c) and (f), 3121(a)(20), 3231(e)(5), 3306(b)(16) and 3401(a)(19).

No-additional-cost services and qualified employee discounts

A no-additional-cost service is a service provided by an employer to an employee for use by the employee if (1) the service is offered for sale to customers in the ordinary course of the employer's line of business in which the employee performs services, and (2) the employer incurs no substantial additional cost (including foregone revenue) in providing the service to the employee. A qualified employee discount may apply to services provided by an employer to an employee at a discount (that is, at less than the price the employer offers the services to customers) for use by the employee, (1) if the services are offered for sale to customers in the ordinary course of the employer's line of business in which the employee performs services, and (2) to the extent the discount does not exceed 20 percent of the price at which the services are offered by the employer to customers. For purposes of these exclusions, use by a spouse or dependent child of an employee is treated as use by the employee. In addition, use of air transportation by a parent of an employee is treated as use by the employee.

Qualified transportation fringes

Qualified transportation fringes include parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements. Qualified transportation fringes also include a cash reimbursement (under a bona fide reimbursement arrangement) by an employer to an employee for parking, transit passes, or vanpooling. In the case of transit passes, however, a cash reimbursement is considered a qualified transportation fringe only if a voucher or similar item that may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

In general, the amount that can be excluded as qualified transportation fringe benefits is limited to $100 per month in combined transit pass and vanpool benefits and $175 per month in qualified parking benefits, with the limits being adjusted annually for inflation. For months beginning on or after February 17, 2009[169] and before January 1, 2014, the exclusion limit that applies to employer-provided parking applies also to combined employer-provided transit pass and vanpool benefits. For 2013, the monthly exclusion amount is $245. After 2013, the lower monthly exclusion amount (as adjusted for inflation) applies to combined employer-provided transit pass and vanpool benefits. For 2014, the monthly exclusion amount for qualified parking benefits is $250, and the monthly exclusion amount for combined employer-provided transit pass and vanpool benefits is $130.

With respect to any calendar year, a qualified bicycle commuting reimbursement is an employer reimbursement, during the 15-month period beginning with the first day of the calendar year, for reasonable expenses incurred by an employee during the calendar year for the purchase of a bicycle and bicycle improvements, repair, and storage, if such bicycle is regularly used for travel between the employee's residence and place of employment. The exclusion for a qualified bicycle commuting reimbursement for a calendar year is limited to $20 multiplied by the number of months during the year for which the employee regularly uses the bicycle for a

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[169] This is the date of enactment of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5.

substantial portion of the travel between the employee's residence and place of employment and does not receive any other qualified transportation fringe.

Description of Proposal

The proposal repeals the rule under which, for purposes of a no-additional-cost service or a qualified employee discount, use of air transportation by a parent of an employee is treated as use by the employee.

With respect to the qualified transportation fringe exclusion for parking, the proposal applies a permanent monthly limit of $250, which is not adjusted in the future for inflation. With respect to the qualified transportation fringe exclusion for employer-provided transit passes, vanpool benefits or combined transit pass and vanpool benefits, the proposal applies a permanent combined monthly limit of $130, which is not adjusted in the future for inflation. The proposal also repeals the qualified transportation fringe exclusion for qualified bicycle commuting reimbursements.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

21. Repeal of exclusion of net unrealized appreciation in employer securities (sec. 1421 of the discussion draft and sec. 402(e)(4) of the Code)

Present Law

If a qualified retirement plan distributes property, the general rule is that the amount of the distribution is the fair market value of the property on the date of the distribution and amount of the distribution is includible in gross income except to the extent that a portion of the distribution is a return of the employee's investment in the contract.

However, if employer securities are distributed by a qualified retirement plan and either the distribution is a lump sum distribution or the employer securities are attributable to after-tax employee contributions, the net unrealized appreciation in the securities is excluded from the recipient's gross income.[170] Net unrealized appreciation is defined as the excess of the market value of the securities at the time of distribution over the cost or other basis of the securities to the trust.[171] In other words, it generally is the amount by which the value of the securities increased while held by the trust of the qualified retirement plan. The basis of the employer

[170] Section 402(e)(4). Under section 402(e)(4)(E), for purposes of this exclusion for net unrealized appreciation, employer securities include shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form including securities of a parent or subsidiary of the employer. See section 402(e)(4)(D) for the definition of a lump sum distribution.

[171] Treas. Reg. sec. 1.402(a)-1(b)(2) provides rules for determining the cost or other basis of employer securities to the trust.

securities after distribution does not include the amount of net unrealized appreciation excluded from gross income.[172]

The exclusion for net unrealized appreciation is not available upon subsequent distribution after the securities are contributed to another eligible retirement plan in a tax-free rollover.[173] When the securities are received as part of a lump sum distribution, the recipient may elect not to exclude net unrealized appreciation.[174]

Description of Proposal

The exclusion for net unrealized appreciation with respect to employer securities is repealed.

Effective Date

The proposal applies to distributions of employer securities after December 31, 2014.

22. Consistent basis reporting between estate and person acquiring property from decedent (sec. 1422 of the discussion draft and secs. 6035 and 6724 of the Code)

Present Law

The value of an asset for purposes of the estate tax generally is the fair market value at the time of death or at the alternate valuation date.[175] The basis of property acquired from a decedent is the fair market value of the property at the time of the decedent's death or as of an alternate valuation date, if elected by the executor.[176] Under regulations, the fair market value of the property at the date of the decedent's death (or alternate valuation date) is deemed to be its value as appraised for estate tax purposes.[177] However, the value of property as reported on the decedent's estate tax return provides only a rebuttable presumption of the property's basis in the hands of the heir.[178] Unless the heir is estopped by his or her previous actions or statements with regard to the estate tax valuation, the heir may rebut the use of the estate's valuation as his or her

[172] Under Treas. Reg. sec. 1.402(a)-1(b)(1), when employer securities with net unrealized appreciation are sold or exchanged, any gain is treated as long-term capital gain up to the amount of the net unrealized appreciation (regardless of how long the securities were held by the taxpayer). Any gain in excess of the amount of net unrealized appreciation is long-term or short-term gain, depending on how long the taxpayer held the securities after distribution.

[173] Sec. 402(e)(4)(A).

[174] Sec. 402(e)(4)(B).

[175] Secs. 2031 and 2032.

[176] Sec. 1014. See section 1022 for special basis rules apply to property acquired from an electing estate of a decedent who died during 2010.

[177] Treas. Reg. sec. 1.1014-3(a).

[178] See Rev. Rul. 54-97, 1954-1 C.B. 113, 1954.

basis by clear and convincing evidence. The heir is free to rebut the presumption in two situations: (1) the heir has not used the estate tax value for tax purposes, the IRS has not relied on the heir's representations, and the statute of limitations on assessments has not barred adjustments; and (2) the heir does not have a special relationship to the estate which imposes a duty of consistency.[179]

Description of Proposal

Under the proposal, if the inclusion of property in an estate increased estate tax liability on such estate, and the value of the property has been finally determined for estate tax purposes, the basis in the hands of the recipient can be no greater than the value of the property as finally determined. If the value of the property is not finally determined for estate tax purposes, then the basis in the hands of the recipient can be no greater than the value reported in a required statement.

An executor of a decedent's estate that is required to file an estate tax return under section 6018(a) is required to report to both the recipient and the IRS the value of each interest in property included in the gross estate. A person that is required to file an estate tax return under section 6018(b) (returns by beneficiaries) is required to report to each other person holding a legal or beneficial interest in property to which the return relates and to the IRS the value of each interest in property included in the gross estate. The required reports must be furnished by the time proscribed by the Secretary, but in no case later than the earlier of 30 days after the return is due under section 6018 or 30 days after the return is filed. In any case where reported information is adjusted after a statement has been filed, a supplemental statement must be filed not later than 30 days after such adjustment is made.

The proposal grants the Secretary authority to prescribe regulations necessary to carry out the proposal, including the application of the proposal when no estate tax return is required to be filed and when the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property.

The proposal applies the penalty for failure to file correct information returns under section 6721, and failure to furnish correct payee statements under section 6722, to failure to file the new information returns required under the proposal. Additionally, the proposal applies the accuracy-related penalty under section 6662 to any inconsistent estate basis. Inconsistent estate basis for purposes of the accuracy-related penalty is the portion of the understatement attributable to a basis determination with respect to property which is not consistent with the value of the property finally determined for estate tax purposes, or if not finally determined, in accordance with the statement provided under the proposal.

Effective Date

The proposal is applicable to transfers for which an estate tax return is filed after the date of enactment.

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[179] See Technical Advice Memorandum 199933001, January 7, 1999.

F. Employment Tax Modifications

1. Modifications of deduction for Social Security taxes in computing net earnings from self-employment (sec. 1501 of the discussion draft and sec. 1402(a)(12) of the Code)

Present Law

FICA taxes

The Federal Insurance Contributions Act ("FICA") imposes tax on employers and employees based on the amount of wages (as defined for FICA purposes) paid to an employee during the year.[180] The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($117,000 for 2014); and (2) the Medicare or hospital insurance ("HI") tax equal to 1.45 percent of all covered wages.[181] The employee portion of the FICA tax generally must be withheld and remitted to the Federal government by the employer.

The employer portion of the FICA tax is not treated as income or wages to the employee. That is, it is not included in the employee's income and is not subject to FICA tax.

SECA taxes

As a parallel to FICA taxes, taxes under the Self-Employment Contributions Act ("SECA") apply to the self-employment income of self-employed individuals.[182] The rate of the OASDI portion of SECA taxes is generally 12.4 percent, which is equal to the combined employee and employer OASDI tax rates, and applies to self-employment income up to the OASDI taxable wage base (reduced by the individual's OASDI wages, if any). Similarly, the rate of the HI portion of SECA tax is 2.9 percent, the same as the combined employer and employee HI rates, and there is no cap on the amount of self-employment income to which the rate applies.[183]

Self-employment income for SECA purposes means net earnings from self-employment with certain modifications. Net earnings from self-employment generally means the income from a self-employed individual's trade or business less deductions attributable to the trade or

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[180] Secs. 3101-3128.

[181] Beginning 2013, the employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

[182] Secs. 1401-1403.

[183] Beginning 2013, an additional 0.9 percent HI tax applies to self-employment income in excess of the threshold amount of $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

business. In determining net earnings from self-employment, a self-employed individual is permitted a deduction equal to the product of the taxpayer's net earnings from self-employment determined without regard to this deduction ("preliminary" net earnings from self-employment or NESE) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of preliminary NESE.[184] This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes.

Description of Proposal

The proposal modifies the deduction from net earnings from self-employment to make SECA taxes economically equivalent to FICA taxes.[185] Under the proposal, the deduction is determined as the sum of two amounts, corresponding to the OASDI and HI portions of SECA taxes.

The OASDI portion of the deduction is 7.1064 percent of preliminary net earnings from self-employment up to 1.0765 multiplied by the OASDI taxable wage base (reduced by the individual's OASDI wages, if any). The HI portion of the deduction is 1.4293 percent of preliminary net earnings from self-employment in excess of the amount taken into account in determining the OASDI portion of the deduction (that is, preliminary net earnings from self-employment up to 1.0765 multiplied by the OASDI taxable wage base (reduced by the individual's OASDI wages, if any)).

The calculation is summarized in the following table. For purposes of the table, the OASDI base amount is 1.0765 times the OASDI taxable wage base reduced by the individual's OASDI wages, if any.

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[184] A parallel deduction applies in determining self-employment income for purposes of Social Security benefits. The additional HI tax is not taken into acconnt in computing this deduction. Under section 164(f), a self-employed individual may deduct one-half of SECA taxes (other than the additional HI tax) for income tax purposes.

[185] A parallel change is made to the deduction applicable in determining self-employment income for purposes of Social Security benefits.

Table 3.–Calculation of Deduction Allowed in Determining SECA Taxes

If preliminary NESE are...	Amount of deduction in calculating net earnings from self-employment is...
Up to the OASDI base amount	7.1064 percent of preliminary NESE.
In excess of the OASDI base amount	7.1064 percent of preliminary NESE up to the OASDI base amount, plus 1.4293 percent of preliminary NESE in excess of the OASDI base amount.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

2. Determination of net earnings from self-employment (sec. 1502 of the discussion draft and secs. 3101, 3102, 2111, 1401, and 1402 of the Code)

Present Law

In general

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").[186] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").[187]

FICA

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[188] The amount of wages subject to this component is capped at $117,000 for 2014. Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped.[189] The wages of

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[186] See Chapter 21 of the Code.

[187] Sec. 1401.

[188] Secs. 3101 and 3111.

[189] Beginning 2013, the employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. The threshold amount is

individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax. The employee portion of the FICA tax is collected through withholding from wages.[190]

SECA

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at $117,000 for 2014. Under the HI component, the rate is 2.9 percent, and the amount of self-employment income subject to the HI component is not capped.[191]

For SECA tax purposes, net earnings from self-employment generally includes the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules.[192] Net earnings from self-employment generally includes the distributive share of income or loss from any trade or business of a partnership in which the individual is a partner.

Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

S corporation shareholders

An S corporation is treated as a passthrough entity for Federal income tax purposes. Each shareholder takes into account and is subject to Federal income tax on the shareholder's pro rata share of the S corporation's income.[193]

$250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. Sec. 3101(b).

[190] Sec. 3102.

[191] Beginning 2013, an additional 0.9 percent HI tax applies to self-employment income in excess of the threshold amount of $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. Sec. 1401(b).

[192] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), *i.e.*, 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes under section 164(f).

[193] Sec. 1366.

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages from the S corporation.

A shareholder of an S corporation generally is not subject to FICA tax on amounts that are not wages, such as the shareholder's share of the S corporation's income. Unlike a partner's distributive share of income or loss from the partnership's trade or business, which is generally subject to SECA tax, an S corporation shareholder's pro rata share of S corporation income is not subject to SECA tax. Nevertheless, courts have held that an S corporation shareholder is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized by the taxpayer as other than wages. The case law has addressed the issue of whether amounts paid to shareholders of S corporations constitute reasonable compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.[194]

In cases addressing whether payments to an S corporation shareholder were wages for services or were corporate distributions, courts have recharacterized a portion of corporate distributions as wages if the shareholder performing services did not include any amount as wages.[195] In cases involving whether reasonable compensation was paid (not exclusively in the S corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms.[196] The Seventh Circuit, however, has adopted an "independent investor" analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was compensated.[197] The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.[198]

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[194] See the discussion of case law in, *e.g.*, Richard Winchester, *The Gap in the Employment Tax Gap*, 20 Stanford Law and Policy Review 127, 2009; James Parker and Claire Y. Nash, *Anticipate Close Inspection of Closely Held Company Pay Practices - Part I*, 80 Practical Tax Strategies 215, April 2008; *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, at 280.

[195] *David E. Watson, P.C., v. U.S.*, 668 F.3d 1008 (8th Cir. 2012), cert. denied, 133 S. Ct. 364 (2012); *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, *e.g.*, *Joseph M. Grey Public Accountant, P.C., v. U.S.*, 119 T.C. 121 (2002), aff'd, 93 Fed. Appx. 473, 3d Cir., April 7, 2004, and *Nu-Look Design, Inc. v. Commissioner*, 356 F.3d 290 (3d Cir. 2004), cert. denied, 543 U.S. 821 (2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to FICA tax.

[196] See, *e.g.*, *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).

[197] *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

[198] In *Metro Leasing and Dev. Corp. v. Commissioner*, 376 F.3d 1015 (9th Cir. 2004) at 10-11, the Ninth Circuit noted that it is helpful to consider the perspective of an independent investor, and pointed to other Circuits that apply the multi-factor test through the lens of the independent investor test, citing *RAPCO Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996). In determining whether compensation is reasonable, the U.S. Tax Court has applied the multi-factor test viewed through the lens of an independent investor where a case is appealable to a U.S. Court of Appeals which has neither adopted nor rejected the independent investor test. See *Chickie's and*

Partners

In general

A partnership is treated as a passthrough entity for Federal income tax purposes. Each partner includes in income its distributive share of partnership items of income, gain and loss.[199]

A partner's distributive share of partnership items is not treated as wages for FICA tax purposes. Rather, a partner who is an individual is subject to the SECA tax on his or her distributive share of trade or business income of the partnership. The net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as rent, dividends, interest, and capital gains and losses, as described above[200]). This rule applies to individuals who are general partners.

Limited partners

An exclusion from SECA applies in certain circumstances for limited partners of a partnership.[201] Under this rule, in determining a limited partner's net earnings from self-employment, an exclusion is generally provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.[202]

Pete's, Inc. v. Commissioner, T.C. Memo. 2005-243, 90 T.C.M. 399 (2005), at footnote 9; *Miller & Sons Drywall, Inc. v. Commissioner*, T.C. Memo. 2005-114, 89 T.C.M. 1279 (2005).

[199] Secs. 701, 702.

[200] Sec. 1402(a).

[201] Sec. 1402(a)(13).

[202] In *Renkemeyer, Campbell, & Weaver, LLP, v. Commissioner* (136 T. C. 137, 150 (2011)), the Tax Court held that distributive shares of limited partners in a law firm that was an LLP (limited liability partnership under applicable State law) of partnership income "arising from the legal services they performed in their capacity as partners in the law firm are subject to self-employment tax" in the years at issue. See also Amy S. Elliott, "Tax Court Decision Could Reignite Debate Over Partnerships and Employment Taxes," *Tax Notes Today*, March 11, 2011. See also *Howell v. Commissioner* (T.C. Memo. 2012-303, Nov. 1, 2012), in which the Tax Court concluded that a member of a limited liability company (treated as a partnership for tax purposes) who received guaranteed payments had performed services for the partnership and therefore was required to include the payments in net earnings from self-employment. In 1997, the Treasury Department issued proposed regulations defining a limited partner for purposes of the self-employment tax rules. Prop. Treas. Reg. sec. 1.1402(a)-2 (January 13, 1997). These regulations provided, among other things, that an individual is not a limited partner if the individual participates in the partnership business for more than 500 hours during the taxable year. However, in the Taxpayer Relief Act of 1997, the Congress imposed a moratorium on regulations regarding employment taxes of limited partners. The moratorium provided that any regulations relating to the definition of a limited partner for self-employment tax purposes could not be issued or effective before July 1, 1998. No regulations have been issued to date.

The owners of a limited liability company that is classified as a partnership for Federal tax purposes are treated as partners for tax purposes. However, under State law, limited liability company owners are not defined as either general partners or limited partners.[203]

Description of Proposal

In general

The proposal modifies the determination of net earnings from self-employment under the SECA tax by adding the shareholder's pro rata share of income from S corporations, repealing the exception for limited partners, providing a new deduction related to nonlabor income, and providing a new 100-percent deduction for individuals who do not have material participation.

S corporation shareholders

The proposal provides that net earnings from self-employment generally include the income or loss from any trade or business of an S corporation in which the individual is a stockholder. Specifically, the amount included is the individual's pro rata share of nonseparately computed income or loss described in section 1366(a)(2) from any trade or business carried on by an S corporation in which he is a stockholder.

Under the proposal, the same exceptions apply in determining net earnings from self-employment of a stockholder in an S corporation as apply to a partner in a partnership and to an individual carrying on a trade or business. Thus, the same specified types of income or loss are excluded: rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset, or gains or losses from other property that is neither inventory nor held primarily for sale to customers. Consequently, under this rule, an S corporation shareholder is treated in the same manner as a partner in a partnership under the SECA tax.

The proposal does not change the present-law rules applying FICA tax to wages, including wages paid by an S corporation.

Authority is provided to the Treasury Department to provide regulations or other guidance to coordinate for any year to which the proposal applies the application of the cap (which is $117,000 for 2014) on wages of an individual from an S corporation that are subject to the FICA tax with the application of the cap to amounts subject to the SECA tax with respect to that individual's pro rata share of income of that S corporation.

Limited partners

The proposal repeals the present-law exclusion for a limited partner's distributive share of partnership income or loss in determining net earnings from self-employment (including repeal of the exception for partnership guaranteed payments in the nature of remuneration for

[203] The proposal also makes parallel changes to corresponding provisions of the Social Security Act.

services). Thus, under the proposal, limited partners are treated the same as other partners for purposes of determining net earnings from self-employment. Any person who is treated for Federal income tax purposes as a partner in any entity that is treated for Federal income tax purposes as a partnership is treated as a partner in a partnership for purposes of the SECA tax. Thus, for example, a member of an LLC who is treated for Federal income tax purposes as a partner in a partnership is treated as a partner for purposes of the SECA tax. A person treated as a partner under the Federal income tax is so treated for purposes of the SECA tax regardless of whether the person is treated as a partner under applicable State, local, or foreign law.

Nonlabor income deduction

The proposal provides a deduction that reduces net earnings from self-employment by a percentage that is derived from the historical portion of U.S. gross domestic product that represents income other than labor income. The deduction does not depend in any case on the type or nature of any particular item of income or earnings, but rather is calculated under a formula derived by reference to historical nonlabor income.

Under the proposal, an individual's net earnings from self-employment are reduced (but not below zero) by the lesser of (1) 30 percent of the sum of his pass-through net earnings from self-employment and his FICA wages paid by an S corporation in which he is a shareholder, or (2) his pass-through net earnings from self-employment. Thus, in determining the deduction, both the FICA wages paid by an S corporation to an individual shareholder, and the individual shareholder's pro rata share of S corporation income (subject to SECA), are taken into account.

For example, assume an individual performs services for or on behalf of an S corporation that pays him wages, and the individual also wholly owns the S corporation. Further assume that the S corporation's income (before any deduction for wages) is $100 for the year, and the individual has wages from the S corporation of $70 and a pro rata share (as shareholder) of $30. Under the proposal, 30 percent of the sum of the individual's pass-through net earnings from self-employment and his FICA wages is $30, and the individual's pass-through net earnings from self-employment are the same amount, $30. The nonlabor income deduction reduces the individual's net earnings from self-employment by $30 to $0. The individual's FICA tax on the $70 of wages is unaffected. Because both FICA wages and pass-through net earnings from self-employment are subject to payroll tax at the same rate and both are taken into account in determining the nonlabor income deduction, application of the judicially-developed reasonable compensation test is not necessary to determine FICA wages. The nonlabor income deduction is applied after application of the present-law exclusions from net earnings from self-employment for rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

Pass-through net earnings from self-employment is defined as net earnings from self-employment (computed without regard to the proposal) determined without regard to any trade or business carried on by the individual. Thus, for example, if the individual carries on a widget business as a sole proprietor, and also is a partner in a gadget business carried on by the partnership, pass-through net earnings from self-employment is determined with regard only to the gadget business of the partnership, and does not take into account the widget business the individual conducts as a sole proprietor. The Treasury Department is accorded regulatory authority to reallocate items of income, gain, or loss among businesses in which the taxpayer has an interest in any capacity, to carry out the purposes of the proposal.

100-percent deduction for individuals who do not have material participation

The proposal generally provides a 100-percent deduction from net earnings from self-employment for specified amounts in circumstances in which an individual does not have material participation with respect to an entity.

The rule has the effect that an individual's net earnings from self-employment are separated into items from nonparticipation entities, and items that are not from nonparticipation entities. An individual's net earnings from self-employment generally are reduced (but not below zero) by the sum of (1) the reduction determined above under the nonlabor income deduction, but modified to take account only of items from nonparticipation entities at 100 percent, and (2) the reduction determined above under the nonlabor income deduction, but modified to take account only of items that are not from nonparticipation entities at 30 percent.

For this purpose, a nonparticipation entity with respect to any individual is any entity with respect to which the individual does not have material participation.

An individual does not have material participation with respect to a top-tier entity if the individual demonstrates to the satisfaction of the Treasury Department that he or she does not materially participate in any activity carried on by the top-tier entity, and does not materially participate in any activity carried on by any other entity in which the top-tier entity directly or indirectly holds an interest. For this purpose, material participation has the same meaning as under the passive loss rules (sec. 469(h)). The participation of an individual in any activity is treated as including that of the individual's spouse and the lineal descendants of the individual and the individual's spouse.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

3. Repeal of exemption from FICA taxes for certain foreign workers (sec. 1503 of the discussion draft and secs. 3121(b)(1) and (b)(19) and section 3231(e)(1) of the Code)

Present Law

FICA imposes tax on employers and employees based on the amount of wages (as defined for FICA purposes) paid to an employee during the year.[204] The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to

[204] Secs. 3101-3128.

the taxable wage base ($117,000 for 2014); and (2) the Medicare or hospital insurance ("HI") tax equal to 1.45 percent of all covered wages.[205]

Wages as defined for FICA purposes means all remuneration for employment, with certain specified exceptions. Employment as defined for FICA purposes generally means any service, of whatever nature, performed by an employee for an employer within the United States, with certain specified exceptions.[206]

Exceptions from employment apply to service performed by certain categories of employees who are lawfully admitted to the United States on a temporary basis in order to work, specifically, agricultural workers holding H-2A visas and individuals (for example, certain students, researchers, and cultural exchange participants) holding F-1, J-1, M-1, Q-1 or Q-2 visas.[207] Exceptions from employment apply also to certain other types of service, and, in some cases, an employee's service may be eligible for both a FICA exception applicable to certain visa holders and also for another exception.

Instead of FICA taxes, railroad employers and employees are subject, under the Railroad Retirement Tax Act ("RRTA"), to taxes equivalent to the OASDI and HI taxes under FICA with respect to compensation as defined for RRTA purposes ("RRTA compensation").[208] An exception applies for individuals holding F-1, J-1, M-1, Q-1 or Q-2 visas.[209]

Description of Proposal

Under the proposal, the FICA and RRTA exceptions for services performed as employees by agricultural workers holding H-2A visas or individuals holding F-1, J-1, M-1, Q-1 or Q-2 visas are repealed.[210] Thus, FICA taxes apply to wages paid to these employees (and RRTA taxes apply to compensation) unless another exception applies.

[205] Beginning 2013, the employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

[206] The Social Security Act provides exceptions to "wages" and "employment" that parallel the FICA tax exceptions. Therefore, compensation or services that are not subject to FICA tax are also not taken into account in determining Social Security benefits.

[207] Sec. 3121(b)(1) and (b)(16).

[208] Secs. 3201-3233. Under section 3211(a), combined employer and employee rates apply to the RRTA compensation of an employee representative, defined under section 3231(c) generally as an officer or official representative of a railway labor organization. Under sections 3201(b), 3211(b) and 3221(b), RRTA compensation is also subject to an additional tax, referred to as the "Tier 2" tax.

[209] Sec. 3231(e)(1).

[210] The parallel exemptions under the Social Security Act for services performed as employees by agricultural workers holding H-2A visas and individuals holding F-1, J-1, M-1, Q-1 or Q-2 visas are also repealed under the proposal.

Effective Date

The proposal is effective with respect to remuneration received for services performed after December 31, 2014.

4. Repeal of exemption from FICA taxes for certain students (sec. 1504 of the discussion draft and sec. 3121(b)(2) and (b)(10) of the Code)

Present Law

FICA imposes tax on employers and employees based on the amount of wages (as defined for FICA purposes) paid to an employee during the year.[211] The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($117,000 for 2014); and (2) the Medicare or hospital insurance ("HI") tax equal to 1.45 percent of all covered wages.[212]

Wages as defined for FICA purposes means all remuneration for employment, with certain specified exceptions. Employment as defined for FICA purposes generally means any service, of whatever nature, performed by an employee for an employer within the United States, with certain specified exceptions.[213]

An exception from employment for FICA purposes applies in the case of certain services performed by a student in the employ of a school, college, or university.[214] Specifically, FICA does not apply to services performed by a student who is enrolled and regularly attending classes at the school, college, or university. A FICA exception applies also to domestic service performed in a local college club, or local chapter of a college fraternity or sorority, by a student

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[211] Secs. 3101-3128.

[212] Beginning 2013, the employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

[213] The Social Security Act provides exceptions to "wages" and "employment" that parallel the FICA tax exceptions. Therefore, compensation or services that are not subject to FICA tax are also not taken into acconnt in determining Social Security benefits.

[214] Sec. 3121(b)(10) and Treas. Reg. sec. 31.3121(b)(10)-2. The exception also applies to services performed as a student in the employ of an organization that is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of the school, college, or university, if the organization is operated, supervised or controlled by or in connection with such school, college, or university. The Social Security Act provides an exception for students that parallels the FICA exception and that applies for purposes of Social Security and Medicare coverage. Under section 218 of the Social Security Act, a State may enter into a voluntary agreement with the Social Security Administration to provide Social Security and Medicare coverage for groups of State or local government employees who are not mandatorily covered (commonly referred to as a "section 218" agreement). Generally, all the employees in a group must be covered by the agreement, but section 218 permits the exclusion of students who meet the requirements under the parallel student exception under the Social Security Act.

who is enrolled and regularly attending classes at a school, college, or university.[215] Exceptions from employment apply also to certain other types of service, and, in some cases, an employee's service may be eligible for both a FICA exception applicable to students and also for another exception.

Some FICA exceptions are subject to dollar limits. For example, cash remuneration of less than a specified amount ($1,900 for 2014) paid to an employee in a year for domestic service in a private home is exempt from FICA.[216] The FICA rules provide that, in cases in which a FICA exception is subject to a dollar limit, the employer may withhold the employee share of FICA from payments made to the employee even though, at the time of payment, the total amount paid to the employee is less than the limit and, thus, may be exempt from FICA.[217]

Under the Social Security Act, an individual's wages are credited to the individual's earnings record for purposes of determining an individual's eligibility for Social Security benefits and Medicare coverage and for purposes of determining the amount of an individual's Social Security benefits. Eligibility for Social Security benefits and Medicare coverage is based in part on credits (referred to as "quarters of coverage") received for wages. Up to four quarters of coverage can be earned for a year, depending on total wages for the year and the amount needed to earn each quarter of coverage. For 2014, credit for a quarter of coverage is provided for each $1,200 of wages, with a maximum of four quarters of coverage for $4,800 in wages.

Description of Proposal

The proposal amends the FICA exceptions for students by adding a dollar limit. Specifically, a FICA exception applies to a student for a year only if the student's earnings are less than the amount needed to receive a quarter of FICA coverage for the year ($1,200 for 2014).[218] Thus, if a student's earnings exceed the limit, the student's earnings are subject to FICA unless another FICA exception applies. If the limit is exceeded, all of the individual's earnings are subject to FICA, including earnings up to the limit, thus enabling the individual to receive at least one quarter of coverage for the year.

Under the proposal, the rules and procedures relating to the withholding of the employee share of FICA that apply under present law in the case of FICA exceptions that are subject to dollar limits apply also for purposes of the student exception. For example, the employer may

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[215] Sec. 3121(b)(2) and Treas. Reg. sec. 31.3121(b)(2)-1.

[216] Sec. 3121(a)(7)(B).

[217] See sec. 3102(a) and Treas. Reg. sec. 31.3102-1(b). Treas. Reg. sec. 31.6402(a)-2 provides procedures for situations in which FICA taxes are erroneously withheld from an employee's pay. Under these procedures, the employer generally repays the employee for the erroneously withheld amount. In addition, if the employer has paid the erroueously withheld amount to the IRS, the employer may take credit for the amount in determining future taxes that must be paid to the IRS.

[218] The proposal also adds a dollar limit to the parallel exceptions for students under the Social Security Act, which therefore applies also for purposes of excluding students under a section 218 agreemeut.

withhold the employee share of FICA from payments made to the employee even though, at the time of payment, the total amount paid to the employee is less than the limit.

Effective Date

The proposal is effective for remuneration received for services performed after December 31, 2014.

5. Override of Treasury guidance providing that certain employer-provided supplemental unemployment benefits are not subject to employment taxes (sec. 1505 of the discussion draft and sec. 3402(o)(1)(A) and (o)(2)(A) of the Code)

Present Law

Employment taxes

Employment taxes generally consist of taxes on employee wages under the Federal Insurance Contributions Act ("FICA"), the Railroad Retirement Tax Act ("RRTA") and the Federal Unemployment Tax Act ("FUTA"), and required Income Tax Withholding ("ITW") from employee wages.[219] For these purposes, wages is defined broadly to include all remuneration, subject to exceptions specifically provided in the relevant statutory provisions.[220] Remuneration does not fail to be subject to employment taxes merely because it is paid after termination of employment.[221]

Dismissal pay and supplemental unemployment benefits

Income tax withholding is required with respect to dismissal payments, described as any payments made by an employer to an employee on account of dismissal (that is, involuntary separation from the service of the employer), regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments.[222] Dismissal payments are also

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[219] Secs. 3101-3128, 3201-3233, 3301-3311, and 3401-3404, respectively. RRTA taxes apply to employee compensation, as defined under RRTA. However, for purposes of this discussion, the term "wages" includes RRTA compensation.

[220] See, *e.g.*, the next to the last sentence of section 3121(a) providing that an exclusion from wages for income tax withholding purposes is not to be construed to require a similar exclusion from wages for FICA purposes. Similar rules are provided for RRTA purposes (in the last sentence of section 3231(e)(1)) and FUTA purposes (in the last sentence of section 3306(b)).

[221] Treas. Reg. secs. 31.3121(a)-1(i), 31.3306(b)-1(i) and 31.3401(a)-1(a)(5).

[222] Treas. Reg. sec. 31.3401(a)-1(b)(4).

subject to FICA and FUTA.[223] Similarly, lump sum separation and severance allowances paid to laid-off employees in the railway industry are subject to RRTA.[224]

The IRS has established a limited administrative exception to the application of FICA, RRTA, FUTA and income tax withholding in the case of supplemental unemployment benefit ("SUB") pay meeting certain requirements.[225] In order to qualify for the exception, SUB pay benefits must be linked to eligibility for State unemployment compensation and must not be paid in a lump sum.[226]

Income tax withholding is required with respect to the payment of supplemental unemployment compensation benefits.[227] For this purpose, the term supplemental unemployment compensation benefits means amounts paid to an employee, pursuant to a plan to which the employer is a party, because of the employee's involuntary separation from employment (whether or not the separation is temporary), resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, but only to the extent such benefits are includible in the employee's gross income.

Description of Proposal

Under the proposal, various revenue rulings providing employment tax exclusions for supplemental unemployment benefits are null and void, as are any other Treasury or IRS ruling, regulation or other guidance to the extent that such ruling, regulation or guidance provides that any payment made by reason of involuntary termination of employment, including any supplemental unemployment benefit, is not wages for purposes of any Code provision. Thus, the employment tax exclusions established administratively under IRS guidance for SUB pay no

[223] Rev. Rul. 71-408, 1971-2 C.B. 340, which also notes that FICA and FUTA previously contained statutory exceptions for dismissal payments that the employer was not legally required to make, but which were repealed in 1950.

[224] Rev. Rul. 65-251, 1965-2 C.B. 395.

[225] Rev. Rul. 90-72, 1990-2 C.B. 211. However, these payments are subject to income tax withholding under section 3402(o)(1), as discussed herein.

[226] The SUB pay exception was originally established under Rev. Rul. 56-249, 1956-1 C.B. 488, which dealt with benefits payable only to individuals who are unemployed and generally meet the eligibility requirements for State unemployment benefits. Rev. Rul. 56-249 was later amplified and modified by Rev. Rul. 58-128, 1958-1 C.B. 89, Rev. Rul. 60-330, 1960-2 C.C. 46, and Rev. Rul. 77-347, 1977-2 C.B. 362, which applied the exception to benefits that were not tied to the receipt of State unemployment benefits. Rev. Rul. 90-72 states that Rev. Rul. 77-347 is inconsistent with the underlying premises of the exception and revokes Rev. Rul. 77-347.

[227] Sec. 3402(o)(1)(A) and (2)(A). Under section 501(c)(17), a trust forming part of a plan providing supplemental unemployment compensation benefits may be exempt from tax. In *Quality Stores v. United States*, 693 F. 3d 605 (6th Cir. 2012), the court considered the existence of the income tax withholding requirement under section 3402(o) to provide a basis for holding that payments that do not qualify for the IRS administrative exception for SUB pay are nonetheless exempt from FICA. That decision conflicts with an earlier decision in *CSX Corporation v. United States*, 518 F. 2d 1328 (Fed. Cir. 2008) and review of the *Quality Stores* decision is before the Supreme Court. *United States v. Quality Stores*, 82 U.S.L.W. 3177 (Oct. 1, 2013).

longer apply and all supplemental unemployment benefits are subject to FICA, RRTA and FUTA taxes and income tax withholding. The proposal does not override the application of any statutory employment tax exceptions.

The proposal also repeals the present-law provision requiring income tax withholding on supplemental unemployment compensation benefits. These amounts are subject to income tax withholding as wages.

Effective Date

The proposal making various revenue rulings and other rulings, regulations or other guidance null and void is effective for amounts paid after December 31, 2014. Repeal of the present-law provision requiring income tax withholding on supplemental unemployment compensation benefits is effective for amounts paid after December 31, 2013. Repeal of this income tax withholding requirement is not to be construed to create any inference with respect to the exclusion from wages or compensation of any amounts paid before January 1, 2014.

6. Certified professional employer organizations (sec. 1506 of the discussion draft and new secs. 3511 and 7706 of the Code)

Present Law

In general

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the taxes under the Railroad Retirement Tax Act ("RRTA"), the tax under the Federal Unemployment Tax Act ("FUTA"), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").[228]

FICA tax consists of two parts: (1) old age, survivor, and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base for the calendar year ($117,000 for 2014). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.[229]

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[228] Secs. 3101-3128 (FICA), 3201-3241 (RRTA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Sections 3501-3510 provide additional rules.

[229] Beginning 2013, the employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

RRTA taxes consist of tier 1 taxes and tier 2 taxes. Tier 1 taxes parallel the OASDI and HI taxes applicable to employers and employees. Tier 2 taxes consist of employer and employee taxes on railroad compensation up to the tier 2 wage base for the calendar year.

Under FUTA, employers must pay a tax of 6 percent of wages up to the FUTA wage base of $7,000. An employer may take a credit against its FUTA tax liability for its contributions to a State unemployment fund and, in certain cases, an additional credit for contributions that would have been required if the employer had been subject to a higher contribution rate under State law. For purposes of the credit, contributions means payments required by State law to be made by an employer into an unemployment fund, to the extent the payments are made by the employer without being deducted or deductible from employees' remuneration.

Employers are required to withhold income taxes from wages paid to employees. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

Wages paid to employees, and FICA, RRTA, and income taxes withheld from the wages, are required to be reported on employment tax returns and on Forms W-2.[230]

Employment taxes generally apply to all remuneration paid by an employer to an employee. However, various exclusions apply to certain types of remuneration or certain types of services, which may depend on the type of employer for whom an employee performs services.[231] For example, remuneration (subject to a dollar limit) paid to an employee by a tax-exempt organization is excluded from wages for FICA purposes, and services performed in the employ of certain tax-exempt organizations are excluded from employment for FUTA purposes.[232] In addition, various definitions and special rules apply to certain types of employers.[233]

As discussed above, certain employment taxes apply only on amounts up to a specified wage base. If an employee works for multiple employers during a year, separate wage bases generally apply to each employer. However, a single OASDI, RRTA tier 1 or tier 2, or FUTA wage base applies in certain cases in which an employer (a "successor" employer) takes over the business of another employer (the "predecessor" employer) and employs the employees of the predecessor employer.

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[230] Secs. 6011 and 6051.

[231] See, *e.g.*, secs. 3121(a) and (b), 3231(e), 3306(b) and (c), and 3401(a).

[232] Secs. 3121(a)(16) and 3306(c)(8).

[233] See, *e.g.*, secs. 3121, 3122, 3125, 3126, 3127, 3231, 3306, 3308, 3309, 3401(a), 3404, 3506, and 3510.

Responsibility for employment tax compliance

Employment tax responsibility generally rests with the person who is the employer of an employee under a common-law test that has been incorporated into Treasury regulations.[234] Under the regulations, an employer-employee relationship generally exists if the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer, not only as to what is to be done, but also as to how it is to be done. It is not necessary that the employer actually control the manner in which the services are performed, rather it is sufficient that the employer have a right to control. Whether the requisite control exists is determined on the basis of all the relevant facts and circumstances. The test of whether an employer-employee relationship exists often arises in determining whether a worker is an employee or an independent contractor. However, the same test applies in determining whether a worker is an employee of one person or another.

In some cases, a person other than the common-law employer (a "third party") may be liable for employment taxes. For example, if wages are paid to an employee by a third party and the third party, rather than the employer, has control of the payment of the wages, the third party is the statutory employer responsible for complying with applicable employment tax requirements.[235] In addition, an employer may designate a reporting agent to be responsible for FICA tax and income tax withholding compliance,[236] including filing employment tax returns and issuing Forms W-2 to employees.[237] In that case, the reporting agent and the employer are jointly and severally liable for compliance.[238]

[234] Treas. Reg. secs. 31.3121(d)-1(c)(1), 31.3306(i)-1(a), and 31.3401(c)-1.

[235] Sec. 3401(d)(1) (for purposes of income tax withholding, if the employer does not have control of the payment of wages, the person having control of the payment of such wages is treated as the employer); *Otte v. United States*, 419 U.S. 43 (1974) (the person who has the control of the payment of wages is treated as the employer for purposes of withholding the employee's share of FICA from wages); *In re Armadillo Corporation*, 561 F.2d 1382 (10th Cir. 1977), and *In re The Laub Baking Company v. United States*, 642 F.2d 196 (6th Cir. 1981) (the person who has control of the payment of wages is the employer for purposes of the employer's share of FICA and FUTA). The mere fact that wages are paid by a person other than the employer does not necessarily mean that the payor has control of the payment of the wages. Rather, control depends on the facts and circumstances. See, *e.g.*, *Consolidated Flooring Services v. United States*, 38 Fed. Cl. 450 (1997), and *Winstead v. United States*, 109 F. 2d 989 (4th Cir. 1997).

[236] The designated reporting agent rules generally do not apply for purposes of FUTA compliance.

[237] Sec. 3504. Form 2678 is used to designate a reporting agent.

[238] For administrative convenience, an employer may also use a payroll service to handle payroll and employment tax filings on its behalf, but the employer, not the payroll service, continues to be responsible for employment tax compliance.

Professional employer organizations

A professional employer organization (sometimes called an employee leasing company) is a term used for a firm that provides employees to perform services in the businesses of the professional employer organization's customers, generally small and medium-sized businesses. In many cases, before the professional employer organization arrangement is entered into, the employees already work in the customer's business as employees of the customer. The terms of a typical professional employer organization arrangement provide that the professional employer organization is the employer of the employees and is responsible for paying the employees and for the related employment tax compliance. The customer typically pays the professional employer organization a fee based on payroll costs plus an additional amount.[239]

In some cases, the employees provided to work in the customer's business are legally the employees of the customer, and the customer is legally responsible for employment tax compliance. Nonetheless, customers generally rely on the professional employer organization for employment tax compliance (without designating the professional employer organization as a reporting agent) and treat the employees as employees of the professional employer organization.

Reporting by large food and beverage establishments

Certain reporting requirements relating to tips apply to large food or beverage establishments.[240] In the case of such an establishment, an employer is generally required to report the following information to the IRS each calendar year: (1) the gross receipts of the establishment from the provision of food and beverages (other than certain receipts); (2) the aggregate amount of charge receipts (other than certain receipts); (3) the aggregate amount of charged tips on the charge receipts; (4) the sum of the aggregate amount of tips reported to the employer by employees and certain amounts required to be reported by the employer on employees' Form W-2s; and (5) with respect to each employee, the amount of tips allocated to the employee based on the receipts of the establishment. The employer must also provide employees with written statements showing certain information each calendar year, including the amount of tips allocated to the employee for the year.

User fees

User fees apply to requests to the IRS for ruling letters, opinion letters, determination letters, and similar requests.[241] The user fees that apply are determined by the IRS and are generally required to be determined after taking into account the average time and difficulty involved in a request.

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[239] A professional employer organization may also provide employees with employee benefit coverage, such as nnder a pension plan or a health plan, even if the customer does not maintain such a plan. In such a case, the fee paid by the customer also covers employee benefit costs.

[240] Sec. 6053(c).

[241] Sec. 7528.

Description of Proposal

Treatment of certified professional employer organization as employer for employment tax purposes

Under the proposal, if certain requirements are met, for purposes of employment taxes and other obligations under the employment tax rules, a certified professional employer organization is treated as the employer of any work site employee performing services for any customer of the certified professional employer organization, but only with respect to remuneration remitted to the work site employee by the certified professional employer organization. In addition, no other person is treated as the employer for employment tax purposes with respect to remuneration remitted by the certified professional employer organization to a work site employee.

Under the proposal, exceptions, exclusions, definitions, and other rules that are based on the type of employer and that would apply if the certified professional employer organization were not treated as the employer under the proposal continue to apply. Thus, for example, if services performed in the employ of a customer that is a tax-exempt organization would be excluded from employment for FUTA purposes, the fact that a certified professional employer organization is treated as the employer for employment tax purposes does not affect the application of the exclusion.

The proposal provides rules under which, on entering into a service contract with a customer with respect to a work site employee, a certified professional employer organization is treated as a successor employer and the customer is treated as the predecessor employer. Similarly, on termination of a service contract with respect to a worksite employee, the customer is treated as a successor employer and the certified professional employer organization is treated as a predecessor employer. Thus, wages paid by the customer and the certified professional employer organization to a work site employee during a calendar year are subject to a single OASDI, RRTA tier 1 or tier 2, or FUTA wage base.

The proposal does not apply in the case of a customer who is related to the certified professional employer organization.[242] In addition, an individual with net earnings from self-employment derived from a customer's trade or business (i.e., a self-employed individual), including a customer who is a sole proprietor or a partner of a customer that is a partnership, is not a work site employee for employment tax purposes with respect to remuneration paid by a certified professional employer organization.

As discussed more fully below, a work site employee is an individual who performs services (1) for a customer pursuant to a contract between the customer and the certified professional employer organization that meets certain requirements and (2) at a work site that

[242] Whether a customer and a certified professional employer organization are related is determined under the rules of section 267(b) (relating to transactions between related taxpayers) or 707(b) (relating to transactions between a partner and partnership). However, rules based on more than 50 percent ownership are applied by substituting 10 percent for 50 percent.

meets certain requirements. Thus, if the contract or work site fails to meet these requirements, the individual is not a work site employee. The proposal applies also in the case of an individual (other than a self-employed individual) who is not a work site employee, but who performs services under a contract that meets the specified requirements. In this case, solely for purposes of a certified professional employer organization's liability for employment taxes and other obligations under the employment tax rules, a certified professional employer organization is treated as the employer of such an individual, but only with respect to remuneration remitted to the individual by the certified professional employer organization. With respect to such an individual, exceptions, exclusions, definitions, and other rules that are based on the type of employer and that would apply if the certified professional employer organization were not treated as the employer under the proposal continue to apply.

A certified professional employer organization is eligible for the FUTA credit with respect to contributions made to a State unemployment fund with respect to a work site employee by the certified professional employer organization or a customer. An additional FUTA credit may be claimed by a certified professional employer organization if, under State law, a certified professional employer organization is permitted to collect and remit contributions with respect to a work site employee to the State unemployment fund.

Except to the extent necessary for purposes of the proposal treating a certified professional employer organization as the employer for employment tax purposes, nothing in the proposal is to be construed to affect the determination of who is an employee or employer for purposes of the Code.

Certified professional employer organization

A certified professional employer organization is a person who has been certified by the Secretary of the Treasury ("Secretary"), for purposes of being treated as the employer for employment tax purposes under the proposal, as meeting certain requirements. These requirements are met if the person:

- demonstrates that the person (and any owner, officer, and such other persons as may be specified in regulations) meets requirements established by the Secretary with respect to tax status, background, experience, business location, and annual financial audits;
- agrees to satisfy the bond and independent financial review requirements (described below) on an ongoing basis;
- agrees to satisfy any reporting obligations imposed by the Secretary;
- computes its taxable income using an accrual method of accounting unless the Secretary approves another method;
- agrees to verify on such periodic basis as prescribed by the Secretary that it continues to meet the requirements for certification; and
- agrees to notify the Secretary in writing within such time as prescribed by the Secretary of any change that materially affects the continuing accuracy of any agreement or information that was previously made or provided.

Under the bond requirement, a certified professional employer organization must post a bond for the payment of employment taxes in a minimum amount and in a form acceptable to the Secretary. The minimum amount is determined for the period April 1 of any calendar year through March 31 of the following calendar year and is the greater of (1) five percent of the employment taxes for which the certified professional employer organization is liable under the proposal during the preceding calendar year (but not to exceed $1,000,000), or (2) $50,000. However, during the first three full calendar years that a professional employer organization is in existence, the amount described in (1) of the preceding sentence does not apply. For this purpose, under rules provided by the Secretary, an organization is treated as in existence as of the date that it begins providing services to any client that are comparable to the services being provided with respect to work site employees, regardless of whether such date occurred before or after the organization is certified by the IRS. If a certified professional employer organization has employment tax liability of more than $5,000,000 for a calendar year, the exception no longer applies as of April 1 of the following year.

Under the independent financial review requirements, a certified professional employer organization must: (1) have, as of the most recent audit date (that is, six months after the completion of the certified professional employer organization's fiscal year), caused to be prepared and provided to the Secretary an opinion of an independent certified public accountant as to whether the certified professional employer organization's financial statements are presented fairly in accordance with generally accepted accounting principles; and (2) provide to the Secretary, not later than the last day of the second month beginning after the end of each calendar quarter, from an independent certified public accountant an assertion regarding Federal employment tax payments and an examination level attestation on the assertion. The assertion must state that the certified professional employer organization has withheld and made deposits of all required FICA, RRTA, and withheld income taxes for the calendar quarter, and the attestation must state that the assertion is fairly stated in all material respects. If a certified professional employer organization fails to file the required assertion and attestation with respect to any calendar quarter, the independent financial review requirements are treated as not satisfied for the period beginning on the due date for the attestation.

For purposes of the bond and independent financial review requirements, all professional employer organizations that are members of a controlled group of corporations or under common control are treated as a single organization.[243] The Secretary may suspend or revoke the certification of a person's certified professional employer organization status if the Secretary determines that the person does not satisfy the representations or other requirements for certification or fails to satisfy the applicable accounting, reporting, payment, or deposit requirements.

Work site employee

A work site employee is an individual who: (1) performs services for a customer of a certified professional employer organization pursuant to a contract between the customer and the

[243] Whether entities are members of a controlled group of corporations or under common control is determined under the rules of section 414(b) and (c).

certified professional employer organization that meets certain requirements (described below); and (2) performs services at a work site meeting certain requirements (described below).[244]

The contract between the customer and the certified professional employer organization must be in writing and, with respect to an individual performing services for the customer, must provide that the certified professional employer organization will:

- assume responsibility for payment of wages to the individual, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for reporting, withholding, and paying any employment taxes with respect to the individual's wages, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for any employee benefits that the contract may require the certified professional employer organization to provide, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for recruiting, hiring and firing workers in addition to the customer's responsibility for recruiting, hiring and firing workers;
- maintain employee records relating to the individual; and
- agree to be treated as a certified professional employer organization for employment tax purposes with respect to such individual.

For purposes of whether an individual is a work site employee, the work site where the individual performs services meets the applicable requirements if at least 85 percent of the individuals performing services for the customer at the work site are subject to one or more contracts with the certified professional employer organization that meet the above requirements.[245]

Regulations

The Secretary is directed to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal. The Secretary is also directed to develop reporting and recordkeeping rules, regulations, and procedures to ensure compliance with the proposal with respect to entities applying for and receiving certification as certified professional employer organizations. These are to be designed in a manner to streamline, to the extent possible, the application of the requirements of the proposal, the exchange of information between a certified professional employer organization and its customers, and the reporting and recordkeeping obligations of a certified professional employer organization.

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[244] As discussed above, a self-employed individual is not a work site employee.

[245] For this purpose, excluded employees under section 414(q)(5), such as employees who are under age 21 or have not completed six months of service, are not taken into account.

Other rules

Reporting by large food and beverage establishments

Under the proposal, if a certified professional employer organization is treated for employment tax purposes as the employer of a work site employee, the customer for whom the work site employee performs services is the employer for purposes of the reporting required with respect to a large food or beverage establishment. The certified professional employer organization is required to furnish the customer with any information necessary to complete the required reporting.

User fees

Under the proposal, the user fee charged under the program for certifying a professional employer organization is an annual fee and may not exceed $1,000.

No inference as to effect of proposal

Nothing contained in the proposal or the amendments made by the proposal is to be construed to create any inference with respect to the determination of who is an employee or employer (1) for Federal tax purposes (other than the purposes set forth in the proposal), or (2) for purposes of any other provision of law.

Effective Date

The proposal is effective with respect to wages paid for services performed on or after January 1 of the first calendar year beginning more than 12 months after the date of enactment of the proposal. The Secretary is directed to establish the certification program for professional employer organizations not later than six months before the proposal becomes effective.

G. Pensions and Retirement

1. Changes to rules for individual retirement arrangements (secs. 1601 through 1604 of the discussion draft and secs. 219, 408, and 408A of the Code)

Present Law

Individual retirement arrangements

There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[246] to which both deductible and nondeductible contributions may be made,[247] and Roth IRAs, to which only nondeductible contributions may be made.[248] The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income to the extent attributable to earnings on the account and the deductible contributions. For a Roth IRA, all contributions are after-tax (that is, no deduction is allowed), but qualified distributions are not includible in gross income.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is the lesser of a certain dollar amount ($5,500 for 2014) or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. The dollar limit is increased to reflect increases in the cost-of living using calendar year 2007 as the base year. The index used is the consumer price index for all-urban consumers published by the Department of Labor (CPI-U). However, if the amount of any increase is not a multiple of $500, the increase is rounded down to the nearest multiple of $500.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions up to $1,000 to an IRA. The IRA catch-up contribution limit is not indexed.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit (reduced by any contributions to Roth IRAs) if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income ("AGI")

[246] Sec. 408.

[247] Sec. 219.

[248] Sec. 408A.

for the taxable year over certain indexed levels.[249] To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible contributions to a traditional IRA (that is, no AGI limits apply), subject to the same contribution limits as the limits on deductible contributions, including catch-up contributions. An individual who has attained age 70½ prior to the close of a year is not permitted to make contributions to a traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent that the withdrawal is a return of the individual's basis.[250] All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels. The AGI phase-out ranges for 2014 for Roth IRA contributions are: (1) for single taxpayers, $114,000 to $129,000; (2) for married taxpayers filing joint returns, $181,000 to $191,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70½.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.[251]

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of contributions to the Roth IRA are not includible in income. All Roth IRAs are treated as a single contract for purposes of determining the amount that is a return of contributions.

Separation of traditional and Roth IRA accounts

Contributions to traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

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[249] Sec. 219(g). Certain modifications apply in determining AGI for this purpose and determining eligibility to make Roth IRA contributions.

[250] Basis results from after-tax contributions to traditional IRAs or a rollovers to traditional IRAs of after-tax amounts from another eligible retirement plan.

[251] Sec. 408A(d)(2).

Taxpayers generally may convert an amount in a traditional IRA into a Roth IRA.[252] The amount converted is includible in the taxpayer's income as if a withdrawal had been made, except that the 10-percent early distribution tax does not apply.[253] The conversion is accomplished by a trustee-to-trustee transfer of the amount from the traditional IRA to the Roth IRA, or by a distribution from the traditional IRA and contribution to the Roth IRA within 60 days.

Rollovers to IRAs of distributions from tax-favored employer-sponsored plans (qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans) are also permitted. For tax-free rollovers, distributions from pretax accounts under an employer-sponsored plan must be contributed to a traditional IRA and distributions from a designated Roth account are only permitted to be contributed to a Roth IRA. A distribution from an employer-sponsored plan that is not from a designated Roth account is also permitted to be rolled over into a Roth IRA, subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, a rollover from an eligible employer plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply.[254]

Recharacterization

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize (by a trustee-to-trustee transfer to the other type of IRA) the amount of that contribution as a contribution to the other type of IRA (traditional or Roth) before the due date for the individual's income tax return for that year.[255] In the case of a recharacterization, the contribution will be treated as having been made to the transferee plan (and not the transferor plan) as of the date of the original contribution. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA. The amount transferred must be accompanied by any net income allocable to the contribution and no deduction is allowed with respect to the contribution to the transferor plan. Even if a recharacterization is accomplished by transferring a specific asset, net income is calculated as a prorata portion of income on the entire account rather than income allocable to the specific asset transferred. However, when doing a Roth conversion of an amount for a year, an individual may divide up the amount being converted and establish multiple Roth IRAs (for example, Roth IRAs with different investment strategies) and select which Roth IRA

[252] Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA.

[253] The early distribution tax is imposed if the taxpayer withdraws the amount within five years of the conversion.

[254] Sec. 408A(d)(3) and Notice 2008-30, 2008-12 I.R.B. 638. As in the case of a Roth IRA conversion of an amount from a traditional IRA, the special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from the Roth IRA within a specified five-year period after the rollover.

[255] Sec. 408A(d)(6).

to recharacterize as a traditional IRA by transferring the entire amount in the account to a traditional IRA (for example, the entire amount in the account of any IRA for which the value of the assets in the account declines during the year).[256] The individual may then later convert that traditional IRA to Roth IRA, including the lower value in income. Treasury regulations prevent the conversion from taking place immediately after the recharcterization. The regulations require a minimum period to elapse before a reconversion after a recharacterization (meaning a conversion of an amount previously contributed to a Roth IRA in a Roth conversion and then recharacterized as a contribution to a traditional IRA).[257] Generally the reconversion cannot occur sooner than the later of 30 days after the recharacterization or a date during the taxable year following the taxable year of the original conversion.

Simple IRA plans and simplified employee pensions

Simple IRA plans and simplified employee pensions are special types of employer-sponsored retirement plans under which the employer makes contributions to IRAs established for each of its employees in accordance with the Code requirements for each type of plan. Only contributions to traditional IRAs are allowed for these plans.

Rollover contributions from employer sponsored retirement plans

Distributions from tax-favored employer-sponsored plans are permitted to be rolled over tax-free to a traditional IRA or another tax-favored employer-sponsored plan.

Description of Proposal

Under the proposal, the rules for IRAs are changed as described below.

Elimination of income limits on contributions to Roth IRAs

The AGI limits on making contributions to a Roth IRA are eliminated. Thus contributions are permitted to be made to a Roth IRA by a taxpayer for a year regardless of the taxpayer's AGI.

No deductible or nondeductible contributions to traditional IRAs

No deductible or nondeductible contributions are allowed to be made to traditional IRAs. Only rollover contributions of distributions from other traditional IRAs or tax-favored retirement plans and contributions under a SIMPLE IRA plan or a simplified employee pension plan are allowed to be made to a traditional IRA. Nondeductible contributions continue to be allowed to be made to Roth IRAs.

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[256] A-2 of Treas. Reg. sec. 1.408A-5.

[257] Treas. Reg. sec. 1.408A-5.

Suspension of inflation adjustment of dollar limit on contributions to Roth IRAs

The proposal suspends cost-of-living adjustments to the dollar limit on contributions to Roth IRAs through 2023. Thus, the 2014 annual limit on contributions to a Roth IRA remains at $5,500 through 2023. Cost-of living adjustments resume beginning with 2024 using calendar year 2022 as the base year, rounding down to the nearest multiple of $500 (as under present law). As under present law, Roth IRA catch-up contributions are not indexed, and thus remain at $1,000 per year even after 2023.

Repeal of special rule permitting recharacterization of IRA contributions

Under the proposal, the special rule that allows IRA contributions to one type of IRA (either traditional or Roth) to be recharacterized as a contribution to the other type of IRA is repealed. Thus, for example, under the proposal, a conversion contribution establishing a Roth IRA during a taxable year can no longer be recharacterized as a contribution to a traditional IRA (thereby unwinding the conversion) because the investment experience of the Roth IRA after the conversion resulted in net losses, rather than net gains, and the individual wanted to be able convert that amount at the lower value, including in income only that lower value.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

2. Repeal of exception to 10-percent penalty for first-time home purchases and elimination of first-time home purchase as a qualified distribution from a Roth IRA (sec. 1605 of the discussion draft and secs. 72(t) and 408A of the Code)

Present Law

Early distribution tax

The Code imposes an early distribution tax on distributions made from qualified retirement plans, 403(b) plans, and IRAs before an employee (or an IRA owner) attains age 59½ unless an exception applies.[258] The tax is equal to 10 percent of the amount of the distribution that is includible in gross income.[259] One of the exceptions is for qualified first-time homebuyer distributions which are distributions from IRAs used for first-time homebuyer expenses that meet certain requirements and are limited to $10,000.[260]

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[258] Sec. 72(t).

[259] The 10-percent tax is in addition to the taxes that would otherwise be due on distribution.

[260] Qualified first time homebuyer distribution is defined in section 72(t)(8).

Qualified distributions from Roth IRAs

There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[261] to which both deductible and nondeductible contributions may be made,[262] and Roth IRAs, to which only nondeductible contributions may be made.[263] The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income to the extent attributable to earnings on the account and the deductible contributions. For a Roth IRA, all contributions are after-tax (that is, no deduction is allowed) but, qualified distributions from the Roth IRA are not includible in gross income.

A qualified distribution from a Roth IRA is a distribution that (1) is made after the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability of the IRA owner, or is a qualified first-time home buyer distribution.[264] Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of contributions to the Roth IRA are not includible in income.

Description of Proposal

The proposal repeals the exception from the 10 percent early distribution tax for qualified first-time homebuyer distributions from IRAs. The proposal also eliminates qualified first-time home buyer distributions as a basis for a distribution from a Roth IRA being a qualified distribution (and thus not includible in gross income).

Effective Date

The proposal is effective for distributions after December 31, 2014.

3. Termination of new simplified employee pensions (sec. 1611 of the discussion draft and sec. 408(k) of the Code)

Present Law

A simplified employee pension ("SEP") is a type of tax-favored employer-sponsored retirement plan under which an employer may make contributions to a SEP IRA for each eligible employee up to the lesser of 25 percent of the employee's compensation or the dollar limit

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[261] Sec. 408.

[262] Sec. 219.

[263] Sec. 408A.

[264] Sec. 408A(d)(2).

applicable to contributions to a qualified defined contribution plan ($52,000 for 2014).[265] All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee has (1) attained age 21, (2) performed services for the employer during at least three of the immediately preceding five years, and (3) received at least $550 (for 2014) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP ("SARSEP") under which employees could make elective deferrals. However, contributions may continue to be made to SARSEPs that were established before 1997. Elective deferrals under a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan ($17,500 for 2014). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a SARSEP up to a limit of $5,500 (for 2014).

Description of Proposal

Under the proposal, a new SEP plan is not permitted to be established by an employer after December 31, 2014. However, contributions are permitted to continue to any SEP plan of an employer maintaining a SEP plan for its employees as of December 31, 2014 if such SEP plan and the terms thereof satisfy the requirements for SEPs on and after December 31, 2014. Thus, under the SEP plan of the employer, contributions may be made to a SEP IRA of an employee of the employer even if the employee did not participate in the plan on that date and the SEP IRA for the employee is established after that date.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

4. Termination for new SIMPLE 401(k) plans (sec. 1612 of the discussion draft and sec. 401(k)(11) of the Code)

Present Law

A small employer that employs no more than 100 employees who earned $5,000 or more during the prior calendar year can establish a simplified tax-favored retirement plan, which is called a simple retirement plan. There are two types of simple retirement plans, one that is a form of section 401(k) plan ("SIMPLE 401(k) plan") and the other is a plan under which contributions are made to an individual retirement arrangement for each employee (a "SIMPLE IRA plan"). A simple retirement plan allows employees to make elective deferrals, subject to a limit of $12,000 (for 2014). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a simple retirement plan up to a limit of $2,500 (for 2014). A SIMPLE 401(k) plan is deemed to satisfy the nondiscrimination tests that otherwise apply to elective deferrals and matching contributions.

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[265] Sec. 408(k).

Employer contributions to a simple retirement plan generally must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective deferrals on a dollar-for-dollar basis up to three percent of the employee's compensation. Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a nonelective contribution of two percent of compensation on behalf of each eligible employee whether or not the employee makes elective deferrals. No contributions other than employee elective deferrals, required employer matching contributions, or employer nonelective contributions can be made to a simple retirement plan.

Description of Proposal

Under the proposal, a new SIMPLE 401(k) plan is not permitted to be established by an employer for plan years beginning after December 31, 2014. However, contributions are permitted to continue to any SIMPLE 401(k) plan in existence for the last plan year beginning before January 1, 2015, but only if the arrangement meets the requirements for being a SIMPLE 401(k) plan for such plan year and each plan year thereafter.

Effective Date

The proposal applies to plan years beginning after December 31, 2014.

5. Rules related to designated Roth contributions (sec. 1613 of the discussion draft and secs. 401(a)(30), 402(g), 402A, and 408(p) of the Code)

Present Law

Section 401(k) plans, section 403(b) plans, and governmental section 457(b) plans

In general

A qualified retirement plan that is a profit-sharing plan or stock bonus plan (and certain money purchase pension plans) may allow an employee to make an election between cash and an employer contribution to the plan pursuant to a qualified cash or deferred arrangement.[266] A plan with this feature is generally referred to as a section 401(k) plan. A section 403(b) plan may allow a similar salary reduction agreement under which an employee may make an election between cash and an employer contribution to the plan.[267]

Amounts contributed pursuant to these qualified cash or deferred arrangements and salary reduction agreements generally are referred to as elective deferrals. The elective deferrals generally are excludable from gross income (pretax elective deferrals) and only taxed along with attributable earnings upon distribution from the plan. Alternatively the plan may include a

[266] Sec. 401(k).

[267] Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations, and (2) educational institutions of State or local governments (including public schools). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans.

qualified Roth contribution program under which eligible employees are offered a choice of either making pretax elective deferrals or making elective deferrals that are not excluded from income and are designated as Roth contributions.[268] However, the plan is not permitted to only allow employees to make designated Roth contributions; pretax elective deferrals must also be permitted.[269] If certain requirements are satisfied, distributions of designated Roth contributions and attributable earnings are excluded from gross income. The employer may also make nonelective and matching contributions for employees under a section 401(k) or 403(b) plan. These are not permitted to be designated as Roth contributions and generally are pretax contributions.

A dollar limit applies to the aggregate amount of elective deferrals (both pretax elective deferrals and designated Roth contributions) that an employee is permitted to contribute to section 401(k) and section 403(b) plans for a taxable year, which is $17,500 for 2014.[270] An employee age 50 or over is allowed to contribute an additional catch up amount of $5,500 for 2014.[271]

If an individual's total elective deferrals for a taxable year under section 401(k) plans and section 403(b) plans exceed the $17,500 limit plus, if applicable, the catch-up contributions limit, and the plan distributes the excess (plus allocable income) by April 15 following the taxable year, the excess amount is includable in the individual's gross income.[272] If the excess is not distributed by April 15, the excess is includable in gross income but the individual receives no basis in the account for the amount included in gross income. Thus, that amount will be taxed again when distributed. In the case of an excess in the form of designated Roth contributions that is not distributed by April 15, any distribution attributable to the excess cannot be a qualified distribution, and the individual is not entitled to basis to reflect that the excess amount is an after-tax contribution.

A governmental section 457(b) plan may also provide for elective deferrals. Contributions to a governmental section 457(b) plan are subject to a dollar limit of $17,500 (for 2014) plus an additional $5,500 catch-up contribution limit (for 2014) for participants at least

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[268] Sec. 402A.

[269] Treas. Reg. secs. 1.401(k)-1(f) and 1.403(b)-3(c).

[270] An employee with compensation less than $17,500 may make elective contributions only up to the amount of his or her compensation. Pursuant to section 415(c) and 403(b)(1), total contributions (including elective contributions) for an employee to a section 401(k) plan or 403(b) plan for a plan year for an employee generally cannot exceed $52,000 for 2014 (or the employee's compensation, if less). In some cases additional elective contributions or other contributions may be made under a section 403(b) plan.

[271] The total of an employee's elective contributions, including catch-up contributions, cannot exceed the employee's compensation.

[272] Generally, the employee informs a plan that an excess has occurred and requests that the plan distribute the excess amount.

age 50 (or the participant's compensation, if less).[273] This limit is separate from the limit on elective deferrals to section 401(k) and section 403(b) plans.[274] As in the case of a section 401(k) plan or a section 403(b) plan, the plan may include a qualified Roth contribution program under which employees are given the choice between making pretax elective deferrals and designated Roth contributions.

Designated Roth accounts

All designated Roth contributions made under the plan must be maintained in a separate account (a designated Roth account). A qualified distribution from a designated Roth account is excludable from gross income. A qualified distribution is a distribution that is made after (1) an employee's completion of a specified 5-year period and (2) the employee's attainment of age 59½, death, or disability.

A distribution from a designated Roth account (other than a qualified distribution) is included in the distributee's gross income to the extent allocable to income under the contract and excluded from gross income to the extent allocable to investment in the contract (commonly referred to as basis), taking into account only the designated Roth contributions as basis.

SIMPLE IRA plan

An eligible employer can establish a simplified tax-favored retirement plan, which is called a SIMPLE IRA plan. An eligible employer is an employer which had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year. Compensation for this purpose is wages reported on the employees Form W-2 plus elective pretax deferrals. An employer that maintains a SIMPLE IRA plan for one or more years and then exceeds this limit may remain an eligible employer for 2 years following the year in which the employer last satisfied the limit.

A SIMPLE IRA under a SIMPLE IRA plan is not permitted to be a Roth IRA. Under a SIMPLE IRA plan, contributions are made only to a traditional IRA (not a Roth IRA) for each employee (a "SIMPLE IRA"). A SIMPLE IRA plan allows employees to make pretax elective deferrals to a SIMPLE IRA, subject to a limit of $12,000 (for 2014). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a SIMPLE IRA plan up to a limit of $2,500 (for 2014). The employer is required to make certain specified matching or nonelective contributions to the SIMPLE IRA for each eligible employee. In the case of a SIMPLE IRA plan, the group of eligible employees generally must include any

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[273] Under a special rule, additional catch-up contributions may be made by a participant to a governmental section 457(b) for the last three years before attainment of normal retirement age.

[274] For example, if an employee participates in both a section 403(b) plan and a governmental section 457(b) plan of the same employer, the employee may contribute up to $17,500 (plus $5,500 catch-up contribntions if at least age 50) to the section 403(b) plan and up to $17,000 (plus $5,500 catch-up contribntions if at least age 50) to the section 457(b) plan. This separate application of the elective contribution limit for governmental section 457(b) plans is eliminated by section 1618 of the discussion draft.

employee who has received at least $5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive $5,000 in the current year.[275]

Description of Proposal

Limit on pretax elective deferrals

Except as described below for plans of eligible employers, under the proposal, the combined limit on pretax elective deferrals under section 401(k) plans and 403(b) plans, and pretax deferrals under a governmental section 457(b) plan is reduced to one half the dollar limits on total elective deferrals and catch-up contributions (the aggregate amount of pretax elective deferrals and designated Roth contributions). Thus, the general limit on pretax elective deferrals is $8,750 (one half of $17,500), and the catch-up contribution limit is $2,750 (one half of $5,500). As a result, for an employee over age 50, the general elective contribution limit applicable to the aggregate amount of pretax elective deferrals and designated Roth contributions is $23,000, but the pretax elective deferrals cannot exceed one half that amount or $11,500.

Qualified Roth contribution program

The limit on designated Roth contributions is the full $17,500 limit, plus (if applicable) the full $5,500 catch up contribution limit, reduced by the amount of any pretax elective deferrals. Under the proposal, section 401(k) plans, section 403(b) plans, and governmental section 457(b) plans are permitted to offer only a qualified Roth contribution program with respect to elective deferrals (both with respect to the $17,500 limit and the $5,500 catch-up contribution limit), and are not required to also offer employees the opportunity to make pretax elective deferrals.[276]

Plan maintained by an eligible employer

The rule reducing the limit on pretax elective deferrals to one half the elective deferral limit and, if applicable, the catch-up contribution limit does not apply to a section 401(k) plan, section 403(b) plan, or governmental section 457(b) plan, maintained by an eligible employer. Under the proposal, the only change to the present-law rules applicable to one of these types of plans maintained by an eligible employer is that the plan is permitted to only allow designated Roth contributions (under a qualified Roth contribution program) and is not required to also allow pretax elective deferrals. Otherwise the rules remain unchanged. Thus, the employer may maintain a plan that only allows pretax elective deferrals and the limit remains the maximum limit of $17,500 (plus $5,500 catch up, if applicable). Reporting will be required on the

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[275] An employer is permitted to exclude collectively bargained employees described in section 410(b)(3)(A).

[276] As under present law, employer matching and nonelective contributions under section 401(k) plans and 403(b) plans are made on a pretax basis.

employee's Form W-2 to identify that the elective deferrals are under a plan of an eligible employer.

The definition of an eligible employer for this purpose is the definition of an eligible employer under the SIMPLE IRA plan rules, generally an employer that had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year with a 2-year grace period for an employer with employees that exceed this limit.

SIMPLE IRA plans

The proposal permits a SIMPLE IRA to be a Roth IRA. The proposal also allows a SIMPLE IRA plan to permit employees to choose to make after-tax elective deferrals to Roth IRAs in lieu of elective deferrals to traditional IRAs, subject to the combined limit of $12,000 (plus $2,500 for catch-up contributions, if applicable). However, a SIMPLE IRA plan is also permitted to continue to only allow pretax elective deferrals to traditional IRAs.

The proposal also provides a new option for a SIMPLE IRA plan under which the plan may provide for elective deferrals up to the full limit of $17,500 plus catch-up contributions of $5,500 (applicable to elective deferrals under section 401(k) and 403(b) plans, and governmental section 457(b) plans), but only if the plan allows after-tax elective deferrals to be made to a SIMPLE IRA that is a Roth IRA and does not allow pretax elective deferrals to be made to traditional IRAs in excess of one half the applicable limit, $8,750 plus catch-up contributions, if applicable of $2,750. [277]

Effective Date

The proposal is effective for plan years and taxable years beginning after December 31, 2014. With respect to SIMPLE IRA plans, the proposal is effective for calendar year beginning after December 31, 2014.

6. Modification of required distribution rules for pension plans (sec. 1614 of the discussion draft and sec. 401(a)(9) of the Code)

Present Law

Minimum distribution rules[278] apply to employer sponsored tax-favored retirement plans[279] and individual retirement arrangements ("IRAs"). In general, under these rules,

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[277] As under present law, employer matching and nonelective contributions under a SIMPLE IRA plan (including a SIMPLE IRA plan that takes advantage of this proposal) are made to a traditional IRA.

[278] Sec. 401(a)(9), 403(b)(1), 408(a)(6), 408(b)(3), 457(d)(2).

[279] Tax-favored employer-sponsored retirement plans include qualified retirement plans and annuities under sections 401(a) and 403(a), tax-deferred annuity plans under section 403(b), and governmental eligible deferred compensation plans under section 457(b). Tax-favored retirement plans are of two general types: defined benefit plans, under which benefits are determined under a plan formula and paid from general plan assets, rather than individual accounts; and defined contribution plans, under which benefits are based on a separate account for

distribution of minimum benefits must begin no later than a required beginning date and a minimum amount must be distributed each year.[280] Minimum distribution rules also apply to benefits payable with respect to an employee (or IRA owner) who has died. The regulations provide a methodology for calculating the required minimum distribution from an individual account under a defined contribution plan or from an IRA.[281] In the case of annuity payments under a defined benefit plan or an annuity contract, the regulations provide requirements that the stream of annuity payments must satisfy. Failure to comply with the minimum distribution requirement results in an excise tax imposed on the individual who was required to take the distributions equal to 50 percent of the required minimum amount not distributed for the year. The excise tax may be waived in certain cases. For qualified retirement plans, satisfying the minimum distribution requirement under the plan terms and operation is also a qualification requirement for the trust of the plan to remain tax-exempt.

Required beginning date

For traditional IRAs, the required beginning date is April 1 following the calendar year in which the employee (or IRA owner) attains age 70½. For employer-sponsored tax-favored retirement plans, for an employee other than an employee who is a five-percent owner in the year the employee attains age 70½, the required beginning date is April 1 after the later of the calendar year in which the employee attains age 70½ or retires. For an employee who is a five-percent owner under an employer-sponsored tax-favored retirement plan in the year the employee attains age 70½, the required beginning date is the same as for IRAs even if the employee continues to work past age 70½.

Lifetime rules

While an employee (or IRA owner) is alive, distributions of the individual's interest are required to be made (in accordance with regulations) over the life or life expectancy of the employee (or IRA owner), or over the joint lives or joint life expectancy of the employee (or IRA owner) and a designated beneficiary.[282] For defined contribution plans and IRAs, the required minimum distribution for each year is determined by dividing the account balance as of the end of the prior year by a distribution period which, while the employee (or IRA owner) is alive, is the factor for the employee (or IRA owner's) age from the uniform lifetime table included in the

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each participant, to which are allocated contributions, earnings and losses. Minimum distribution requirements also apply to eligible deferred compensation plans under section 457(b) of tax-exempt employers.

[280] Under section 408A(c)(5), these lifetime requirements do not apply to a Roth IRA.

[281] Reflecting the direction from Congress in section 823 of the Pension Protection Act (Pub. L. No. 109-280), pursuant to Treas. Reg. sec. 1.401(a)(9)-1, A-2(d), a governmental plan within the meaning of section 414(d) or an governmental eligible deferred compensation plan is treated as having complied with the statutory minimum distribution rules if the plan complies with a reasonable and good faith interpretation of those rules.

[282] Sec. 401(a)(9)(A).

Treasury regulations.[283] This table is based on the joint life and last survivor expectancy of the individual and a hypothetical beneficiary 10 years younger. The distribution period for annuity payments under a defined benefit plan or annuity contract (to the extent not limited to the life of the employee (or IRA owner) or the joint lives of the employee (or IRA owner) and a designated beneficiary) is generally subject to the same limitations as apply to individual accounts.

Distributions after death

Payments over a distribution period

The after-death minimum distributions rules vary depending on (1) whether an employee (or IRA owner) dies on or after the required beginning date or before the required beginning date, and (2) whether there is a designated beneficiary for the benefit.[284] Under the regulations, a designated beneficiary is an individual designated as a beneficiary under the plan or IRA.[285] Similar to the lifetime rules, for defined contribution plans and IRAs ("individual accounts"), the required minimum distribution for each year after the death of the employee (or IRA owner) is generally determined by dividing the account balance as of the end of the prior year by a distribution period.

If an employee (or IRA owner) dies on or after the required beginning date, the basic statutory rule is that the remaining interest must be distributed at least as rapidly as under the method of distribution being used before death.[286] Under the regulations, for individual accounts, this rule is also interpreted as requiring the minimum required distribution to be calculated using a distribution period. If there is no designated beneficiary, the distribution period is equal to the remaining years of the employee's (or IRA owner's) life, as of the year of death.[287] If there is a designated beneficiary, the distribution period (if longer) is the

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[283] Treas. Reg. sec. 1.401(a)(9)-5. For an individual with a spouse as designated beneficiary who is more than 10 years younger (and thus the number of years in the couple's joint life and last survivor expectancy is greater than the uniform lifetime table), the joint life expectancy and last survivor expectancy of the couple (calculated using the table in the regulations) is used.

[284] In the case of amounts for which the employee or IRA owner's surviving spouse is the beneficiary, the surviving spouse generally is permitted to do a tax-free rollover of such amounts into an IRA (or account of a tax-favored employer-spousored plan of the spouse's employer) established in the surviving spouse's name as IRA owner or employee. The rules applicable to the rollover account, including the minimum distribution rules, are the same rules that apply to an IRA owner or employee. In the case of an IRA for which the spouse is sole beneficiary, this is can be accomplished by simply renaming the IRA as an IRA held by the spouse as IRA owner rather as a beneficiary.

[285] Treas. Reg. sec. 1.401(a)(9)-4, A-1. The individual need not be named as long as the individual is identifiable under the terms of the plan (or IRA). There are special rules for multiple beneficiaries and for trusts named as beneficiary (where the beneficiaries of the trust are individuals). However, the fact that an interest under a plan or IRA passes to a certain individual under a will or otherwise under State law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan or IRA.

[286] Sec. 401(a)(9)(B)(i).

[287] Treas. Reg. sec. 1.401(a)(9)-5, A-5(a)(2).

beneficiary's life expectancy calculated using the life expectancy table in the regulations, calculated in the year after the year of death.[288]

If an employee (or IRA owner) dies before the required beginning date and any portion of the benefit is payable to a designated beneficiary, the statutory rule is that distributions are generally required to begin within one year of the employee's (or IRA owner's) death (or such later date as prescribed in regulations) and are permitted to be paid (in accordance with regulations) over the life or life expectancy of the designated beneficiary. If the beneficiary of the employee (or IRA owner) is the individual's surviving spouse, distributions are not required to commence until the year in which the employee (or IRA owner) would have attained age 70½. If the surviving spouse dies before the employee (or IRA owner) would have attained age 70½, the after-death rules apply after the death of the spouse as though the spouse were the employee (or IRA owner). Under the regulations, for individual accounts, the required minimum distribution for each year is determined using a distribution period and the period is measured by the designated beneficiary's life expectancy, calculated in the same manner as if the individual died on or after the required beginning date.[289]

In cases where distribution after death is based on life expectancy (either the remaining life expectancy of the employee (or IRA owner) or a designated beneficiary), the distribution period generally is fixed at death and then reduced by one for each year that elapses after the year in which it is calculated. If the designated beneficiary dies during the distribution period, distributions continue to the subsequent beneficiaries over the remaining years in the distribution period.[290]

The distribution period for annuity payments under a defined benefit plan or annuity contract (to the extent not limited to the life of a designated beneficiary) is generally subject to the same limitations as apply to individual accounts.

Five-year rule

If an employee (or IRA owner) dies before the required beginning date and there is no designated beneficiary, then the entire remaining interest of the employee (or IRA owner) must generally be distributed by the end of the fifth year following the individual's death.[291]

[288] Treas. Reg. sec. 1.401(a)(9)-5, A-5(a)(1).

[289] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

[290] If the distribution period is based on the surviving spouse's life expectancy (whether the employee or IRA owner's death is before or after the required beginning date), the spouse's life expectancy generally is recalculated each year while the spouse is alive and then fixed the year after the spouse's death.

[291] There are provisions in the regulations allowing a designated beneficiary to take advantage of the 5-year rule. See Treas. Reg. secs. 1.401(a)(9)-4, A-4, and 1.4974-2, A-7(b).

Defined benefit plans and annuity distribution

The regulations provide rules for the amount of annuity distributions from a defined benefit plan or an annuity purchased from an insurance company paid over life or life expectancy. Annuity distributions are generally required to be nonincreasing with certain exceptions, which include, for example, increases to the extent of certain specified cost of living indexes, a constant percentage increase (for a qualified plan, the constant percentage cannot exceed five-percent per year), certain accelerations of payments, increases to reflect when an annuity is converted to a single life annuity after the death of the beneficiary under a joint and survivor annuity or after termination of the survivor annuity under a QDRO.[292] If distributions are in the form of a joint and survivor annuity and the survivor annuitant both is not the surviving spouse and is younger than the employee (or IRA owner), the survivor annuitant is limited to a percentage of the life annuity benefit for the employee (or IRA owner). The survivor benefit as a percentage of the benefit of the primary annuitant is required to be smaller (but not required to be less than 52 percent) as the difference in the ages of the primary annuitant and the survivor annuitant become greater.

Description of Proposal

Required beginning date

Under the proposal, if an employee becomes a five-percent owner after age 70½ but before retiring and thus before the employee's required beginning date with respect to tax-favored retirement plans of the employee's employer, the required beginning date for that employee becomes April 1 of the year following the year that the employee becomes a five-percent owner.

Other than the modification to the required beginning date for five-percent owners, the proposal makes no changes to the required minimum distribution rules during the lifetime of the employee (or IRA owner). Thus, for example, the proposal is not expected to result in a change to the regulations under section 401(a)(9) for required minimum distributions during the lifetime of the employee (or IRA owner) under which the required minimum distribution for each year is generally determined by dividing the account balance as of the end of the prior year by a distribution period which is the number corresponding to the employee's (or IRA owner's) age for the year from the uniform lifetime table included in the Treasury regulations.

After death rules

General rule

Under the proposal, the five-year rule is the general rule for all distributions after death (regardless of whether the employee (or IRA owner) dies before, on, or after the required beginning date) unless the designated beneficiary is an eligible beneficiary as defined in the proposal.

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292 Treas. Reg. sec. 1.401(a)(9)-6, A-14.

Eligible beneficiaries

For eligible beneficiaries, the exception to the five-year rule (for death before the required beginning date under present law) applies whether or not the employee (or IRA owner) dies before, on, or after the required beginning date. The exception generally allows distributions over life or life expectancy of an eligible beneficiary beginning in the year following the year of death. Eligible beneficiaries includes any beneficiary who, as of the date of death, is the surviving spouse of the employee (or IRA owner), is disabled, is a chronically ill individual, is an individual who is not more than 10 years younger than the employee (or IRA owner), or is a child of the employee (or IRA owner) who has not reached the age 22. In the case of a child who has not reached the age 22, under the exception to the five-year rule, calculation of the minimum required distribution under this exception is only allowed through the year that the child reaches age 22.

However, unlike present law, under the proposal, the five-year rule also applies after the death of an eligible beneficiary or after a child reaches age 22. Thus for example, if a disabled child of an employee (or IRA owner) is an eligible beneficiary of a parent who dies when the child is age 20 and the child dies at age 30, even though 52.1 years remain in the life expectancy of the child calculated for the child's age (21) in the year after the employee's (or IRA owner's) death, the disabled child's remaining beneficiary interest must be distributed by the end of the fifth year following the death of the disabled child. If a child is an eligible beneficiary based on having not reached the age 22 before the employee's (or IRA owner's) death, the five-year rule applies beginning with the earlier of date of the child's death or the date that the child reaches age 22. The child's entire interest must be distributed by the end of the fifth year following that date.

As under present law, if the surviving spouse is the beneficiary, there is a special rule that allows the commencement of distribution to be delayed until end of the year that the employee (or IRA owner) would have been age 70½. If the spouse dies before distributions were required to begin to the spouse, the surviving spouse is treated as the employee (or IRA owner) in determining the required distributions to beneficiaries of the surviving spouse.

Definition of disabled and chronically ill individual

Under the proposal, the definition of disabled in section 72(m)(7) is incorporated by reference. Under this definition, disabled means unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to end in death or to be for long-continued and indefinite duration. Under section 72(m)(7), an individual is not considered to be disabled unless proof of the disability is furnished in such form and manner as the Secretary may require. The substantial gainful activity to which section 72(m)(7) refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability (or prior to retirement if the individual was retired at the time the disability arose).[293]

[293] Treas. Reg. sec. 1.72-17(f). Under the regulations, in determining whether an individual is disabled, primary consideration is given to the nature and severity of the individual's impairment. However, consideration is

Under the proposal, the definition of a chronically ill individual for qualified long-term care insurance under section 7702B(c)(2) is incorporated by reference with a modification. Under this definition, a chronically ill individual is any individual who (1) is unable to perform (without substantial assistance from another individual) at least two activities of daily living for an indefinite period (expected to be lengthy in nature)[294] due to a loss of functional capacity, (2) has a level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the level of disability described above requiring assistance with daily living based on loss of functional capacity, or (3) requires substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment. The activities of daily living for which assistance is needed for purposes of determining loss of functional capacity are eating, toileting, transferring, bathing, dressing, and continence.

Defined benefit plans and annuities

The new general rule under the proposal applies to all after-death distributions under all retirement plans subject to the required minimum distribution requirements, including annuity distributions under defined benefit plans and distributions under qualified annuity contracts distributed by individual accounts. Thus, for example, under the proposal, after the death of an employee (or IRA owner), distribution in the form of the survivor life annuity (including a distribution that began before death as a joint and survivor annuity) is only permitted to an eligible beneficiary.

Plan amendments to comply with the proposal

It is intended that Treasury and IRS will provide sponsors of qualified retirement plans relief from the anti-cut back rules for amendments to eliminate forms of benefit with respect to benefits already accrued to the extent necessary to comply with the proposal[295] and provide all plans a remedial amendment period that provides sufficient time to amend the terms of their plans to reflect this change to the minimum distributions requirements.[296]

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also given to other factors such as the individual's education, training, and work experience. Whether or not an impairment in a particular case constitutes a disability is determined with reference to all the facts in the case.

[294] Section 7702B(c) only requires this period to be at least 90 days.

[295] Section 411(d)(6) prohibits a plan from being amended to eliminate optional forms of benefit with respect to benefits already accrued except to the extent prescribed in regulations. Treas. Reg. sec. 1.411(d)-4(b)(2)(i) authorizes the IRS to provide relief under which a plan is allowed to be amended to eliminate optional forms of benefit to the extent necessary comply with a statutory change. In contrast to defined benefit plans, a defined contribution plan with respect to benefits already accrued may be amended to eliminate optional forms of benefit, provided that, after elimination of the form, a single sum payment is available at the same time or times as the form of benefit being eliminated and the single sum is based on the same or greater portion of the account balance as the form of distribution being eliminated.

[296] Pursuant to section 401(b), the regulation thereunder, and Rev Proc. 2007-44, 2007-2I C.B. 54, in the case of a statutory change in the qualification requirements applicable to a retirement plan, an employer generally has at least until 8½ months after the employer's taxable year (within which the plan year ends for which the

Effective Date

Required beginning date change for five-percent owners

For the proposal changing the definition of required beginning date for employees who become five-percent owners after age 70½, the proposal applies to any employee who becomes five-percent owner with respect to plan years ending in calendar years beginning before, on, or after the date of the enactment. If an employee became a five percent owner with respect to a plan year ending in a calendar year before January 1, 2014, and the employee has not retired before the calendar year 2014, the employee's required beginning date is April 1, 2015. However if under present law, an employee's required beginning date occurred before April 1, 2015 because the employee retired during a year before 2014, the proposal does not cause the employee to have an earlier required beginning date.

Required distributions after death

For determining minimum required distributions after the death of an employee (or IRA owner), the proposal is generally effective for distributions with respect to employees (or IRA owners) who die after December 31, 2014.

In the case of an employee (or IRA owner) who dies before January 1, 2015, if the designated beneficiary of the employee (or IRA owner) dies after December 31, 2014, the proposal applies to any beneficiary of the designated beneficiary as though the designated beneficiary were an eligible beneficiary. Thus, the entire interest must be distributed by the end of the fifth year after the death of the designated beneficiary.

In the case of an employee (or IRA owner) who dies after December 31, 2014, the proposal does not apply to a qualified annuity that is a binding annuity contract in effect on the date of the enactment and at all times thereafter. To be a qualified annuity, the annuity must be a commercial annuity (as defined in section 3405(e)(6)) or an annuity payable by a defined benefit plan, and (2) an annuity under which the annuity payments are substantially equal periodic payments (not less frequently than annually) over the lives of such employee (or IRA owner) and a designated beneficiary (or over a period not extending beyond the life expectancy of such employee (or IRA owner) or the life expectancy of such employee (or IRA owner) and a designated beneficiary) in accordance with the required minimum distribution regulations for annuity payments (as in effect before enactment of this proposal). In addition to these requirements, to be a qualified annuity, annuity payments to the employee (or IRA owner) must begin before January 1, 2015 and the employee (or IRA owner) must have made an irrevocable election before that date as to the method and amount of the annuity payments to the employee

statutory change is first effective) to amend the plan to comply with the statutory change. The amendment must be retroactively effective to the date that the change first applies to the plan and the plan must comply operationally with the change in law and with the plan as amended during the period that the amendment is retroactively effective. The regulations also provide that the IRS can extent this time period for amending the plan, and Rev. Proc 2007-44 provides an additional period to make corrections to the initial plan amendment. Also see Rev. Roc. 2009-36, 2009-2 C.B. 309 for a special rule for governmental plans.

or any designated beneficiaries. Alternatively, if an annuity is not a qualified annuity solely based on annuity payments not having begun irrevocably before January 1, 2015, an annuity can be a qualified annuity if the employee (or IRA owner) has made an irrevocable election before the date of enactment as to the method and amount of the annuity payments to the employee (or IRA owner) or any designated beneficiaries.

7. Reduction in age for allowable in-service distributions (sec. 1615 of the discussion draft and secs. 401(a)(36) and sec. 457(d)(1) of the Code)

Present Law

Overview

There are three basic types of funded tax-favored employer-sponsored defined contribution plans: qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans. These tax-favored employer-sponsored retirement plans are accorded special tax treatment under present law. Most contributions, earnings on contributions, and benefits are not included in gross income until amounts are distributed, even if the arrangement is funded and benefits are vested. Additionally, many distributions can be rolled over to another plan for further deferral of income inclusion. Defined contribution plans may provide for nonelective contributions and matching contributions by employers and elective deferrals or after-tax contributions by employees. Elective deferrals are contributions made pursuant to an election by an employee between cash compensation and a contribution to the plan.

Elective deferrals under a qualified retirement plan may only be made under a section 401(k) plan. A section 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan that contains a qualified cash or deferred arrangement.[297] Thus, such arrangements are subject to the rules generally applicable to qualified defined contribution plans. In addition, special rules apply to such arrangements. One requirement is that no distributions prior to severance from employment generally are permitted for amounts attributable to elective deferrals unless the employee has attained age 59½.

Section 403(b) plans are another form of tax-favored employer-sponsored plan that provide tax benefits similar to qualified retirement plans. Section 403(b) plans may be maintained only by (1) charitable organizations tax-exempt under section 501(c)(3), and (2) educational institutions of State or local governments (*i.e.*, public schools, including colleges and universities). Elective deferrals are also permitted under section 403(b) plans and are subject to the same requirement that generally no distributions are permitted prior to severance from employment unless the employee has attained age 59½.

[297] Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement. Except for certain grandfathered plans, a State or local governmental employer may not maintain a section 401(k) plan.

Governmental section 457(b) plans

In the case of a State or local government employer, a section 457(b) plan is generally limited to elective deferrals and provides tax benefits similar to a section 401(k) or 403(b) plan in that deferrals are contributed to a trust or custodial account for the exclusive benefit of participants, but are not included in income until distributed (and may be rolled over to another tax-favored plan).[298] However distributions from a governmental section 457(b) plan prior to severance from employment are generally not permitted until the employee attains age 70½.[299]

Pension plans

For purposes of the qualification requirements applicable to pension plans, stock bonus plans, and profit-sharing plans under the Code, a pension plan is a plan established and maintained primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually life, after retirement.[300] A pension plan (i.e., a defined benefit plan or money purchase pension plan) generally may not provide for distributions before the attainment of the normal retirement age under the plan to participants who have not separated from employment. However, a pension plan is not treated as failing to be a qualified retirement plan solely because the plan provides that a distribution may be made to an employee who has attained age 62 (even if earlier than the normal retirement age under the plan) and who is not separated from employment at the time of the distribution.[301]

Description of Proposal

The proposal changes the age at which distributions are permitted prior to termination of employment to age 59½ for both pension plans and governmental section 457(b) plans, thus making the rules for these plans consistent with the rules for section 401(k) plans and section 403(b) plans. Under the proposal, a pension plan does not fail to be a qualified retirement plan solely because the plan provides that a distribution may be made to an employee who has attained age 59½ and who is not separated from employment at the time of the distribution.

Effective Date

The proposal is effective for distributions made after December 31, 2014.

[298] In the case of a tax-exempt employer, section 457(b) and 457(f) limit the amount of unfunded nonqualified deferred compensation that can be provided on a tax-deferred basis.

[299] Sec. 457(d)(1)(A)(i).

[300] Treas. Reg. sec. 1.401-1(b)(1)(i).

[301] Sec. 401(a)(36).

8. Modification of rules governing hardship distributions (sec. 1616 of the discussion draft and sec. 401(k)(2) of the Code)

Present Law

Elective deferrals under a qualified cash or deferred arrangement (a "section 401(k) plan") may not be distributable prior to the occurrence of one or more specified events.[302] One event upon which distribution is permitted is the financial hardship of the employee.[303] The amount allowed to be distributed on account of hardship is limited to the dollar amount of elective deferrals reduced for the amount of elective deferrals previously distributed on account of hardship. Applicable Treasury regulations provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the heavy need.[304]

The Treasury regulations provide a safe harbor under which a distribution may be deemed necessary to satisfy an immediate and heavy financial need. One requirement of this safe harbor is that the employee be prohibited from making elective deferrals and employee contributions to the plan and all other plans maintained by the employer for at least six months after receipt of the hardship distribution. The same rules apply to hardship distributions of elective deferrals from section 403(b) plans.

Description of Proposal

The Secretary of the Treasury is directed to revise the applicable regulations within one year of the date of enactment to eliminate the requirement that an employee be prohibited from making elective deferrals and employee contributions for six months after the receipt of a hardship distribution in order for the distribution to be deemed necessary to satisfy an immediate and heavy financial need. It is intended that an employee not be prevented for any period after the receipt of a hardship distribution from continuing to make elective deferrals and employee contributions.

Effective Date

The proposal applies to plan years beginning after December 31, 2014.

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[302] A section 401(k) plan legally is not a separate type of plan, but is a qualified retirement plan that contains a qualified cash or deferred arrangement.

[303] Sec. 401(k)(2)(B)(i)(IV).

[304] Treas. Reg. sec. 1.401(k)-1(d)(3).

9. Extended rollover period for the rollover of plan loan offset amounts in certain cases (sec. 1617 of the discussion draft and sec. 402(c) of the Code)

Present Law

Taxation of retirement plan distributions

General rule

A distribution from a tax-favored retirement plan is generally includible in gross income, except to the extent that the distribution is a recovery of basis under the plan, or the amount of distribution is contributed to another eligible retirement plan in a tax-free rollover. In the case of a distribution from a retirement plan to a participant under age 59½, the distribution (other than a distribution from certain governmental plans) is also subject to a 10-percent early distribution tax, unless an exception applies.

Rollovers

A distribution from a qualified retirement plan, section 403(b) plan, or a governmental section 457(b) plan that is an eligible rollover distribution may be rolled over to another such plan or an IRA. The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution ("60-day rollover"). Amounts that are rolled over are usually not included in gross income.[305] Generally, any distribution of the balance to the credit of a participant is an eligible rollover distribution with exceptions, for example, certain periodic payments, required minimum distributions, and hardship distributions.[306]

Qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans are required to offer a direct rollover with respect to any eligible rollover distribution before paying the amount to the participant or beneficiary.[307] If an eligible rollover distribution is not directly rolled over into an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20-percent income tax withholding.[308] Participants who do not

[305] Distributions from qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans may be rolled into a Roth IRA. Distributions from these plans that are rolled over into a Roth IRA and that are not distributions from a designated Roth account (discussed below) must be included in gross income.

[306] Sec. 402(c)(4). Treas. Reg. sec. 1.402(c)-1 identifies certain other payments that are not eligible for rollover, including, for example, certain corrective distributions, loans that are treated as deemed distributions under section 72(p), and dividends on employer securities as described in section 404(k). In addition, pursuant to section 402(c)(11), any distribution to a beneficiary other than the participant's surviving spouse is only permitted to be rolled over to an IRA using a direct rollover; 60-day rollovers are not available to nonspouse beneficiaries.

[307] Sec. 401(a)(31). Unless a participant elects otherwise, a mandatory cashout of more than $1,000 must be directly rolled over to an IRA chosen by the plan administrator or the payor.

[308] Treas. Reg. sec. 1.402(c)-2, Q&A-1(b)(3).

elect a direct rollover but who roll over eligible distributions within 60 days of receipt also defer tax on the rollover amounts; however, the 20 percent withheld will remain taxable unless the participant substitutes funds within the 60-day period.

Plan loan as a deemed distribution

Tax-favored employer-sponsored retirement plans may provide loans to participants. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan is a deemed distribution from the retirement plan.[309] These requirements include the following: the amount of the loan must not exceed the lesser of 50 percent of the participant's account balance or $50,000; the terms of the loan must provide for a repayment period of not more than five years and provide for level amortization of loan payments (with payments not less frequently than quarterly); and the terms of the loan must be legally enforceable. Loans specifically for home purchases may be repaid over a longer period. Thus if a plan participant ceases to make payments on a loan before it is repaid, a deemed distribution of the outstanding loan balance generally occurs.

A deemed distribution of an unpaid loan balance is generally taxed as though an actual distribution occurred, including being subject to a 10-percent early distribution tax, if applicable. However, a deemed distribution is not eligible for rollover to another eligible retirement plan.

Loan offset amount

A plan may also provide that, in certain circumstances (for example, upon a participant's termination of employment with the employer), a participant's obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the amount in participant's account balance is offset by the amount attributable to the loan (the amount of the unpaid loan balance). In the case of a loan offset, an actual distribution equal to the unpaid loan balance (as opposed to a deemed distribution under section 72(p)) occurs, and (unlike a deemed distribution) the amount of the distribution is eligible for tax-free rollover to another eligible retirement plan. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution and the plan loan offset amount is generally not subject to 20-percent income tax withholding.

Description of the Proposal

Under the proposal, the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution is extended from 60 days after the date of the offset to the due date (including extensions) for filing the Federal income tax return for the taxable year in which the plan loan offset occurs (meaning the taxable year in which such amount is treated as distributed from a qualified employer plan). Under the proposal, a qualified plan loan offset amount is a plan loan offset amount which is treated as distributed from a qualified retirement plan, a section 403(b) plan or a governmental section 457(b) plan to a participant or beneficiary solely by reason of either the termination of the plan, or the failure to

[309] Sec. 72(p).

meet the repayment terms of the loan from such plan because of the separation from service of the participant (whether due to layoff, cessation of business, termination of employment, or otherwise). As under present law, a loan offset amount under the proposal is the amount by which a participant's accrued benefit under the plan is reduced to repay a loan from the plan.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

10. Coordination of contribution limitations for 403(b) plans and governmental 457(b) plans (sec. 1618 of the discussion draft and secs. 402(g), 403(b), 415 and 457(b) of the Code)

Present Law

There are three types of account-based tax-favored employer-sponsored retirement plans: a qualified defined contribution plan, a tax-sheltered annuity plan (referred to as a section 403(b) plan), and an eligible deferred compensation plan of a State or local government (referred to as a governmental section 457(b) plan). A qualified defined contribution plan may include a qualified cash or deferred arrangement (referred to as a section 401(k) plan), under which an employee elects to have contributions made to the plan (referred to as elective deferrals) rather than receiving the same amount as cash compensation. Elective deferrals are generally made on a pretax basis unless designated by the participant as Roth contributions, which are made on an after-tax basis. A defined contribution plan may also provide for after-tax employee contributions and for employer nonelective contributions and matching contributions. A section 403(b) plan may also provide for these different types of contributions. Although a governmental section 457(b) plan may provide for employer contributions, these plans generally provide only for elective deferrals.

In the case of a section 401(k) plan or a section 403(b) plan, specific annual limits apply to elective deferrals by a participant and additional annual limits apply to aggregate contributions for the participant. For 2014, elective deferrals are generally limited to the lesser of (1) $17,500 plus an additional $5,500 catch-up contribution limit for participants at least age 50 and (2) the participant's compensation. If an employee participates in both a section 401(k) plan and a section 403(b) plan of the same employer,[310] a single limit applies to elective deferrals under both plans. However, under a special rule, in the case of employees who have completed 15 years of service, additional elective deferrals are permitted under a section 403(b) plan maintained by an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches. In this case, the annual limit is increased by the least of (1) $3,000, (2) $15,000 reduced by the employee's additional elective deferrals for previous years, and (3) $5,000 multiplied by the employee's years of service and reduced by the employee's elective deferrals for previous years.

[310] For this purpose members of a controlled group or affiliated service group are treated as a single employer.

For 2014, the limit on aggregate contributions to a qualified defined contribution plan (including a section 401(k) plan) or a section 403(b) plan is the lesser of (1) $52,000 and (2) the participant's compensation.[311] Because employees generally do not receive compensation for years after they have terminated employment, contributions generally cannot be made for former employees. However, under a special rule, employer contributions to a section 403(b) plan can be made for up to five years after termination of employment. In addition, under special rules, certain contribution amounts are permitted for church employees and foreign missionaries.

The limit described above on aggregate contributions to a qualified defined contribution plan applies to contributions for a participant to any defined contribution plans maintained by the same employer, defined generally to include any members of a controlled group (using an ownership standard of more than 50 percent, rather than at least 80 percent) or affiliated service group. Similarly, the limit on aggregate contributions to a section 403(b) plan applies to contributions for a participant to any section 403(b) plan maintained by the same employer, including any members of a controlled group or affiliated service group. However, contributions to a qualified defined contribution plan and to a section 403(b) plan maintained by the same employer are subject to separate limits unless the participant in the section 403(b) plan is in control of the employer maintaining the qualified defined contribution plan. This could occur, for example, if the participant in the section 403(b) plan owns a separate business that maintains a qualified defined contribution plan. In that case, a single limit applies to the contributions for the participant to the section 403(b) plan and the defined contribution plan. However, deferrals under a governmental section 457(b) plan are not taken into account in applying this limit.

In the case of a governmental section 457(b) plan, all contributions are subject to a single limit, generally for 2014, the lesser of (1) $17,500 plus an additional $5,500 catch-up contribution limit for participants at least age 50 and (2) the participant's compensation. This limit is separate from the limit on elective deferrals to section 401(k) and section 403(b) plans. Thus, for example, if an employee participates in both a section 403(b) plan and a governmental section 457(b) plan of the same employer, the employee may contribute up to $17,500 (plus $5,500 catch-up contributions if at least age 50) to the section 403(b) plan and up to $17,500 (plus $5,500 catch-up contributions if at least age 50) to the section 457(b) plan. In addition, under a special rule, catch-up contributions may be made by a participant to a governmental section 457(b) for the last three years before attainment of normal retirement age. Additional contributions may be made up to the lesser of (1) two times the otherwise applicable dollar limit for the year (two times $17,500 for 2014, or $35,000) and (2) the participant's otherwise applicable limit for the year plus the amount by which the limit applicable to the participant for previous years exceeded the participant's deferrals for the previous years. If a higher limit applies to a participant for a year under this special rule than under the general catch-up rule, the general catch-up rule does not apply for the year.

[311] Employee contributions to qualified defined benefit plans are also taken into account in applying this limit.

Description of Proposal

The proposal applies a single aggregate limit to contributions for a participant in a governmental section 457(b) plan and elective deferrals for the same participant under a section 401(k) plan or a 403(b) plan of the same employer. Thus, the limit for governmental section 457(b) plans is coordinated with the limit for section 401(k) and 403(b) plans in the same manner as the limits are coordinated under present law for elective deferrals to section 401(k) and section 403(b) plans.

The proposal repeals the special rules allowing additional elective deferrals and catch-up contributions under section 403(b) plans and governmental section 457(b) plans. Thus, the same limits apply to elective deferrals and catch-up contributions under section 401(k) plans, section 403(b) plans and governmental section 457(b) plans.

The proposal repeals the special rules allowing employer contributions to section 403(b) plans for up to five years after termination of employment and the special contribution rules for church employees and foreign missionaries.

The proposal also revises application of the limit on aggregate contributions to a qualified defined contribution plan or a section 403(b) plan (that is, the lesser of (1) $52,000 (for 2014) and (2) the participant's compensation). As revised, a single aggregate limit applies to contributions for a participant to any defined contribution plans, any section 403(b) plans, and any governmental section 457(b) plans maintained by the same employer, including any members of a controlled group or affiliated service group.[312]

Effective Date

The proposal is effective for plan years and taxable years beginning after December 31, 2014.

11. Application of 10-percent early distribution tax to governmental 457 plans (sec. 1619 of the discussion draft and sec. 72(t) of the Code)

Governmental section 457(b) plans

Special rules apply with respect to deferred compensation arrangements of State and local government and tax-exempt employers.[313] Amounts deferred under an eligible deferred compensation plan, i.e., a section 457(b) plan, are not currently included in income. In the case of a State or local government employer, a section 457(b) plan is generally limited to elective deferrals and provides tax benefits similar to a section 401(k) or 403(b) plan in that deferrals are

[312] As under present law, employee contributions to qualified defined benefit plans are also taken into account in applying this limit.

[313] Sec. 457.

contributed to a trust or custodial account for the exclusive benefit of participants, but are not included in income until distributed (and may be rolled over to another tax-favored plan).[314]

Deferrals under a governmental section 457(b) plan are subject to the same limits as elective deferrals ($17,500 for 2014) and catch-up contributions ($5,500 for 2014) under a section 401(k) plan or a section 403(b) plan, or, if less, the employee's compensation.[315] As of 2011, a governmental section 457(b) plan may include a qualified Roth contribution program, allowing a participant to elect to have all or a portion of the participant's deferrals under the plan be treated as designated Roth contributions.

Early distribution tax

The Code imposes provides an early distribution tax on distributions made from qualified retirement plans, 403(b) plans and IRAs before employee or an IRA owner attains age 59½ unless an exception applies.[316] The tax is equal to 10 percent of the amount of the distribution that is includible in gross income. The 10-percent tax is in addition to the taxes that would otherwise be due on distribution. This early distribution tax does not apply to distributions from governmental section 457(b) plans.

Description of Proposal

The proposal imposes the 10-percent early distribution tax on distributions from governmental section 457(b) plans.

Effective Date

The proposal is effective for distributions on or after February 26, 2014.

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[314] In the case of a tax-exempt employer, section 457(b) and 457(f) limit the amount of unfunded nonqualified deferred compensation that can be provided on a tax-deferred basis.

[315] Under present law, the section 457(b) plan limits apply separately from the combined limit applicable to section 401(k) and 403(b) plan contributions, so that an employee covered by a governmental section 457(b) plan and a section 401(k) or 403(b) plan can contribute the full amount to each plan. In addition, under a special catch-up rule, for one or more of the participant's last three years before normal retirement age, the otherwise applicable limit is increased to the lesser of (1) two times the normal annual limit ($34,000 for 2012) or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year. Section 1618 of the discussion draft eliminates these special rules with respect to governmental section 457(b) plans.

[316] Sec. 72(t).

12. Inflation adjustments for employer-sponsored retirement plan dollar limitations on benefits and contributions (secs. 1620 to 1624 of the discussion draft and secs. 402(g), 415(d), and 408(p) of the Code)

Present Law

In general

There are several types of funded tax-favored employer-sponsored retirement plans: qualified retirement plans, section 403(b) plans, governmental section 457(b) plans, simplified employee pensions, and simple retirement plans. Tax-favored retirement plans are of two general types: defined benefit plans, under which benefits are determined under a plan formula and paid from general plan assets, rather than individual accounts; and defined contribution plans, under which benefits are based on a separate account for each participant, to which are allocated contributions, earnings and losses. Defined contribution plans generally may provide for nonelective contributions and matching contributions by employers and elective deferrals or after-tax contributions by employees. Elective deferrals are contributions made pursuant to an election by an employee between cash compensation and a contribution to the plan. Among the requirements that apply to tax-favored qualified retirement plans are dollar limits on the benefits and contributions that are permitted to be provided under the plan.[317]

The dollar limits generally are indexed to reflect cost-of-living increases. The index used for adjusting the dollar limits is generally the same index used for cost-of-living increases in Social Security benefits. An adjustment with respect to any calendar year is based on the index for the calendar quarter ending September 30 of the preceding calendar year over such index for the base period which starts from the base calendar quarter. However for each limit, there is a rounding rule under which any increase that is not a multiple of a specified dollar amount (such as $500) is rounded down to the next lowest multiple for that dollar amount.

Qualified retirement plans and annuities

Limits on defined benefit plans

In the case of a qualified defined benefit plan, a dollar limit applies on the amount of benefits payable with respect to a participant. The dollar limit is expressed in terms of a benefit commencing at age 65 in the form of a straight life annuity for the life of the participant. The dollar limit on the annual payments under the annuity is $210,000 a year (for 2014).[318] The limit applies to the aggregate of all benefits accrued by an employee under all defined benefit plans

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[317] Generally, any limit on contributions or benefits is the lesser of a dollar limit or a percentage of the employee's compensation.

[318] Section 415(b)(1)(A). The limit is expressed as an annuity commencing at age 65, but there is no actuarial adjustment required for commencement between age 62 and 65.

maintained by the same employer.[319] This limit is only increased for cost-of-living in multiples of $5,000.

Limits on Contribution to Defined Contribution Plans

In the case of a qualified defined contribution plan, a dollar limit applies on the amount of contributions that can be made for each employee for a year under all defined contribution plans of the same employer. The dollar limit is $52,000 (for 2014), and generally applies to allocations to a participant's account under the terms of the plan as of any date during the year.[320] The limit is only increased for cost-of-living in multiples of $1,000.

Elective deferrals

Certain qualified defined contribution plans ("section 401(k)" plans) include a feature under which an employee may elect to have elective deferrals made to the plan, subject to a dollar maximum. The dollar limit is $17,500 (for 2014) and is applied to the amount of deferrals for the employee's taxable year (which is generally the calendar year).[321] Additional elective deferrals ("catch-up contributions") are allowed for employees aged 50 or older, up to a dollar limit of $5,500 (for 2014). Both limits are only increased for cost-of-living in multiples of $500.

Elective deferrals up to these limits are either not includable in gross income (but then subsequent distributions attributable to the contributions are includable in gross income) or are designated Roth contributions (in which case the contributions are includable in gross income but then subsequent qualified distributions attributable to the Roth contributions are excludible from gross income).

The amount of elective deferrals (but not catch up contributions) is also included in the contributions subject to the general limit ($52,000 for 2014).

Section 403(b) plans

Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations,[322] and (2) educational institutions of State or local governments (i.e., public schools, including colleges and universities). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans. Employers may make nonelective or matching contributions to such plans on behalf of

[319] In applying the limits under both defined benefit plans and defined contributions plans, and the qualification requirement generally to a plan, the members of a control group as determiued under section 414(b), (c), (m) , and (o) are treated as a single employer.

[320] Sec. 415(c)(1)(A). Employee contributions to a defined benefit plan are also taken into account for purposes of this limit.

[321] Sec. 402(g).

[322] Sec. 501(c)(3).

their employees, and the plan may provide for employees to make pretax elective deferrals, designated Roth contributions or other after-tax contributions.

Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the general limit on contributions ($52,000 for 2014) and the special limits for elective deferrals ($17,500 for 2014) and catch-up contributions ($5,500 for 2014) under a section 401(k) plan. If elective deferral and catch-up contributions are made to both a section 401(k) plan and a section 403(b) plan for the same employee, a single limit applies to the elective deferrals under both plans.[323]

Governmental section 457(b) plans

Deferrals under a governmental section 457(b) plan are generally subject to the same limits as elective deferrals ($17,500 for 2014) and catch-up contributions ($5,500 for 2014) under a section 401(k) plan or a section 403(b) plan. However, the section 457(b) plan limits apply separately from the combined limit applicable to section 401(k) and 403(b) plan contributions, so that an employee covered by a governmental section 457(b) plan and a section 401(k) or 403(b) plan can contribute the full amount to each plan.[324]

Employer-sponsored retirement plans using IRAs

SIMPLE IRA plan

An employer that employs no more than 100 employees who earned $5,000 or more during the prior calendar year can establish a simple retirement plan, under which an IRA is established for each employee (that is, a SIMPLE IRA). A SIMPLE IRA plan allows employees to make elective deferrals, but is subject to a special limit, $12,000 (for 2014).[325] The catch-up contribution limit for an individual age 50 or over is $2,500 (for 2014). Both limits are only increased for cost-of-living in multiples of $500.

Simplified employee pension plan

A simplified employee pension ("SEP") is a type of employer-sponsored retirement plan under which an employer may make contributions to a SEP IRA for each eligible employee up to the lesser of 25 percent of the employee's compensation or the dollar limit applicable to contributions to a qualified defined contribution plan ($52,000 for 2014).

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[323] Any elective deferrals under SIMPLE IRAs and SARSEPs (discussed below) are also taken into account for purposes of this single limit.

[324] This separate application of the deferral limit for governmental section 457(b) plans is eliminated by section 1618 of the discussion draft.

[325] There is also a type of simple retirement plan that is a form of section 401(k) plan ("SIMPLE 401(k) plan") nnder which elective deferrals and catch up contribntions are also subject to this lower limit. Section 1612 of the discussion draft provides that no new SIMPLE 401(k) plans may be established.

Certain SEP plans established before 1997 may include a salary reduction feature ("SARSEP") under which employees can make elective deferrals. Elective deferrals under a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan ($17,500, plus catch-up contribution up to $5,500 for a participant age 50 or over, for 2014).

Description of Proposal

The proposal suspends the adjustments for cost of living on tax-favored retirement plan dollar limits and holds these limits at the 2014 level through 2023. Thus, through 2023, the defined benefit plan dollar limit remains at an annuity with annual payments equal to $210,000 commencing at age 65; the defined contribution plan dollar limit remains at $52,000; the elective deferral dollar limit remains at $17,500; and the catch-up contribution dollar limit remains at $5,500. The dollar limit on deferral limits under section 457(b) plans also remains at $17,500 and the limit on catch-up contributions for these plans remains at $5,500. Similarly, the limit on elective deferrals under simple retirement plans remains at $12,000 and the limit on catch up contributions for simple retirement plans remains at $2,500. Adjustments resume in 2024 using the quarter beginning July 1, 2022 as the base calendar quarter.

Effective Date

The suspension of adjustments to the defined benefit plan dollar limit and the defined contribution plan dollar limit applies to years ending with or within a calendar year beginning after 2014. The suspension of the adjustment to the elective deferral dollar limit applies to plan years and taxable years beginning after December 31, 2014. The suspension of the adjustments to dollar limit on elective deferrals under simple retirement plans is effective for calendar years beginning after 2014. The proposal otherwise applies to taxable years beginning after December 31, 2014.

H. Certain Provisions Related to Members of Indian Tribes

1. Indian general welfare benefits (secs. 1701-1703 of the discussion draft and new sec. 139E of the Code)

Present Law

Except as otherwise provided, gross income means all income from whatever source derived. The general welfare doctrine is an IRS administrative rule that operates to exclude certain payments from gross income. Excludable payments generally consist of payments: (i) made from a governmental fund, (ii) for the promotion of general welfare (on the basis of the need of the recipient), and (iii) which do not represent compensation for services. Examples of excludable benefits include disaster relief, adoption assistance, housing and utility subsidies for low income persons, and government benefits paid to the blind.

Prior to IRS Notice 2012-75 (the "Notice"),[326] there was some uncertainty concerning the application of the general welfare doctrine to certain benefits provided by Indian tribes to their members. Benefits that have been scrutinized by the IRS include payments for housing, cultural, education, and elder programs provided by Indian tribal governments. The issue is whether the tribal governments can provide such benefits tax-free to their members because they are addressing a social welfare need, without considering the financial need of the members.

In response to requests from tribes to provide guidance on this issue, the IRS has issued the Notice, which provides safe harbors under which the IRS presumes that the individual need requirement of the general welfare exclusion is met for benefits provided under certain Indian tribal governmental programs.

Description of Proposal

The proposal contains similar requirements to the Notice under which benefits would qualify for exclusion from income under the general welfare doctrine, including that the benefits (i) are provided pursuant to a specific Indian tribal government program, (ii) are available to any tribal member who meets certain guidelines, (iii) are for the promotion of general welfare, (iv) are not lavish or extravagant, and (v) are not compensation for services.

The proposal requires the Secretary of the Treasury ("Secretary") to establish a Tribal Advisory Committee to advise on matters relating to the taxation of Indians. In consultation with the Committee, the proposal requires the Secretary to establish and require training of IRS agents on Federal Indian law and training of tribal financial officers about the proposal. The proposal also requires the Secretary to suspend audits and examinations of Indian tribal governments and tribe members relating to the general welfare exclusion until this education has been completed. The proposal allows the Secretary to waive interest and penalties to the extent those penalties relate to excluding a payment under the general welfare exclusion.

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[326] Notice 2012-75, 2012-51 I.R.B. 715, December 17, 2012.

The proposal applies to years for which the tribal member's refund statute of limitation period has not expired and provides a one-year waiver of the refund statute of limitations period in the event that the period expires before the end of the one-year period beginning on the date of enactment of the Act.

Effective Date

The proposal is effective on the date of enactment.

TITLE II – REPEAL OF ALTERNATIVE MINIMUM TAX

Present Law

Individual alternative minimum tax

In general

An alternative minimum tax ("AMT") is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. For taxable years beginning in 2014, the tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $182,500 ($91,250 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The breakpoints are indexed for inflation. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the taxable income adjusted to take account of specified tax preferences and adjustments.

The exemption amounts for taxable years beginning in 2014 are: (1) $82,100 in the case of married individuals filing a joint return and surviving spouses; (2) $52,800 in the case of other unmarried individuals; (3) $41,050 in the case of married individuals filing separate returns; and (4) $23,500 in the case of an estate or trust. For taxable years beginning in 2014, the exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $156,500 in the case of married individuals filing a joint return and surviving spouses, (2) $117,300 in the case of other unmarried individuals, and (3) $78,250 in the case of married individuals filing separate returns or an estate or a trust. The amounts are indexed for inflation.

Alternative minimum taxable income is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

Preference items in computing AMTI

The minimum tax preference items are:

1. The excess of the deduction for percentage depletion over the adjusted basis of each mineral property (other than oil and gas properties) at the end of the taxable year.

2. The amount by which excess intangible drilling costs (*i.e.*, expenses in excess the amount that would have been allowable if amortized over a 10-year period) exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference applies to independent producers only to the extent it reduces the producer's AMTI (determined without regard to this preference and the net operating loss deduction) by more than 40 percent.

3. Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds, certain housing bonds, and bonds issued in 2009 and 2010) issued after August 7, 1986.

4. Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

5. Seven percent of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock).

In addition, losses from any tax shelter farm activity or passive activities are not taken into account in computing AMTI.

Adjustments in computing AMTI

The adjustments that individuals must make to compute AMTI are:

1. Depreciation on property placed in service after 1986 and before January 1, 1999, is computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence. Depreciation on property acquired after September 10, 2001, which is allowed an additional allowance under section 168(k) for the regular tax is computed without regard to any AMT adjustments.

2. Mining exploration and development costs are capitalized and amortized over a 10-year period.

3. Taxable income from a long-term contract (other than a home construction contract) is computed using the percentage of completion method of accounting.

4. The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), is calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

5. Miscellaneous itemized deductions are not allowed.

6. Itemized deductions for State, local, and foreign real property taxes; State and local personal property taxes; State, local, and foreign income, war profits, and excess profits taxes; and State and local sales taxes are not allowed.

7. Medical expenses are allowed only to the extent they exceed ten percent of the taxpayer's adjusted gross income.

8. Deductions for interest on home equity loans are not allowed.

9. The standard deduction and the deduction for personal exemptions are not allowed.

10. The amount allowable as a deduction for circulation expenditures is capitalized and amortized over a 3-year period.

11. The amount allowable as a deduction for research and experimentation expenditures from passive activities is capitalized and amortized over a 10-year period.

12. The regular tax rules relating to incentive stock options do not apply.

Other rules

The taxpayer's net operating loss deduction generally cannot reduce the taxpayer's AMTI by more than 90 percent of the AMTI (determined without the net operating loss deduction).

The alternative minimum tax foreign tax credit reduces the tentative minimum tax.

The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT. Certain exceptions apply.

If an individual is subject to AMT in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit (the "AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax liability in such subsequent year. The AMT credit is allowed only to the extent that the taxpayer's AMT liability is the result of adjustments that are timing in nature. The individual AMT adjustments relating to itemized deductions and personal exemptions are not timing in nature, and no minimum tax credit is allowed with respect to these items.

An individual may elect to write off certain expenditures paid or incurred with respect of circulation expenses, research and experimental expenses, intangible drilling and development expenditures, development expenditures, and mining exploration expenditures over a specified period (three years in the case of circulation expenses, 60 months in the case of intangible drilling and development expenditures, and 10 years in case of other expenditures). The election applies for purposes of both the regular tax and the alternative minimum tax.

Corporate alternative minimum tax

In general

Present law imposes an alternative minimum tax ("AMT") on a corporation to the extent the corporation's tentative minimum tax exceeds its regular tax. This tentative minimum tax is computed at the rate of 20 percent on the alternative minimum taxable income ("AMTI") in excess of a $40,000 exemption amount that phases out. The exemption amount is phased out by an amount equal to 25 percent of the amount that the corporation's AMTI exceeds $150,000.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

A corporation with average gross receipts of less than $7.5 million for the prior three taxable years is exempt from the corporate minimum tax. The $7.5 million threshold is reduced to $5 million for the corporation's first 3-taxable year period.

Preference items in computing AMTI

The corporate minimum tax preference items are:

1. The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

2. The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to an independent producer to the extent the preference would not reduce the producer's AMTI by more than 40 percent.

3. Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds, certain housing bonds, and bonds issued in 2009 and 2010) issued after August 7, 1986.

4. Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

Adjustments in computing AMTI

The adjustments that corporations must make in computing AMTI are:

1. Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence. Depreciation on property which is allowed "bonus depreciation" for the regular tax is computed without regard to any AMT adjustments.

2. Mining exploration and development costs must be capitalized and amortized over a 10-year period.

3. Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

4. The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

5. The special rules applicable to Merchant Marine construction funds are not applicable.

6. The special deduction allowable under section 833(b) for Blue Cross and Blue Shield organizations is not allowed.

7. The adjusted current earnings adjustment applies, as described below.

Adjusted current earning ("ACE") adjustment

The adjusted current earnings adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings of a corporation exceed its AMTI (determined without the ACE adjustment and the alternative tax net operating loss deduction). In determining ACE the following rules apply:

1. For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.

2. Amounts excluded from gross income under the regular tax but included for purposes of determining earnings and profits are generally included in determining ACE.

3. The inside build-up of a life insurance contract is included in ACE (and the related premiums are deductible).

4. Intangible drilling costs of integrated oil companies must be capitalized and amortized over a 60-month period.

5. The regular tax rules of section 173 (allowing circulation expenses to be amortized) and section 248 (allowing organizational expenses to be amortized) do not apply.

6. Inventory must be calculated using the FIFO, rather than LIFO, method.

7. The installment sales method generally may not be used.

8. No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.

9. Depletion (other than for oil and gas properties) must be calculated using the cost, rather than the percentage, method.

10. In certain cases, the assets of a corporation that has undergone an ownership change must be stepped down to their fair market values.

Other rules

The taxpayer's net operating loss carryover generally cannot reduce the taxpayer's AMT liability by more than 90 percent of AMTI determined without this deduction.

The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT. Certain exceptions apply.

If a corporation is subject to AMT in any year, the amount of AMT is allowed as a credit ("AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in the subsequent year. Corporations are allowed to claim a limited amount of AMT credits in lieu of bonus depreciation.

A corporation may elect to write off certain expenditures paid or incurred with respect of circulation expenses, research and experimental expenses, intangible drilling and development expenditures, development expenditures, and mining exploration expenditures over a specified period (three years in the case of circulation expenses, 60 months in the case of intangible drilling and development expenditures, and 10 years in case of other expenditures). The election applies for purposes of both the regular tax and the alternative minimum tax.

Description of Proposal

The proposal repeals the individual and corporate alternative minimum tax.

The proposal allows the AMT credit to offset the taxpayer's regular tax liability for any taxable year. In addition, the AMT credit is refundable for any taxable year beginning after 2015 and before 2020 in an amount equal to 50 percent (100 percent in the case of taxable years beginning in 2019) of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability. Thus, full amount of the minimum tax credit will be allowed in taxable years beginning before 2020.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

In determining the alternative minimum taxable income for taxable years beginning before January 1, 2015, the net operating loss deduction carryback from taxable years beginning on December 31, 2014, are determined without regard to any AMT adjustments or preferences.

The repeal of the election to write off certain expenditures over a specified period applies to amounts paid or incurred after December 31, 2014.

TITLE III – BUSINESS TAX REFORM

A. Tax Rates

1. 25-percent corporate tax rate (sec. 3001 of the discussion draft and sec. 11 of the Code)

Present Law

Corporate taxable income is subject to tax under a four-step graduated rate structure. The top corporate tax rate is 35 percent on taxable income in excess of $10 million. The corporate taxable income brackets and tax rates are as set forth in the table below:

Table 4.–Corporate Income Tax Rates

Taxable Income	Tax rate (percent)
Not over $50,000	15
Over $50,000 but not over $75,000	25
Over $75,000 but not over $10,000,000	34
Over $10,000,000	35

An additional five-percent tax is imposed on a corporation's taxable income in excess of $1 million. The maximum additional tax is $11,750. Also, a second additional three-percent tax is imposed on a corporation's taxable income in excess of $15 million. The maximum second additional tax is $100,000.

Certain personal service corporations pay tax on their entire taxable income at the rate of 35 percent.

Present law provides if the maximum corporate tax rate exceeds 35 percent, the maximum rate on a corporation's net capital gain will be 35 percent.

Description of Proposal

The proposal reduces the maximum corporate tax rate from 35 percent to 25 percent for taxable years beginning after December 31, 2018.

The proposal is phased-in. For taxable years beginning in 2015 the maximum rate is 33 percent; for taxable years beginning in 2016 the maximum rate is 31 percent; for taxable years beginning in 2017 the maximum rate is 29 percent; and for taxable years beginning in 2018 the maximum rate is 27 percent.[327] For each of these taxable years the 25-percent rate applies to so much of the taxable income as does not exceed $75,000.

Personal service corporations are taxed at the same tax rates as other corporations.

The proposal repeals the maximum corporate tax rate on net capital gain as obsolete.

The proposal provides a withholding rate on certain foreign income equal to the maximum corporate tax rate.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

[327] For fiscal year corporations, the rules relating to changes of rates during a taxable year currently in section 15 apply.

B. Reform of Business-Related Exclusions and Deductions

1. Revision of treatment of contributions to capital (sec. 3101 of the discussion draft, new sec. 76 of the Code, and sec. 118 of the Code)

Present Law

The gross income of a corporation does not include any contribution to its capital.[328] For purposes of this rule, a contribution to the capital of a corporation does not include any contribution in aid of construction or any other contribution from a customer or potential customer.[329] A special rule allows certain contributions in aid of construction received by a regulated public utility that provides water or sewerage disposal services to be treated as a tax-free contribution to the capital of the utility.[330] No deduction or credit is allowed for, or by reason of, any expenditure that constitutes a contribution that is treated as a tax-free contribution to the capital of the utility.[331]

If property is acquired by a corporation as a contribution to capital and is not contributed by a shareholder as such, the adjusted basis of the property is zero.[332] If the contribution consists of money, the corporation must first reduce the basis of any property acquired with the contributed money within the following 12-month period, and then reduce the basis of other property held by the corporation.[333] Similarly, a utility's adjusted basis of any property acquired with a contribution in aid of construction will be zero.[334]

Description of Proposal

The proposal repeals section 118.

Further, the proposal provides that a contribution to capital, other than a contribution of money or property made in exchange for stock of a corporation or any interest in an entity, is included in gross income of a taxpayer.[335]

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[328] Sec. 118(a).

[329] Sec. 118(b).

[330] Sec. 118(c).

[331] Sec. 118(c)(4).

[332] Sec. 362(c)(1).

[333] Sec. 362(c)(2). See also Treas. Reg. sec. 1.362-2.

[334] Sec. 118(c)(4).

[335] See section 3423 of the discussion draft, "Nonrecognition for derivative transactions by a corporation with respect to its stock," for a discussion of a proposal revising section 1032 with respect to contributions in exchange for stock of a corporation or an ownership interest in an entity.

For example, a contribution of municipal land by a municipality that is not in exchange for stock (or for a partnership interest or other interest) of equivalent value is considered a contribution to capital that is includable in gross income. By contrast, a municipal tax abatement for locating a business in a particular municipality is not considered a contribution to capital.

Effective Date

The proposal applies to contributions made, and transactions entered into, after the date of enactment.

2. Repeal of deduction for local lobbying expenses (sec. 3102 of the discussion draft and sec. 162(e) of the Code)

Present Law

In general

A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[336] However, section 162(e) denies a deduction for amounts paid or incurred in connection with (1) influencing legislation,[337] (2) participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office, (3) any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums, or (4) any direct communication with a covered executive branch official[338] in an attempt to influence the official actions or positions of such official. Expenses paid or incurred in connection with lobbying and political activities (such as research for, or preparation, planning, or coordination of, any previously described activity) also are not deductible.[339]

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[336] Sec. 162(a).

[337] The term "influencing legislation" means any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of legislation. The term "legislation" includes actions with respect to Acts, bills, resolutions, or similar items by the Congress, any State legislature, any local council, or similar governing body, or by the public in a referendum initiative constitutional amendment, or similar procedure. Secs. 162(e)(4) and 4911(e)(2).

[338] The term "covered executive branch official" means (1) the President, (2) the Vice President, (3) any officer or employee of the White House Office of the Executive Office of the President, and the two most senior level officers of each of the other agencies in such Executive Office, (4) any individual servicing in a position in level I of the Executive Schednle under section 5312 of title 5, United States Code, any other individual designated by the President as having Cabinet level status, and (5) any immediate deputy of an individual described in (4). Sec. 162(e)(6).

[339] Sec. 162(e)(5)(C).

Exceptions

Local legislation

Notwithstanding the above, a deduction is allowed for ordinary and necessary expenses incurred in connection with any legislation of any local council or similar governing body (collectively, "local legislation").[340] With respect to local legislation, the exception permits a deduction for amounts paid or incurred in carrying on any trade or business (1) in direct connection with appearances before, submissions to, or sending communications to the committees, or individual members, of such local legislation with respect to legislation or proposed legislation of direct interest to the taxpayer, or (2) in direct connection with communication of information between the taxpayer and an organization of which the taxpayer is a member with respect to any such legislation or proposed legislation which is of direct interest to the taxpayer and such organization, and (3) that portion of the dues so paid or incurred with respect to any organization of which the taxpayer is a member which is attributable to the expenses of the activities described in (1) or (2) carried on by such organization.[341]

For purposes of this exception, legislation of an Indian tribal government is treated in the same manner as local legislation.[342]

De minimis

For taxpayers with $2,000 or less of in-house expenditures related to lobbying and political activities, a de minimis exception is provided that permits a deduction.[343]

Description of Proposal

The proposal repeals the exception for amounts paid or incurred related to lobbying local councils or similar governing bodies, including Indian tribal governments. Thus, the general disallowance rules applicable to lobbying and political expenditures will apply to costs incurred related to such local legislation.

Effective Date

The proposal applies to amounts paid or incurred after December 31, 2014.

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[340] Sec. 162(e)(2).

[341] Sec. 162(e)(2)(B).

[342] Sec. 162(e)(7).

[343] Sec. 162(e)(5)(B).

3. Expenditures for repairs in connection with casualty losses (sec. 3103 of the discussion draft and sec. 165 of the Code)

Present Law

In general, a taxpayer may claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.[344] The amount of any loss is limited to the adjusted basis of the property.[345] For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft.[346] Personal casualty or theft losses for the taxable year are allowable only if they exceed a $100 limitation per casualty or theft.[347] In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.[348] If the disaster occurs in a Presidentially declared disaster area, the taxpayer may elect to take into account the casualty loss in the taxable year immediately preceding the taxable year in which the disaster occurs.[349]

With respect to restoration of a unit of property, a taxpayer generally must capitalize as an improvement amounts paid to restore a unit of property, including an amount paid to make good the exhaustion for which an allowance is or has been made.[350] A restoration includes, in relevant part, an amount paid for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment either as a result of a casualty loss or relating to a casualty event.[351] However, with respect to amounts paid or incurred for repairs in connection with casualty losses or events, the regulations limit the amount required to be capitalized to the excess (if any) of (1) the taxpayer's basis adjustments resulting from the casualty, over (2) the amount paid for the restoration of damage to the unit of property as a result of the casualty that also constitutes an improvement.[352] Amounts paid in excess of such limitation are analyzed

[344] Sec. 165(a).

[345] Sec. 165(b).

[346] Sec. 165(c)(3).

[347] Sec. 165(h)(1).

[348] Sec. 165(h)(2).

[349] Sec. 165(i).

[350] Treas. Reg. sec. 1.263(a)-3(k)(1), effective for taxable years beginning on or after January 1, 2014.

[351] Treas. Reg. sec. 1.263(a)-3(k)(1)(iii).

[352] Treas. Reg. secs. 1.263(a)-3(k)(1) and (4). See also the preamble to the final regulations under section 263(a) issued September 13, 2013 (T.D. 9636, 78 Fed. Reg. 57686, September 19, 2013).

under the applicable provisions of the Internal Revenue Code and regulations[353] to determine if capitalization is required.[354]

Description of Proposal

The proposal amends the rules for repairs incurred in connection with a casualty loss. Specifically, the proposal requires the capitalization of any expenditure made for any repair of damage to property in connection with a casualty loss where a casualty loss deduction for such property is allowed under section 165. The proposal provides an election to expense repair costs in lieu of deducting the casualty loss. If the taxpayer makes such election, no deduction is allowed for a casualty loss under section 165 and the requirement to capitalize repair expenditures shall not apply. When an election is made to forego the casualty loss deduction, it is intended that costs incurred to improve or better the property beyond the state of such property prior to the casualty loss[355] will continue to be capitalized.

Effective Date

The proposal applies to losses sustained after December 31, 2014.

4. Reform of accelerated cost recovery system (sec. 3104 of the discussion draft and sec. 168 of the Code)

Present Law

Overview

For Federal income tax purposes, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income.[356] Under the modified accelerated cost recovery system ("MACRS"), adopted in 1986, the amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[357]

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[353] See, *e.g.*, Treas. Reg. sec. 1.162-4, 1.263(a)-2, or 1.263(a)-3.

[354] Treas. Reg. sec. 1.263(a)-3(k)(4)(ii). See also, Treas. Reg. sec. 1.263(a)-3(k)(7), Example 5.

[355] See Treas. Reg. sec. 1.263(a)-3(j) for the rules governing the capitalization of amounts paid for a betterment to a unit of property.

[356] Sec. 167(a).

[357] The Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 201 (1986).

Recovery periods and depreciation methods

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance.[358] The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[359] switching to the straight-line method for the first taxable year where using the straight-line method with respect to the adjusted basis as of the beginning of that year will yield a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property. Table 5 provides general rules for class lives and recovery periods as provided in sections 168(c) and (e).

Table 5.–General Rules for Class Lives and Recovery Periods

Type of Property	General Rule-Class Life	MACRS Applicable Recovery Period
3-year property	4 years or less	3 years
5-year property	More than 4 but less than 10 years	5 years
7-year property	10 or more but less than 16 years; also, property (other than real property) without a class life	7 years
10-year property	16 or more but less than 20 years	10 years

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[358] Exercising authority granted by Congress, the Secretary issued Revenue Procedure 87-56 (1987-2 C.B. 674), laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Revenue Procedure 88-22 (1988-1 C.B. 785). In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Revenue Procedure 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

[359] Under the declining balance method the depreciation rate is determined by dividing the appropriate percentage (here 150 or 200) by the appropriate recovery period. This leads to accelerated depreciation when the declining balance percentage is greater than 100. The table below illustrates depreciation for an asset with a cost of $1,000 and a seven-year recovery period under the 200-percent declining balance method, the 150-percent declining balance method, and the straight-line method.

Recovery method	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Total
200-percent declining balance	285.71	204.08	145.77	104.12	86.77	86.77	86.77	1,000.00
150-percent declining balance	214.29	168.37	132.29	121.26	121.26	121.26	121.26	1,000.00
Straight-line	142.86	142.86	142.86	142.86	142.86	142.86	142.86	1,000.00

Type of Property	General Rule-Class Life	MACRS Applicable Recovery Period
15-year property	20 or more but less than 25 years	15 years
20-year property	25 or more years	20 years
Water utility property	50 years	25 years
Residential rental property	40 years	27.5 years
Nonresidential real property	40 years	39 years
Any railroad grading or tunnel bore	50 years	50 years

Placed-in-service conventions

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention.[360] Under MACRS, nonresidential real property, residential rental property, and any railroad grading or tunnel bore generally are subject to the mid-month convention, which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month.[361] All other property generally is subject to the half-year convention, which treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year.[362] However, if substantial property is placed in service during the last three months of a taxable year, a special rule requires use of the mid-quarter convention,[363] designed to prevent the recognition of disproportionately large amounts of first-year depreciation under the half-year convention.

Alternative depreciation system

The alternative depreciation system ("ADS") is required to be used for property used predominantly outside the United States, tax-exempt bond financed property, and certain tax-exempt use property.[364] An election to use ADS is available to taxpayers for any class of property for any taxable year.[365] Under ADS, all property is depreciated using the straight-line

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[360] Treas. Reg. sec. 1.167(a)-10(b).

[361] Secs. 168(d)(2) and (d)(4)(B).

[362] Secs. 168(d)(1) and (d)(4)(A).

[363] The mid-quarter convention treats all property placed in service (or disposed of) during any quarter as placed in service (or disposed of) on the mid-point of such quarter. Secs. 168(d)(3) and (d)(4)(C).

[364] Sec. 168(g).

[365] Sec. 168(g)(7).

method, over recovery periods which generally are equal to the class life of the property, with certain exceptions.[366]

Description of Proposal

Depreciation

In general

Under the proposal, the depreciation method for tangible property is the straight line method and the applicable recovery period generally is the class life of the property.[367] A recovery period is specifically assigned for the following property:

- Property with no class life (12 years);
- Any race horse, and any horse other than a race horse that is more than 12 years old at the time it is placed in service (3 years);
- Semi-conductor manufacturing equipment (5 years);
- Qualified technological equipment (5 years);
- Automobile or light general purpose truck (5 years);
- Qualified rent-to-own property (9 years);
- Certain telephone switching equipment (9.5 years);
- Railroad track (10 years);
- Smart electric distribution property (10 years);
- Airplanes (12 years);[368]
- Natural gas gathering line (14 years);
- Tree or vine bearing fruit or nuts (20 years);
- Telephone distribution plant (24 years);
- Real property, including nonresidential real property and residential rental property (40 years);
- Water treatment and utility property (50 years);
- Clearing and grading improvements, and tunnel bore (50 years); and

[366] Sec. 168(g)(2).

[367] See, *e.g.*, Rev. Proc. 87-56 (1987-2 C.B. 674) for class lives of certain property.

[368] While the proposal increases the recovery period for fixed wing aircraft from six years to 12 years, the recovery period for helicopters remains unchanged from present law (*i.e.*, remains the six-year class life).

- Tax-exempt use property subject to lease (recovery period shall be no less than 125 percent of the lease term).

Under the proposal, the Secretary is required to develop a schedule of class lives for all tangible property, except for property with a recovery period that was specifically assigned. One year following the delivery of the schedule of class lives, the revised class lives will take effect, replacing Revenue Procedure 87-56.

Inflation adjustment

The proposal provides an election for taxpayers to increase their depreciation deductions to take into account inflation. The election is made annually and applies to all property (except for specified property used outside the United States, real property, water treatment and utility property, and any clearing and grading land improvements or tunnel bore) placed in service during such taxable year.[369] With respect to property for which an election has been made, the taxpayer increases the depreciation deductions associated with such property by applying an inflation adjustment percentage to the modified adjusted basis of such property.[370] The term "modified adjusted basis" means the taxpayer's adjusted basis in such property determined as if the inflation adjustment had not been applied. The term "inflation adjustment percentage" means the cost-of-living adjustment for such calendar year, which is the percentage (if any) by which the Chained Consumer Price Index for all Urban Consumers ("C-CPI-U")[371] for the preceding calendar year exceeds the C-CPI-U for the second preceding calendar year. The overall depreciation allowance (including the inflation adjustment) for a taxable year with respect to any property may not exceed such property's adjusted basis as of the beginning of such taxable year.

The below table illustrates depreciation for an asset with a cost of $1,000 and a seven-year recovery period under the straight-line method using the half-year convention with and without the election to apply the inflation adjustment. For purposes of the inflation adjustment, an inflation rate of three percent is assumed in the below table.

[369] Once elected, the taxpayer is required to apply the inflation adjustment percentage to such property for all subsequent taxable years.

[370] The increase for the first taxable year is reduced to take into account the placed in service convention applicable to the property (*i.e.*, reduced by one-eighth for property subject to the mid-quarter convention, and reduced by one-half for all other property).

[371] For a discussion of the indexing tax provisions for inflation, see the description of section 1001 of the discussion draft, "Simplification of individual income tax rates."

Table 6.–Example

Year	Straight line method	Straight line with the inflation adjustment	Straight line beginning year basis	Adjusted basis end of year
1	71.40	86.40	1,000.00	913.60
2	142.90	170.76	928.60	742.84
3	142.90	166.47	785.70	576.37
4	142.80	162.08	642.80	414.29
5	142.90	157.90	500.00	256.39
6	142.80	153.51	357.10	102.87
7	142.90	102.87	214.30	0.00
8	71.40	0.00	71.40	0.00

__Normalization__

The proposal continues the rule that the tax benefits of public utility property may be normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account. In addition to requiring the normalization of depreciation deductions, the proposal 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 date of enactment).

If an excess deferred tax reserve is reduced more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method, the taxpayer will not be treated as using a normalization method of accounting with respect to any of its assets. Thus, if the excess deferred tax reserve is not normalized, the taxpayer must compute its depreciation allowances using the depreciation method, useful life determination, averaging convention, and salvage value limitation used for purposes of setting rates and reflecting operating results in regulated books of account.

The excess deferred tax reserve is the reserve for deferred taxes computed under prior law over what the reserve for deferred taxes would be if the tax rate in effect under the proposal had been in effect for all prior periods. The average rate assumption method is the method that reduces the excess deferred tax reserve over the remaining regulatory lives of the property that gave rise to the reserve for deferred taxes. Under this method, the excess deferred tax reserve is reduced as the timing differences (*i.e.*, differences between tax depreciation and regulatory depreciation with respect to each asset or group of assets in the case of vintage accounts) reverse over the life of the asset. 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. The excess deferred tax reserve is multiplied by a formula that is designed to insure that the excess is reduced to zero at the end of the regulatory life of the asset that generated the reserve.

Effective Date

The amendments made by this proposal apply to property placed in service after December 31, 2016.

5. Repeal of amortization of pollution control facilities (sec. 3105 of the discussion draft and sec. 169 of the Code)

Present Law

In general, a taxpayer may elect to recover the cost of any certified pollution control facility over a period of 60 months.[372] A certified pollution control facility is defined as a new, identifiable treatment facility which (1) is used in connection with a plant in operation before January 1, 1976, to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat; and (2) does not lead to a significant increase in output or capacity, a significant extension of useful life, a significant reduction in total operating costs for such plant or other property (or any unit thereof), or a significant alteration in the nature of a manufacturing production process or facility.[373] A certified air pollution control facility placed in service after April 11, 2005 used in connection with an electric generation plant which is primarily coal fired is eligible for 84-month amortization if the associated plant or other property was not in operation prior to January 1, 1976.[374]

For a pollution control facility with a useful life greater than 15 years, only the portion of the basis attributable to the first 15 years is eligible to be amortized over a 60-month or 84-month period.[375] In addition, a corporation must reduce the amount of basis otherwise eligible for the 60-month or 84-month recovery period by 20 percent.[376] The amount of basis not eligible for 60-month or 84-month amortization is depreciable under the regular tax rules for depreciation.[377]

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[372] Sec. 169. For purposes of computing alternative minimum taxable income, the depreciation deduction is determined using the straight-line method over the applicable tax recovery period.

[373] Sec. 169(d).

[374] Sec. 169(d)(5).

[375] The amount attributable to the first 15 years is equal to an amount which bears the same ratio to the portion of the adjusted basis of the facility, which would be eligible for amortization but for the application of this rule, as 15 bears to the number of years of useful life of the facility.

[376] Sec. 291(a)(4).

[377] Sec. 169(g).

Description of Proposal

The proposal repeals section 169 such that the costs of certified pollution control facilities must be capitalized and amortized in accordance with the general cost recovery provisions under sections 167 and 168.

Effective Date

The proposal applies to facilities placed in service after December 31, 2014.

6. Net operating loss deduction (sec. 3106 of the discussion draft and sec. 172 of the Code)

Present Law

Under present law, a net operating loss ("NOL") generally means the amount by which a taxpayer's business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years.[378] NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.[379]

Different carryback periods apply with respect to NOLs arising in different circumstances. Extended carryback periods are allowed for NOLs attributable to specified liability losses and casualty and certain disaster losses. Limitations are placed on the carryback of excess interest losses attributable to corporate equity reduction transactions. Extended carrybacks for bank bad debt losses, 2008 and 2009 net operating losses, losses where investment in transmission property and pollution control investments, and losses attributable to federally declared disasters were provided but have expired.

Description of Proposal

In the case of a corporation, the proposal limits the NOL deduction to 90 percent of taxable income (determined without regard to the deduction). Carryovers to other years are adjusted to take account of this limitation.

The proposal repeals the special carryback provisions other than the provision relating to certain casualty and disaster losses.

Effective Date

The proposal limiting the NOL deduction for corporations applies to taxable years beginning after December 31, 2014.

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378 Sec. 172(b)(1)(A).

379 Sec. 172(b)(2).

The repeal of the special carryback rules generally applies to losses arising in taxable years beginning after December 31, 2014. The repeal of the extended carryback provisions which have expired is effective on the date of enactment.

7. Circulation expenditures (sec. 3107 of the discussion draft and sec. 173 of the Code)

Present Law

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life.[380] However, section 173 allows a deduction for expenditures to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical. In lieu of a current deduction, a taxpayer may elect to amortize such costs over a three-year period.[381]

Description of Proposal

The proposal requires that specified circulation expenditures be capitalized and amortized over the 36-month period beginning with the mid-point of the month in which the expenditures are paid or incurred.

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

The proposal provides transition relief allowing 75 percent of specified circulation expenditures made in taxable years beginning in 2016, 50 percent of specified circulation expenditures made in taxable years beginning in 2017, and 25 percent of specified circulation expenditures made in taxable years beginning in 2018, to be deducted, with the remaining percentage of the specified circulation expenditures to be capitalized and amortized over 36 months. The taxpayer may make an irrevocable election not to apply the transition rule.

Effective Date

The proposal applies to amounts paid or incurred in taxable years beginning after December 31, 2015.

[380] Secs. 167 and 263(a).

[381] Secs. 173(b) and 59(e).

8. Amortization of research and experimental expenditures (sec. 3108 of the discussion draft and sec. 174 of the Code)

Present Law

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life.[382] Taxpayers, however, may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business.[383] Taxpayers may choose to forgo a current deduction, capitalize their research expenditures, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months.[384] Taxpayers, alternatively, may elect to amortize their research expenditures over a period of 10 years.[385]

Amounts defined as research or experimental expenditures under section 174 generally include all costs incurred in the experimental or laboratory sense related to the development or improvement of a product.[386] In particular, qualifying costs are those incurred for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.[387] Uncertainty exists when information available to the taxpayer is not sufficient to ascertain the capability or method for developing, improving, and/or appropriately designing the product.[388] The determination of whether expenditures qualify as deductible research expenses depends on the nature of the activity to which the costs relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Examples of qualifying costs include

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382 Secs. 167 and 263(a).

383 Secs. 174(a) and (e).

384 Sec. 174(b). Taxpayers generating significant short-term losses often choose to defer the deduction for their research and experimentation expenditures under this section. Additionally, section 174 amounts are excluded from the definition of "start-up expenditures" under section 195 (section 195 generally provides that start-up expenditures in excess of $5,000 either are not deductible or are amortizable over a period of not less than 180 months once an active trade or business begins). So as not to generate significant losses before beginning their trade or business, a taxpayer may choose to defer the deduction and amortize its section 174 costs beginning with the month in which the taxpayer first realizes benefits from the expenditures.

385 Secs. 174(f)(2) and 59(e). This special 10-year election is available to mitigate the effect of the alternative minimum tax adjustment for research expenditures set forth in section 56(b)(2). Taxpayers with significant losses also may elect to amortize their otherwise deductible research and experimentation expenditures to reduce amounts that could be subject to expiration under the net operating loss carryforward regime.

386 Treas. Reg. sec. 1.174-2(a)(1) and (2). Product is defined to include any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

387 Treas. Reg. sec. 1.174-2(a)(1).

388 *Ibid.*

salaries for those engaged in research or experimentation efforts, amounts incurred to operate and maintain research facilities (*e.g.*, utilities, depreciation, rent), and expenditures for materials and supplies used and consumed in the course of research or experimentation (including amounts incurred in conducting trials).[389] In addition, under administrative guidance, the costs of developing computer software have been accorded treatment similar to research expenditures.[390]

However, generally no current deduction under section 174 is allowable for expenditures for the acquisition or improvement of land or of depreciable or depletable property used in connection with any research or experimentation.[391] In addition, no current deduction is allowed for research expenses incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.[392]

Description of Proposal

Under the proposal, amounts defined as specified research or experimental expenditures are required to be capitalized and amortized over a five-year period, beginning with the midpoint of the taxable year in which the specified research or experimental expenditures were paid or incurred. Specified research or experimental expenditures which are attributable to research that is conducted outside of the United States[393] are required to be capitalized and amortized over a period of 15 years, beginning with the midpoint of the taxable year in which such expenditures were paid or incurred. Specified research or experimental expenditures subject to capitalization include expenditures for software development.

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

As a conforming amendment to the repeal of the alternative minimum tax,[394] taxpayers may no longer elect to amortize their research expenditures over a period of 10 years.

A transition rule is provided for domestic research or experimental expenditures[395] paid or incurred during any taxable year beginning before 2021. For taxable years beginning in 2015,

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[389] See Treas. Reg. sec. 1.174-4(c). The definition of research and experimental expenditures also includes the costs of obtaining a patent, such as attorneys' fees incurred in making and perfecting a patent. Treas. Reg. sec. 1.174-2(a)(1).

[390] Rev. Proc. 2000-50, 2000-2 C.B. 601.

[391] Sec. 174(c).

[392] Sec. 174(d).

[393] For this purposes, the term "United States" inclndes the United States, the Commonwealth of Puerto Rico, and any possession of the United States.

[394] See the description of section 2001 of the discussion draft, "Repeal of alternative minimum tax."

60 percent of domestic research or experimental expenditures are allowed as a deduction and the remainder are capitalized and amortized over a two-year period. For taxable years beginning in 2016 and 2017, 40 percent of domestic research or experimental expenditures are allowed as a deduction and the remainder are capitalized and amortized over a three-year period. For taxable years beginning in 2018, 2019, and 2020, 20 percent of domestic research or experimental expenditures are allowed as a deduction and the remainder are capitalized and amortized over a four-year period. The taxpayer may make an irrevocable election not to apply the transition rule.

Effective Date

The proposal applies to amounts paid or incurred in taxable years beginning after December 31, 2014.

9. Repeal of deductions for soil and water conservation expenditures and endangered species recovery expenditures (sec. 3109 of the discussion draft and sec. 175 of the Code)

Present Law

Under present law, a taxpayer engaged in the business of farming may treat expenditures that are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, for the prevention of erosion of land used in farming, or made pursuant to a recovery plan under the Endangered Species Act of 1973[396] as expenses that are not chargeable to capital account. Such expenditures are allowed as a deduction, not to exceed 25 percent of the gross income derived from farming during the taxable year.[397] Any excess above such percentage is deductible for succeeding taxable years, not to exceed 25 percent of the gross income derived from farming during each succeeding taxable year.

Description of Proposal

The proposal repeals section 175 such that soil and water conservation expenditures and endangered species recovery expenditures must be capitalized in accordance with general tax principles.[398]

Effective Date

The proposal applies to amounts paid or incurred after December 31, 2014.

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[395] Domestic research or experimental expenditures are specified research or experimental expenditures which are attributable to research that is not conducted outside of the United States.

[396] 16 U.S.C. sec. 1533(f)(B).

[397] Sec. 175.

[398] See, *e.g.*, secs. 263(a) and 167.

10. Amortization of certain advertising expenses (sec. 3110 of the discussion draft and new sec. 177 of the Code)

Present Law

Advertising expenses generally are deductible as ordinary and necessary business expenses in the year in which they are paid or incurred.[399] Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and recovered over such useful life.[400]

Description of Proposal

Under the proposal, a taxpayer must capitalize and amortize 50 percent of its specified advertising expenses over a 10-year period, beginning with the midpoint of the tax year in which the expenses are paid or incurred. The remaining 50 percent of a taxpayer's specified advertising expenses may continue to be deducted in the year paid or incurred (as under present law).

The proposal provides an exemption from the capitalization requirement for taxpayers with advertising expenses for the taxable year of $1 million or less. However, if the taxpayer's otherwise deductible advertising expenses for any taxable year exceed $1.5 million, the $1 million amount is reduced (but not below zero) by twice such excess amount. The $1 million and $1.5 million amounts are adjusted for inflation in taxable years beginning after 2015.

A "specified advertising expense" is defined as any amount paid or incurred for the development, production, or placement (including any form of transmission, broadcast, publication, display, or distribution) of any communication to the general public (or portions thereof) which is intended to promote the taxpayer or a trade of business of the taxpayer, including any service, facility, or product provided as part of such trade or business. Specified advertising expense includes only deductions that would (but for this section) be deductible by the taxpayer for the taxable year under other provisions of the Code. Thus, the determination of amounts that are capitalizable under section 263 or other Code sections is not affected by this proposal.

The proposal provides certain exclusions from the definition of a specified advertising expense: (1) wages paid to the taxpayer's employees unless the employee's services are primarily related to specified advertising activities (including supervision of such employees); (2) depreciation expense allowed under section 167 for tangible property; (3) amortization deductions allowable under section 197;[401] (4) any discount, coupon, rebate, slotting allowance,

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[399] See sec. 162 and Rev. Rul. 92-80, 1992-2 C.B. 57.

[400] See secs. 263, 167, and 168.

[401] It is intended that amortization expenses allowable under other provisions of the Code (*e.g.*, section 167) are not part of this exception. For example, a taxpayer who acquires stadium naming rights and capitalizes such amount paid pursuant to section 263(a), includes the current year amortization of such amount as a specified advertising expense for purposes of this proposal. Likewise, a taxpayer who incurs costs in connection with entering into a three-year contract to receive advertising services and capitalizes such amounts pursuant to section 263(a)

sample, prize, loyalty reward point, or any other item determined by the Secretary to be similar; (5) amounts paid or incurred with respect to any communications appearing on the taxpayer's tangible property subject to depreciation or treated as inventory;[402] (6) amounts paid or incurred for the creation of any logo, trademark, or trade name; (7) amounts paid or incurred for package design;[403] (8) amounts paid or incurred for marketing research; (9) amounts paid or incurred for business meals; and (10) amounts paid or incurred as qualified sponsorship payments (as defined in section 513(i)(2)) with respect to an organization subject to the tax imposed by section 511.

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

A transition rule is provided for specified advertising expenses paid or incurred during any taxable year beginning before 2018. For taxable years beginning in 2015, 20 percent of specified advertising expenses are required to be capitalized and amortized over the 10-year period. For taxable years beginning in 2016, 30 percent of specified advertising expenses are required to be capitalized and amortized over the 10-year period. For taxable years beginning in 2017, 40 percent of specified advertising expenses are required to be capitalized and amortized over the 10-year period. The taxpayer may make an irrevocable election not to apply the transition rule.

While package design expenses are excluded from capitalization under new section 177, the proposal requires such costs to be treated as allocable indirect costs for purposes of section 263A with respect to packages which utilize such design.[404]

Effective Date

The proposal applies to amounts paid or incurred in taxable years beginning after December 31, 2014.

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includes the current year amortization of such amounts as a specified advertising expense for purposes of this proposal.

402 Items such as signage on the taxpayer's business premises or logo(s) appearing on the taxpayer's product(s) are intended to be covered under this exception.

403 "Package design" is any amount to which new section 263A(i) applies.

404 For a discussion of section 263A, see section 3312 of the discussion draft, "Modification of rules for capitalization and inclusion in inventory costs of certain expenses."

11. Expensing certain depreciable business assets for small business (sec. 3111 of the discussion draft and sec. 179 of the Code)

Present Law

A taxpayer may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation.[405] For taxable years beginning in 2013, the maximum amount a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year.[406] The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,000,000.[407] The $500,000 and $2,000,000 amounts are not indexed for inflation.

In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. For taxable years beginning before 2014, qualifying property also includes off-the-shelf computer software and qualified real property (*i.e.*, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).[408] Of the $500,000 expense amount available under section 179, the maximum amount available with respect to qualified real property is $250,000 for each taxable year.[409]

For taxable years beginning in 2014 and thereafter, a taxpayer may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year, subject to limitation. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property (not including off-the-shelf computer software or qualified real property) that is purchased for use in the active conduct of a trade or business.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for such taxable year that is derived from the active conduct of a trade or business (determined

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[405] Additional section 179 incentives have been provided with respect to qualified property meeting applicable requirements that is used by a business in an enterprise zone (sec. 1397A), a renewal community (sec. 1400J), the New York Liberty Zone (sec. 1400L(f)), or the Gulf Opportunity Zone (sec. 1400N(e)). In addition, section 179(e) provides for an enhanced section 179 deduction for qualified disaster assistance property.

[406] For the years 2003 through 2006, the relevant dollar amount is $100,000 (indexed for inflation); in 2007, the dollar limitation is $125,000; for the 2008 and 2009 years, the relevant dollar amount is $250,000; and for 2010, 2011, and 2012, the relevant dollar limitation is $500,000. Sec. 179(b)(1).

[407] For the years 2003 through 2006, the relevant dollar amount is $400,000 (indexed for inflation); in 2007, the dollar limitation is $500,000; for the 2008 and 2009 years, the relevant dollar amount is $800,000; and for 2010, 2011, and 2012, the relevant dollar limitation is $2,000,000. Sec. 179(b)(2).

[408] Secs. 179(d)(1)(A)(ii) and (f).

[409] Sec. 179(f)(3).

without regard to this provision).[410] Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to limitations). However amounts attributable to qualified real property that are disallowed under the trade or business income limitation may only be carried over to taxable years in which the definition of eligible section 179 property includes qualified real property.[411] Thus, if a taxpayer's section 179 deduction for 2012 with respect to qualified real property is limited by the taxpayer's active trade or business income, such disallowed amount may be carried over to 2013. Any such carryover amounts that are not used in 2013 are treated as property placed in service in 2013 for purposes of computing depreciation. That is, the unused carryover amount from 2012 is considered placed in service on the first day of the 2013 taxable year.[412]

No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.[413] An expensing election is made under rules prescribed by the Secretary.[414] In general, any election or specification made with respect to any property may not be revoked except with the consent of the Commissioner. However, an election or specification under section 179 may be revoked by the taxpayer without consent of the Commissioner for taxable years beginning after 2002 and before 2014.[415]

Description of Proposal

The proposal provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2013, is $250,000 of the cost of qualifying property placed in service for the taxable year. The $250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $800,000. The $250,000 and $800,000 amounts are indexed for inflation for taxable years beginning after 2014.

In addition, the proposal makes permanent, for taxable years beginning after 2013, the treatment of off-the-shelf computer software as qualifying property. The proposal also makes

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[410] Sec. 179(b)(3).

[411] Section 179(f)(4) details the special rules that apply to disallowed amounts.

[412] For example, assume that during 2012, a company's only asset purchases are section 179-eligible equipment costing $100,000 and qualifying leasehold improvements costing $200,000. Assume the company has no other asset purchases during 2012, and has a taxable income limitation of $150,000. The maximnm section 179 deduction the company can claim for 2012 is $150,000, which is allocated pro rata between the properties, such that the carryover to 2013 is allocated $100,000 to the qualified leasehold improvements and $50,000 to the equipment.

Assume further that in 2013, the company had no asset purchases and had taxable income of $0. The $100,000 carryover from 2012 attributable to qualified leasehold improvements is treated as placed in service as of the first day of the company's 2013 taxable year. The $50,000 carryover allocated to equipment is carried over to 2013 under section 179(b)(3)(B).

[413] Sec. 179(d)(9).

[414] Sec. 179(c)(1).

[415] Sec. 179(c)(2).

permanent the treatment of qualified real property as eligible section 179 property for taxable years beginning after 2013.

The proposal permits the taxpayer to revoke any election and any specification contained therein, made under section 179 after 2002.

Further, the proposal strikes the flush language in section 179(d)(1) that excludes air conditioning and heating units from the definition of qualifying property.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2013.

12. Repeal of election to expense certain refineries (sec. 3112 of the discussion draft and sec. 179C of the Code)

Present Law

Section 179C provides a temporary election to expense 50 percent of qualified refinery property. The remaining 50 percent is recovered as under present law.[416] Qualified refinery property includes assets, located in the United States, used in the refining of liquid fuels: (1) with respect to the construction of which there is a binding construction contract before January 1, 2010; (2) which are placed in service before January 1, 2014; (3) which increase the capacity of an existing refinery by at least five percent or increase the percentage of total throughput attributable to qualified fuels (as defined in section 45K(c)) such that it equals or exceeds 25 percent; and (4) which meet all applicable environmental laws in effect when the property is placed in service.

Description of Proposal

The proposal repeals section 179C.

Effective Date

The proposal is effective for property placed in service after December 31, 2013.

13. Repeal of deduction for energy efficient commercial buildings (sec. 3113 of the discussion draft and sec. 179D of the Code)

Present Law

Section 179D provides a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer.[417] The deduction is limited to an amount equal to

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[416] See sec. 168.

[417] Energy-efficient commercial building property is defined as property (1) which is installed on or in any building located in the United States that is within the scope of Standard 90.1-2001 of the American Society of

$1.80 per square foot of the property for which such expenditures are made.[418] The deduction is allowed in the year in which the property is placed in service.[419]

If a deduction is allowed under this section, the basis of the property is reduced by the amount of the deduction.[420] The deduction is effective for property placed in service after December 31, 2005, and prior to January 1, 2014.[421]

If a corporation makes an election under section 179D to deduct expenditures, the full amount of the deduction does not reduce earnings and profits. Rather, the expenditures that are deducted reduce corporate earnings and profits ratably over a five-year period.[422]

Description of Proposal

The proposal repeals section 179D. The proposal also repeals the related earnings and profits rule.

Effective Date

The proposal is effective for property placed in service after December 31, 2013.

14. Repeal of election to expense advanced mine safety equipment (sec. 3114 of the discussion draft and sec. 179E of the Code)

Present Law

A taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as an expense in the taxable year in which the equipment is placed in service.[423] "Qualified advanced mine safety equipment property" means any advanced mine safety equipment property for use in any underground mine located in the United States the

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Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America ("ASHRAE/IESNA"), (2) which is installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, and (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1-2001 (as in effect on April 2, 2003). Sec. 179D(c).

[418] Sec. 179D(b).

[419] Sec. 179D(a).

[420] Sec. 179D(e).

[421] Sec. 179D(h).

[422] Sec. 312(k)(3)(B).

[423] Sec. 179E(a).

original use of which commences with the taxpayer and which is placed in service after December 20, 2006, and before January 1, 2014.[424]

Advanced mine safety equipment property means any of the following: (1) emergency communication technology or devices used to allow a miner to maintain constant communication with an individual who is not in the mine; (2) electronic identification and location devices that allow individuals not in the mine to track at all times the movements and location of miners working in or at the mine; (3) emergency oxygen-generating, self-rescue devices that provide oxygen for at least 90 minutes; (4) pre-positioned supplies of oxygen providing each miner on a shift the ability to survive for at least 48 hours; and (5) comprehensive atmospheric monitoring systems that monitor the levels of carbon monoxide, methane and oxygen that are present in all areas of the mine and that can detect smoke in the case of a fire in a mine.[425]

Description of Proposal

The proposal repeals section 179E.

Effective Date

The proposal applies to property placed in service after December 31, 2013.

15. Repeal of deduction for expenditures by farmers for fertilizer, etc. (sec. 3115 of the discussion draft and sec. 180 of the Code)

Present Law

A taxpayer engaged in the business of farming may elect to deduct expenses (otherwise chargeable to capital account) which are paid or incurred during the taxable year for the purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming.[426]

Description of Proposal

The proposal repeals section 180 such that amounts paid or incurred during the taxable year for the purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming are subject to the general capitalization principles.[427]

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[424] Secs. 179E(c) and (g).

[425] Sec. 179E(d).

[426] Sec. 180.

[427] See, *e.g.*, secs. 471 and 263A.

Effective Date

The proposal applies to expenses paid or incurred in taxable years beginning after December 31, 2014.

16. Repeal of special treatment of certain qualified film and television productions (sec. 3116 of the discussion draft and sec. 181 of the Code)

Present Law

Under section 181, taxpayers may elect[428] to deduct the cost of any qualifying film and television production, commencing prior to January 1, 2014, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.[429] Taxpayers may elect to deduct up to $15 million of the aggregate cost of the film or television production under this section.[430] The threshold is increased to $20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.[431]

A qualified film or television production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format) or television program if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.[432] The term "compensation" does not include participations and residuals (as defined in section 167(g)(7)(B)).[433] With respect to property which is one or more episodes in a television series, each episode is treated as a separate production and only the first 44 episodes qualify under the provision.[434] Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.[435]

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[428] See Treas. Reg. section 1.181-2 for rules on making an election under this section.

[429] For this purpose, a production is treated as commencing on the first date of principal photography.

[430] Sec. 181(a)(2)(A).

[431] Sec. 181(a)(2)(B).

[432] Sec. 181(d)(3)(A).

[433] Sec. 181(d)(3)(B).

[434] Sec. 181(d)(2)(B).

[435] Sec. 181(d)(2)(C).

For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as if it were a deduction allowable for amortization.[436]

Description of Proposal

The proposal repeals section 181 such that amounts paid or incurred to produce any film or television program are subject to the general capitalization principles and cost recovery rules.[437]

Effective Date

The proposal applies to productions commencing after December 31, 2013.

17. Repeal of special rules for recoveries of damages of antitrust violations, etc. (sec. 3117 of the discussion draft and sec. 186 of the Code)

Present Law

In the case of losses resulting from a patent infringement, a breach of fiduciary duty, or antitrust injury for which there is a recovery under section 4 of the Clayton Act,[438] a special deduction is allowed which has the effect of reducing the amounts required to be included in income to the extent that the losses to which they relate did not give rise to a tax benefit.[439]

When a compensatory amount is received or accrued during a year for a compensable injury, a deduction is allowed for the compensatory amount or, if smaller, the unrecovered losses sustained as a result of the compensable injury.[440] Compensable injuries are those sustained as a result of a patent infringement, a breach of contract, or a breach of fiduciary duty or an antitrust injury for which there is a recovery under section 4 of the Clayton Act.[441]

The compensatory amount is the amount received or accrued as damages either as an award in or settlement of a civil action for recovery of a compensable injury.[442] This is to be reduced by the expenses in securing the award or settlement. The provision applies only to recoveries for actual injury and not for any additional amounts.

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[436] Sec. 1245(a)(2)(C).

[437] See secs. 167 and 263A. See also the description of section 3313 of the discussion draft, "Modification of income forecast method."

[438] 15 U.S.C. sec. 15.

[439] Sec. 186.

[440] Sec. 186(a).

[441] Sec. 186(b).

[442] Sec. 186(c).

The unrecovered losses are the net operating losses attributable to the compensatory injury reduced by those allowed as a deduction as a loss carryback or carryover.[443] These net operating losses are also reduced by the amount (if any) of a recovery of a compensatory amount in any other years against which these losses were offset.

Description of Proposal

The proposal repeals section 186 such that compensatory amounts are includable in income in accordance with generally applicable income and revenue recognition principles.[444]

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

18. Treatment of reforestation expenditures (sec. 3118 of the discussion draft and sec. 194 of the Code)

Present Law

A taxpayer may elect to expense up to $10,000 ($5,000 in the case of a separate return by a married individual) of qualifying reforestation expenditures incurred during the taxable year with respect to qualifying timber property.[445] The remaining expenditures are amortized over 84 months (seven years) subject to a mandatory half-year convention.[446] In the case of an individual, the amortization deduction is allowed in determining adjusted gross income (*i.e.*, an "above-the-line deduction") rather than as an itemized deduction.[447]

Qualifying reforestation expenditures are the direct costs a taxpayer incurs in connection with the forestation or reforestation of a site by planting or seeding, and include costs for the preparation of the site, the cost of the seed or seedlings, and the cost of the labor and tools (including depreciation of long lived assets such as tractors and other machines) used in the reforestation activity.[448] Qualifying reforestation expenditures do not include expenditures that would otherwise be deductible and do not include costs for which the taxpayer has been reimbursed under a governmental cost sharing program, unless the amount of the reimbursement is also included in the taxpayer's gross income.[449]

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[443] Sec. 186(d).

[444] See secs. 61 and 451.

[445] Sec. 194.

[446] Sec. 194(a).

[447] Sec. 62(a)(11).

[448] Sec. 194(c)(3).

[449] Treas. Reg. sec. 1.194-3(c).

Qualifying timber property means a woodlot or other site located in the United States which will contain trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products.[450] Qualified timber property does not include either property on which the taxpayer has planted shelter beds (for which section 175 deductions are allowed) or ornamental trees.[451]

Reforestation amortization is subject to recapture as ordinary income on the sale of qualifying timber property within 10 years of the year in which the qualifying reforestation expenditures were incurred.[452]

Description of Proposal

The proposal eliminates the election to expense up to $10,000 ($5,000 in the case of a separate return by a married individual) of qualified reforestation expenditures. Thus, all qualified reforestation expenditures are required to be capitalized and amortized over seven years. The term "qualified reforestation expenditures" means the reforestation expenditures[453] paid or incurred by the taxpayer during the taxable year with respect to qualified timber property.

The proposal changes the definition of qualified timber property to include only property held by the taxpayer for the planting, cultivating, caring for, and cutting of evergreen trees (that are more than six years old when cut) for sale for ornamental purposes. It is intended that costs related to property that no longer meets the definition of qualified timber property shall be included in basis and recovered using cost depletion.[454]

Effective Date

The proposal applies to expenditures paid or incurred in taxable years beginning after December 31, 2014.

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[450] Sec. 194(c)(1).

[451] Treas. Reg. sec. 1.194-3(a).

[452] Sec. 1245(b)(7).

[453] The present-law definition of reforestation expenditures is not changed.

[454] See also the discussion of section 3132 of the discussion draft, "Repeal of special rules for gain or loss on timber, coal, or domestic iron ore."

19. 20-year amortization of goodwill and certain other intangibles (sec. 3119 of the discussion draft and sec. 197 of the Code)

Present Law

Under section 197, when a taxpayer acquires intangible assets held in connection with a trade or business, any value properly attributable to a "section 197 intangible" is amortizable on a straight-line basis over 15 years.[455] Such intangibles include goodwill; going concern value; workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment; business books and records, operating systems, or other information base; any patent, copyright, formula, process, design, pattern, knowhow, format, or similar item; customer-based intangibles; supplier-based intangibles; and any other similar item.[456] The definition of a section 197 intangible also includes any license, permit, or other rights granted by governmental units (even if the right is granted for an indefinite period or is reasonably expected to be renewed indefinitely);[457] any covenant not to compete; and any franchise, trademark, or trade name.[458]

However, interests in land, including leases, easements, grazing rights, and mineral rights granted by a government, may not be amortized over the 15-year period provided in section 197, but instead must be amortized over the period of the grant of the right.[459] Certain financial interests,[460] certain computer software readily available for purchase by the general public,[461] and certain rights acquired separately from the acquisition of assets constituting a trade or business (or substantial portion thereof)[462] are not subject to the 15-year amortization. Certain interests

[455] Secs. 197(a) and 197(c). A franchise is included in the definition of a section 197 intangible. Secs. 197(d)(1)(F) and 197(f)(4). A franchise is defined as "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." Sec. 1253(b)(1).

[456] Sec. 197(d)(1).

[457] Sec. 197(d)(1)(D). Examples include a liquor license, a taxi-cab medallion, an airport landing or take-off right, a regulated airline route, or a television or radio broadcasting license. Renewals of such governmental rights are treated as the acquisition of a new 15-year asset. Treas. Reg. sec. 1.197-2(b)(8). A license, permit, or other right granted by a governmental unit is a franchise if it otherwise meets the definition of a franchise. Treas. Reg. sec. 1.197-2(b)(10). Section 197 intangibles do not include certain rights granted by a government not considered part of the acquisition of a trade or business. Sec. 197(e)(4)(B) and Treas. Reg. sec. 1.197-2(c)(13).

[458] Sec. 197(d)(1)(F).

[459] Sec. 197(e)(2). Treas. Reg. sec. 1.197-2(c)(3). An interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television service. The cost of acquiring a license, permit, or other land improvement right, such as a building construction or use permit, is taken into account in the same manner as the underlying improvement. Treas. Reg. sec. 1.197-2(c)(3).

[460] Sec. 197(e)(1).

[461] Sec. 197(e)(3).

[462] Sec. 197(e)(4).

under leases and debt instruments,[463] any right to service indebtedness which is secured by residential real property (unless such right is acquired as part of the acquisition of a trade or business, or substantial portion thereof) ("mortgage servicing rights"),[464] and certain transaction costs[465] are not section 197 intangibles. In addition, certain self-created intangibles, such as goodwill created through advertising and other expenses, are not subject to section 197.[466]

While mortgage servicing rights are explicitly excluded from section 197, section 167 provides that mortgage servicing rights are depreciated using the straight-line method over a 108-month period.[467] Similarly, section 167 provides that computer software excluded from section 197 is depreciated using the straight-line method over a 36-month period.[468] With respect to certain interests or rights not acquired as part of a purchase of a trade or business that are excluded from section 197, the regulations under section 167 prescribe the amortization method and period based on the type of interest or right separately acquired.[469]

Description of Proposal

The proposal provides that section 197 intangibles are amortized ratably over a 20-year period beginning with the month in which such intangible was acquired. Under the proposal, the exception to the definition of section 197 intangibles for mortgage servicing rights is repealed.[470]

Effective Date

The proposal applies to property acquired after December 31, 2014.

[463] Sec. 197(e)(5).

[464] Sec. 197(e)(6).

[465] Sec. 197(e)(7).

[466] Sec. 197(c)(2). Treas. Reg. sec. 1.197-2(d)(2). See Treas. Reg. secs. 1.263(a)-4(d)(2) and 1.167(a)-3 for the rules governing the capitalization and amortization of certain self-created intangibles.

[467] Sec. 167(f)(3). Treas. Reg. sec. 1.167(a)-14(d).

[468] Sec. 167(f)(1). Treas. Reg. sec. 1.167(a)-14(b).

[469] Sec. 167(f)(2). Treas. Reg. sec. 1.167(a)-14(c).

[470] Since mortgage servicing rights are not excluded from the definition of a section 197 intangible, it is intended that such mortgage servicing rights are considered section 197 intangibles for property acquired after December 31, 2014.

20. Treatment of environmental remediation costs (sec. 3120 of the discussion draft and sec. 198 of the Code)

Present Law

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[471] Treasury regulations provide that a taxpayer may deduct the repair and maintenance costs of tangible property if such amounts are not otherwise required to be capitalized.[472] Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations generally require taxpayers to capitalize amounts paid or incurred that are for a betterment to a unit of property, restore a unit of property, or adapt a unit of property to a new or different use.[473] Amounts paid for repairs and maintenance generally do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on all relevant facts and circumstances.

Taxpayers may elect to treat certain environmental remediation expenditures paid or incurred before January 1, 2012, that would otherwise be chargeable to capital account as deductible in the year paid or incurred.[474] The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.[475] In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure.[476] However, depreciation deductions allowable for such property that would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*[477] and section 263A are treated as qualified environmental remediation expenditures.[478]

A "qualified contaminated site" (a so-called "brownfield") generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance.[479] Both urban and rural

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[471] Sec. 162.

[472] Treas. Reg. sec. 1.162-4(a).

[473] Treas. Reg. sec. 1.263(a)-3(d).

[474] Sec. 198.

[475] Sec. 198(b)(1).

[476] Sec. 198(b)(2).

[477] 418 U.S. 1 (1974).

[478] *Ibid.*

[479] Sec. 198(c).

property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA")[480] cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use, as well as petroleum products defined in section 4612(a)(3).[481]

In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under section 198 is treated as a depreciation deduction and the property is treated as section 1245 property.[482] Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon a sale or other disposition of the property. In addition, sections 280B (demolition of structures) and 468 (special rules for mining and solid waste reclamation and closing costs) do not apply to amounts that are treated as expenses under section 198.[483]

Description of Proposal

The proposal requires qualified environmental remediation expenditures[484] to be capitalized and amortized over a 40-year period.

Effective Date

The proposal is effective for expenditures paid or incurred after December 31, 2014.

21. Repeal of expensing of qualified disaster expenses (sec. 3121 of the discussion draft and sec. 198A of the Code)

Present Law

Under present law, a taxpayer may elect to treat any qualified disaster expense that is paid or incurred by the taxpayer as a deduction for the taxable year in which paid or incurred.[485] For purposes of the provision, a qualified disaster expense is any otherwise capitalizable expenditure paid or incurred in connection with a trade or business or with business-related property that is: (1) for the abatement or control of hazardous substances that were released on

[480] Pub. L. No. 96-510 (1980).

[481] Sec. 198(d).

[482] Sec. 198(e).

[483] Sec. 198(f).

[484] The present-law definition of qualified environmental remediation expenditures is not changed.

[485] Sec. 198A.

account of a Federally declared disaster[486] occurring before January 1, 2010; (2) for the removal of debris from, or the demolition of structures on, real property damaged or destroyed as a result of a Federally declared disaster occurring before January 1, 2010; or (3) for the repair of business-related property damaged as a result of a Federally declared disaster occurring before January 1, 2010.[487]

For purposes of this provision, "business-related property" is property held by the taxpayer for use in a trade or business, for the production of income, or as inventory.[488] In addition, for purposes of recapture as ordinary income, any deduction allowed under this provision is treated as a deduction for depreciation and the property to which the amount would have been capitalized is treated as section 1245 property for purposes of depreciation recapture.[489]

This provision does not apply to any disaster that has been declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the "Act") by reason of severe storms, tornados, or flooding occurring during 2008 in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.[490]

Description of Proposal

The proposal repeals section 198A such that amounts properly chargeable to capital account generally are not permitted a current deduction.

Effective Date

The proposal is effective for amounts paid or incurred after December 31, 2014.

22. Phaseout and repeal of deduction for income attributable to domestic production activities (sec. 3122 of the discussion draft and sec. 199 of the Code)

Present Law

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income[491]) that is equal to nine percent (six percent in the case of oil related

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486 The term "Federally declared disaster" has the meaning given such term by section 165(h)(3)(C)(i).

487 Sec. 198A(b).

488 Sec. 198A(c)(1).

489 Sec. 198A(d).

490 Section 712 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343.

491 For this purpose, adjusted gross income is determined after application of sections 86, 135, 137, 219, 221, 222, and 469, without regard to the section 199 deduction. Sec. 199(d)(2).

qualified production activities income) of the lesser of the taxpayer's qualified production activities income or taxable income for the taxable year.[492] For taxpayers subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to just under 32 percent on qualified production activities income.[493]

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; and (2) other expenses, losses, or deductions which are properly allocable to those receipts.[494]

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property[495] that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States[496] (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film[497] produced by the taxpayer; (3) any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or

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[492] Sec. 199. With respect to a taxpayer that has oil related qualified production activities income, the deduction is limited to six percent of the least of its oil related production activities income, its qualified production activities income, or its taxable income. Sec. 199(d)(9). "Oil related qualified production activities income" means the qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas or any primary product thereof (as defined in section 927(a)(2)(C) prior to its repeal).

[493] This example assumes the deduction does not exceed the wage limitation.

[494] Sec. 199(c)(1). In computing qualified production activities income, the domestic production activities deduction itself is not an allocable deduction. Sec. 199(c)(1)(B)(ii). See Treas. Reg. secs. 1.199-1 through 1.199-9 where the Secretary has prescribed rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining qualified production activities income.

[495] Qualifying production property generally includes any tangible personal property, computer software, and sound recordings. Sec. 199(c)(5).

[496] When used in the Code in a geographical sense, the term "United States" generally includes only the States and the District of Columbia. Sec. 7701(a)(9). A special rule for determining domestic production gross receipts, however, provides that for taxable years beginning after December 31, 2005 and before January 1, 2014, in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term "United States" includes the Commonwealth of Puerto Rico, but only if all of the taxpayer's Puerto Rico-sourced gross receipts are taxable under the Federal income tax for individuals or corporations for such taxable year. Secs. 199(d)(8)(A) and (C). In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico. Sec. 199(d)(8)(B).

[497] Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers. Sec. 199(c)(6).

business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.[498]

The amount of the deduction for a taxable year is limited to 50 percent of the W-2 wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.[499]

Description of Proposal

The proposal repeals section 199 for taxable years beginning after December 31, 2016. However, the repeal is phased in: for taxable years beginning in 2015, the deduction is reduced to 6 percent and for taxable years beginning in 2016 the deduction is reduced to 3 percent. The proposal repeals the limitation for oil related qualified production activities income for taxable years beginning after December 31, 2014, such that for oil-related qualified production activities income, the percentage deduction allowed for taxable years beginning in 2015 and 2016 is the same percentage generally allowed for all other qualified production activities income.

Effective Date

For the phase-out of present law section 199, the proposal applies to taxable years beginning after December 31, 2014. For the repeal of section 199, the proposal applies to taxable years beginning after December 31, 2016.

23. Unification of deduction for organizational expenditures (sec. 3123 of the discussion draft and secs. 195, 248, and 709 of the Code)

Present Law

A taxpayer may elect to deduct up to $5,000 of start-up expenditures in the taxable year in which the active trade or business begins.[500] A corporation or a partnership may elect to deduct up to $5,000 of organizational expenditures in the taxable year in which the active trade or business begins.[501] However, in each case, the $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds

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[498] Sec. 199(c)(4).

[499] For purposes of the provision, "W-2 wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A). See sec. 199(b)(2). The wage limitation for qualified films includes any compensation for services performed in the United States by actors, prodnction personnel, directors, and producers and is not restricted to W-2 wages. Sec. 199(b)(2)(D), effective for taxable years beginning after December 31, 2007.

[500] Sec. 195(b)(1)(A).

[501] Secs. 248(a)(1) and 709(b)(1)(A).

$50,000.[502] Pursuant to such election, the remainder of such start-up expenditures and organizational expenditures may be amortized over a period of not less than 180 months, beginning with the month in which the trade or business begins.[503] A taxpayer is deemed to make an election to deduct and amortize start-up or organizational expenditures for the applicable taxable year, unless the taxpayer affirmatively elects to capitalize such amounts on a timely-filed (including extensions) Federal income tax return.[504] Capitalized amounts are recovered when the business is sold, exchanged, or otherwise disposed.[505]

Start-up expenditures are amounts that would have been deductible as trade or business expenses had they not been paid or incurred before business began.[506] Organizational expenditures are expenditures that are incident to the creation of a corporation or the organization of a partnership, are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.[507]

Description of Proposal

Under the proposal, the rules for start-up expenditures (section 195) and organizational expenditures (sections 248 and 709) are consolidated into a single provision.[508] A taxpayer may elect to deduct up to $10,000 of the sum of start-up and organizational expenditures in the taxable year in which the active trade or business begins. The $10,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of the sum of start-up and organizational expenditures exceeds $60,000. Pursuant to such election, the remainder of such start-up expenditures and organizational expenditures may be amortized over a period of not less than 15 years, beginning with the midpoint of the taxable year in which the trade or business begins.

Effective Date

The proposal applies to expenses paid or incurred in taxable years beginning after December 31, 2014.

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[502] Secs. 195(b)(1)(A)(ii), 248(a)(1)(B) and 709(b)(1)(A)(ii). However, for taxable years beginning in 2010, the Small Business Jobs Act of 2010, Pub. L. No. 111-240, increased the amount of start-up expenditures a taxpayer could elect to deduct to $10,000, with a phase-out threshold of $60,000. Sec. 195(b)(3).

[503] Secs. 195(b)(1)(B), 248(a)(2) and 709(b)(1)(B).

[504] Treas. Reg. secs. 1.195-1(b), 1.248-1(c), 1.709-1(b)(2).

[505] Secs. 195(b)(2) and 709(b)(2). See also Treas. Reg. sec. 1.709-1(b)(3) and *Kingsford Co. v. Commissioner*, 41 T.C. 646 (1964).

[506] Sec. 195(c)(1).

[507] Secs. 248(b) and 709(b)(3).

[508] The definitions of start-up and organizational expenditures are unchanged by the provision.

24. Prevention of arbitrage of deductible interest expense and tax-exempt interest income (sec. 3124 of the discussion draft and sec. 265 of the Code)

Present Law

Expenses and interest relating to tax-exempt income

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax.[509] In general, an interest deduction is disallowed only if the taxpayer has a purpose of using borrowed funds to purchase or carry tax-exempt obligations; a determination of the taxpayer's purpose in borrowing funds is made based on all of the facts and circumstances.[510]

Two-percent rule for individuals and certain nonfinancial corporations

In the absence of direct evidence linking an individual taxpayer's indebtedness with the purchase or carrying of tax-exempt obligations, the Internal Revenue Service takes the position that it ordinarily will not infer that a taxpayer's purpose in borrowing money was to purchase or carry tax-exempt obligations if the taxpayer's investment in tax-exempt obligations is "insubstantial."[511] An individual's holdings of tax-exempt obligations are presumed to be insubstantial if during the taxable year the average adjusted basis of the individual's tax-exempt obligations is two percent or less of the average adjusted basis of the individual's portfolio investments and assets held by the individual in the active conduct of a trade or business.

Similarly, in the case of a corporation that is not a financial institution or a dealer in tax-exempt obligations, where there is no direct evidence of a purpose to purchase or carry tax-exempt obligations, the corporation's holdings of tax-exempt obligations are presumed to be insubstantial if the average adjusted basis of the corporation's tax-exempt obligations is two percent or less of the average adjusted basis of all assets held by the corporation in the active conduct of its trade or business.

Financial institutions

In the case of a financial institution, the Code generally disallows that portion of the taxpayer's interest expense that is allocable to tax-exempt interest.[512] The amount of interest that is disallowed is an amount that bears the same ratio to such interest expense as the taxpayer's average adjusted bases of tax-exempt obligations acquired after August 7, 1986, bears to the average adjusted bases for all assets of the taxpayer.

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[509] Sec. 265(a).

[510] See Rev. Proc. 72-18, 1972-1 C.B. 740.

[511] *Ibid.*

[512] Sec. 265(b)(1). A "financial institution" is any person that (1) accepts deposits from the public in the ordinary course of such person's trade or business and is subject to Federal or State supervision as a financial institution or (2) is a corporation described by section 585(a)(2). Sec. 265(b)(5).

Exception for certain obligations of qualified small issuers

The general rule denying financial institutions' interest expense deductions allocable to tax-exempt obligations does not apply to qualified tax-exempt obligations. Instead, only 20 percent of the interest expense allocable to qualified tax-exempt obligations is disallowed.[513] A qualified tax-exempt obligation is a tax-exempt obligation that (1) is issued after August 7, 1986, by a qualified small issuer, (2) is not a private activity bond, and (3) is designated by the issuer as qualifying for the exception from the general rule of section 265(b).[514]

A qualified small issuer is an issuer that reasonably anticipates that the amount of tax-exempt obligations that it will issue during the calendar year will be $10 million or less. The Code specifies the circumstances under which an issuer and all subordinate entities are aggregated. For purposes of the $10 million limitation, an issuer and all entities that issue obligations on behalf of such issuer are treated as one issuer. All obligations issued by a subordinate entity are treated as being issued by the entity to which it is subordinate. An entity formed (or availed of) to avoid the $10 million limitation and all entities benefiting from the device are treated as one issuer.

Composite issues (*i.e.*, combined issues of bonds for different entities) qualify for the qualified tax-exempt obligation exception only if the requirements of the exception are met with respect to (1) the composite issue as a whole (determined by treating the composite issue as a single issue) and (2) each separate lot of obligations that is part of the issue (determined by treating each separate lot of obligations as a separate issue). Thus a composite issue may qualify for the exception only if the composite issue itself does not exceed $10 million, and if each issuer benefitting from the composite issue reasonably anticipates that it will not issue more than $10 million of tax-exempt obligations during the calendar year, including through the composite arrangement.

Investment interest expense

In the case of a taxpayer other than a corporation, the deduction allowable for investment interest for any taxable year may not exceed the investment income for the year.[515] Investment interest means interest paid or accrued on indebtedness incurred to purchase or carry property held for investment. Net investment income includes gross income from property held for investment reduced by investment expenses (other than interest) directly connected with the production of investment income.

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[513] Secs. 265(b)(3)(A), 291(a)(3), and 291(e)(1). Section 291(a)(3) reduces by 20 percent the amount allowable as a deduction with respect to any financial institution preference item. Financial institution preference items include interest on debt to carry tax-exempt obligations acquired after December 31, 1982, and before August 8, 1986. Section 265(b)(3) treats qualified tax-exempt obligations as if they were acquired on August 7, 1986. As a result, the amount allowable as a deduction by a financial institution with respect to interest incurred to carry a qualified tax-exempt obligation is reduced by 20 percent.

[514] Special rules apply to bonds issued during 2009 and 2010. Secs. 265(b)(3)(G) and 265(b)(7).

[515] Sec. 163(d).

The two-percent floor on miscellaneous itemized deductions allows taxpayers to deduct investment expenses connected with investment income only to the extent such deductions exceed two percent of the taxpayer's adjusted gross income ("AGI").[516] Miscellaneous itemized deductions[517] that are not investment expenses are disallowed first before any investment expenses are disallowed.[518]

Description of Proposal

Pro rata allocation of interest expense for corporations

The proposal applies the present-law financial institution rules to all C corporations. That is, in the case of a C corporation or financial institution, no deduction is allowed for that portion of the taxpayer's interest expense that is allocable to tax-exempt interest. The amount of interest that is disallowed is an amount that bears the same ratio to such interest expense as the taxpayer's average adjusted bases of tax-exempt obligations acquired on or after February 26, 2014 (August 7, 1986, in the case of a financial institution), bears to the average adjusted bases for all assets of the taxpayer.

The proposal repeals the special exception for any qualified tax-exempt obligation of a qualified small issuer and the special exception for certain bonds issued during 2009 or 2010. The proposal also repeals the tracing rule of section 265(a) with respect to interest.

Investment interest expense

In the case of a taxpayer other than a corporation or financial institution, the amount otherwise allowed as a deduction for investment interest for a taxable year is reduced by the amount of tax-exempt interest received by the taxpayer during the year. The amount of investment interest after the reduction is limited to the amount of investment income as under present law, with the excess (if any) carried over and treated as investment interest in the succeeding taxable year.

Under the proposal, tax-exempt debt is treated as property held for investment so that any interest expense properly allocable to tax-exempt debt is treated as investment interest subject to the limitations described above.

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[516] Sec. 67(a).

[517] The miscellaneous itemized deductions are defined in section 67(b) to include itemized deductions of individuals other than certain specific itemized deductions. Thus, miscellaneous itemized deductions generally include, for example, investment management fees and certain employee business expenses, but specifically do not include, for example, interest, taxes, casualty and theft losses, charitable contributions, medical expenses, or other listed itemized deductions.

[518] H.R. Rep. No. 841, 99th Cong., 2d Sess., p. II-154, Sept. 18, 1986 (Conf. Rep.) ("In computing the amount of expenses that exceed the 2-percent floor, expenses that are not investment expenses are intended to be disallowed before any investment expenses are disallowed.").

The following examples illustrate the application of the proposal in the case of a taxpayer other than a corporation or financial institution:

Example 1.—Assume an individual has $100 taxable interest income, $100 tax-exempt interest income, and $20 interest expense properly allocable to the property that produced that income. Under the proposal, $20 of the interest expense is not allowed as a deduction in any taxable year.

Example 2.—Assume the same facts except that the interest expense is $120. $100 is not allowed as a deduction, $20 is allowed as a deduction currently.

Example 3.—Assume the same facts except that the interest expense is $220. $100 is not allowed as a deduction, $100 is allowed as a deduction currently, and $20 is carried forward to the next succeeding taxable year.

Effective Date

The pro rata allocation of interest expense to tax-exempt interest for corporations and financial institutions applies to taxable years ending on or after February 26, 2014.

The repeal of the special exceptions for any qualified tax-exempt obligation of a qualified small issuer and the special exception for certain bonds issued during 2009 or 2010 applies for obligations issued on or after February 26, 2014.

The limitation on investment interest for a taxpayer other than a corporation or financial institution applies to taxable years beginning after December 31, 2014.

25. Prevention of transfer of certain losses from tax indifferent parties (sec. 3125 of the discussion draft and sec. 267 of the Code)

Present Law

Related party sales

Sections 267(a)(1) and 707(b) generally disallow a deduction for a loss on the sale or exchange of property, directly or indirectly, to certain related parties or controlled partnerships. Section 267(d)[519] provides that if a loss has been disallowed under either of such provisions, the

[519] The loss disallowance rules of sections 267(a) and 707(b) together, and the corresponding rule under section 267(d), apply to transactions between the following parties:

(1) Members of a family, which include ancestors, lineal descendants, spouse and siblings (whether by the whole or half blood).
(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the individual.
(3) Two corporations which are members of the same controlled group (as defined in sec. 267(f)).
(4) A grantor and a fiduciary of any trust.
(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts.
(6) A fiduciary of a trust and a beneficiary of such trust.

transferee may reduce any gain that the transferee later recognizes on a disposition of the asset by the amount of loss disallowed to the transferor. Thus, section 267(d) shifts the benefit of the loss to the transferee to the extent of post-sale appreciation.

In the case of a sale or exchange between two corporations that are members of the same controlled group,[520] section 267(f) provides a rule different from that of sections 267(a)(1), 707(b), and 267(d). Under section 267(f), the loss to the transferor is not denied entirely, but rather is deferred until such time as the property is transferred outside the controlled group and there would be recognition of loss under consolidated return principles, or such other time as may be prescribed in regulations. While the loss is deferred, it is not transferred to another party.

Sections 267 and 707 generally operate on an item-by item basis, so that if a transferor sells several items of separately acquired property to a related or controlled party in a single transaction, the disallowance at the time of the sale applies to each loss regardless of any gains recognized on other property in the same transfer.[521]

Transferee basis in gift cases

In the case of property acquired by gift, the basis generally is the basis in the hands of the transferor except that if the basis exceeds the fair market value at the time of the gift, the basis for purposes of determining loss is the fair market value at that time.[522] This rule has the same effect as the rule in section 267(d) which in effect allows the loss at the time of the transfer to offset post-transfer appreciation.

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(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts.
(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust.
(9) A person and an exempt organization to which section 501 applies and which is controlled directly or indirectly by the person or (if such person is an individual) by members of the family of the individual.
(10) A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest or profits interest in the partnership.
(11) Two S corporations in which the same persons own more than 50 percent in value of the outstanding stock of each corporation.
(12) An S corporation and a C corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation.
(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of the estate.
(14) A partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest or profits interest in the partnership.
(15) Two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

[520] Sec. 267(f)(1).

[521] This rule in effect prevents a transferor from selectively realizing certain losses to offset gains in a transaction with a related party.

[522] Sec. 1015.

Transferee basis in certain nontaxable corporate organizations and reorganizations

In the case of certain nontaxable organizations and reorganizations, section 362(a) generally provides that the transferee takes the same basis in property that the property had in the hands of the transferor, increased by the amount of any gain (or dividend) recognized by the transferor. However, section 362(e)(1) provides that in cases involving the importation of a net built-in loss, the transferee's aggregate adjusted basis may not exceed the fair market value of the property immediately after the transaction. This rule applies to a transfer of property if (i) gain or loss with respect to such property is not subject to Federal income tax in the hands of the transferor immediately before the transfer and (ii) gain or loss with respect to such property is subject to such tax in the hands of the transferee immediately after such transfer.

Description of Proposal

The proposal provides that the principles of section 267(d) do not apply to the extent gain or loss with respect to property that has been sold or exchanged is not subject to Federal income tax in the hands of the transferor immediately before the transfer but any gain or loss with respect to the property is subject to Federal income tax in the hands of the transferee immediately after the transfer. Thus, the basis of the property in the hands of the transferee will be its cost for purposes of determining gain or loss, thereby precluding a loss importation result.

Effective Date

The proposal applies to sales and exchanges after December 31, 2014.

26. Entertainment, etc. expenses (sec. 3126 of the discussion draft and sec. 274 of the Code)

Present Law

In general

Under present law, no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation (referred to collectively as "entertainment"), unless the taxpayer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business, or (2) a facility (*e.g.*, an airplane) used in connection with such activity.[523] If the taxpayer establishes that entertainment expenses are directly related to (or associated with) the active conduct of its trade or business, the deduction generally is limited to 50 percent of the amount otherwise deductible under the Code.[524] Similarly, a deduction for any expense for food or beverages generally is limited to 50 percent of the amount otherwise deductible under the Code.[525] In

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[523] See sec. 274(a).

[524] Sec. 274(n).

[525] Sec. 274(n)(1).

addition, no deduction is allowed for membership dues with respect to any club organized for business, pleasure, recreation or other social purpose.[526]

The Code includes a number of exceptions to the general rule disallowing deductions of entertainment expenses and the rules limiting deductions to 50 percent of the otherwise deductible amount. Under one such exception, these rules do not apply to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and wages to an employee.[527] The deduction disallowance rules also do not apply to expenses paid or incurred by the taxpayer for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee (*e.g.*, a nonemployee director) as compensation for services rendered or as a prize or award.[528] The exceptions apply only to the extent that amounts are properly reported by the company as compensation and wages or otherwise includible in income. In no event can the amount of the deduction exceed the amount of the taxpayer's actual cost, even if a greater amount (*i.e.*, fair market value) is includible in income.[529]

These rules also do not apply to expenses paid or incurred by the taxpayer, in connection with the performance of services for another person (other than an employee) under a reimbursement or other expense allowance arrangement if the taxpayer accounts for the expenses to such person.[530] Another exception applies for expenses for recreational, social or similar activities primarily for the benefit of employees other than certain owners and highly compensated employees.[531] An exception applies also to the 50 percent deduction limit for food and beverages provided to crew members of certain commercial vessels and certain oil or gas platform or drilling rig workers.[532]

Expenses treated as compensation

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.[533] In general, an employee or other service provider must include in gross income the amount by which the fair market value of a fringe benefit exceeds the amount paid by the individual (plus the amount, if any excluded

[526] Sec. 274(a)(3).

[527] Sec. 274(e)(2). See below for a discussion of the recent modification of this rule for certain individuals.

[528] Sec. 274(e)(9).

[529] Treas. Reg. sec. 1.162-25T.

[530] Sec. 274(e)(3).

[531] Sec. 274(e)(4).

[532] Sec. 274(n)(2)(E).

[533] Sec. 61(a)(1).

from gross income).[534] Treasury regulations provide rules regarding the valuation of fringe benefits, including flights on an employer-provided aircraft.[535] In general, the value of a non-commercial flight generally is determined under the base aircraft valuation formula, also known as the Standard Industry Fare Level formula or "SIFL."[536] If the SIFL valuation rules do not apply, the value of a flight on a company-provided aircraft generally is equal to the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.[537]

In the context of an employer providing an aircraft to employees for nonbusiness (*e.g.*, vacation) flights, the exception for expenses treated as compensation was interpreted as not limiting the company's deduction for expenses attributable to the operation of the aircraft to the amount of compensation reportable to its employees, which can result in a deduction many times larger than the amount required to be included in income.[538] In many cases, the individual including amounts attributable to personal travel in income directly benefits from the enhanced deduction, resulting in a net deduction for the personal use of the company aircraft.

The exceptions were subsequently modified in the case of specified individuals such that the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income of the specified individual.[539] Specified individuals are individuals who, with respect to an employer or other service recipient (or a related party), are subject to the requirements of section 16(a) of the Securities Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient (or related party) were an issuer of equity securities referred to in section 16(a).[540]

As a result, in the case of specified individuals, no deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment, amusement or recreation, or (2) a facility (*e.g.*, an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income to the specified individual. For example, a company's deduction attributable to aircraft operating costs and other expenses for a specified individual's vacation use of a company aircraft is limited to the amount reported as compensation to the specified individual. However, in the case of other

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[534] Treas. Reg. sec. 1.61-21(b)(1).

[535] Treas. Reg. sec. 1.61-21.

[536] Treas. Reg. sec. 1.61-21(g)(5).

[537] Treas. Reg. sec. 1.61-21(b)(6).

[538] *Sutherland Lumber-Southwest, Inc. v. Commissioner.*, 114 T.C. 197 (2000), aff'd, 255 F.3d 495 (8th Cir. 2001), *acq.*, AOD 2002-02 (February 11, 2002).

[539] Sec. 274(e)(2)(B). See also Treas. Reg. sec. 1.274-9.

[540] Sec. 274(e)(2)(B)(ii).

employees or service providers, the company's deduction is not limited to the amount treated as compensation or includible in income.[541]

Excludable fringe benefits

Certain employer-provided fringe benefits are excluded from an employee's gross income and wages for employment tax purposes, including de minimis fringes and qualified transportation fringes.[542] A de minimis fringe generally means any property or services the value of which is (taking into account the frequency with which similar fringes are provided by the employer) so small as to make accounting for it unreasonable or administratively impracticable.[543] Qualified transportation fringes include qualified parking (*i.e.*, on or near the employer's business premises or on or near a location from which the employee commutes to work by public transit), transit passes, vanpool benefits, and qualified bicycle commuting reimbursements.[544]

Description of Proposal

The proposal provides that no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, (2) membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, (3) a de minimis fringe that is primarily personal in nature and involving property or services that are not directly related to the taxpayer's trade or business, (4) a facility or portion thereof used in connection with any of the above items, or (5) a qualified transportation fringe, including costs of operating a facility used for qualified parking. Thus, the proposal repeals the present law exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50 percent limit to such deductions). The proposal also repeals the present law exception for recreational, social, or similar activities primarily for the benefit of employees. However, taxpayers may still, generally, deduct 50 percent of the food and beverage expenses associated with operating their trade or business (*e.g.*, meals consumed by employees on work travel).

Under the proposal, in the case of all individuals (not just specified individuals), the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income. Thus, under those exceptions, no deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment,

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[541] See Treas. Reg. sec. 1.274-10(a)(2).

[542] Secs. 132(a), 3121(a)(20), 3231(e)(5), 3306(b)(16) and 3401(a)(19).

[543] Sec. 132(e)(1). Examples provided in Treas. Reg. sec. 1.132-6(e)(1) include occasional personal use of an employer's copying machine, local telephone calls, occasional parties or meals for employees and their guests, and coffee, doughnuts and soft drinks.

[544] Sec. 132(f). The qualified transportation fringe exclusions are subject to monthly limits.

amusement or recreation, or (2) a facility (*e.g.*, an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income. As under present law, the exceptions apply only if amounts are properly reported by the company as compensation and wages or otherwise includible in income.

The proposal amends the present-law exception for reimbursed expenses. The proposal disallows a deduction for amounts paid or incurred by a taxpayer in connection with the performance of services for another person (other than an employee) under a reimbursement or other expense allowance arrangement if the person for whom the services are performed is a tax-exempt entity[545] or the arrangement is designated by the Secretary as having the effect of avoiding the 50 percent deduction disallowance.

The proposal clarifies that the exception to the 50 percent deduction limit for food or beverages applies to any expense excludible from the gross income of the recipient related to meals furnished for the convenience of the employer. The proposal thereby repeals as deadwood the special exceptions for food or beverages provided to crew members of certain commercial vessels and certain oil or gas platform or drilling rig workers.

Effective Date

The proposal applies to amounts paid or incurred after December 31, 2014.

27. Repeal of limitation on corporate acquisition indebtedness (sec. 3127 of the discussion draft and sec. 279 of the Code)

Present Law

The Code contains several provisions that limit corporate interest deductions in certain circumstances.

One provision, enacted in 1969, denies a corporate interest deduction for interest in excess of five million dollars on corporate acquisition indebtedness. Corporate acquisition indebtedness is debt under certain subordinated obligations[546] issued to provide consideration for the acquisition of stock or assets of another corporation. The conditions under which the provision applies are further limited. Also, the provision does not apply unless, as of the last day of the taxable year of the issuing corporation in which it issues an obligation, the debt to equity ratio of the issuing corporation exceeds two to one and the projected earnings (as

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[545] As defined in section 168(h)(2)(A), *i.e.*, Federal, State and local government entities, organizations (other than certain cooperatives) exempt from income tax, any foreign person or entity, and any Indian tribal government.

[546] Sec. 279. The provision does not apply unless the obligation is either subordinated to the claims of trade creditors of the issuing corporation generally, or expressly subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued, of the issuing corporation.

defined)[547] do not exceed three times the annual interest to be paid or incurred. Also, the obligation must be either convertible directly or indirectly into stock of the issuing corporation, or part of an investment unit or other arrangement which includes, in addition to such bond or other evidence of indebtedness, an option to acquire, directly or indirectly, stock in the issuing corporation. Special rules apply to banks and lending or finance companies.

Description of Proposal

The proposal repeals the corporate acquisition indebtedness interest limitation

Effective Date

The proposal applies to interest paid or incurred with respect to indebtedness incurred after December 31, 2014.

28. Denial of deductions and credits for expenditures in illegal businesses (sec. 3128 of the discussion draft and sec. 280E of the Code)

Present Law

Under present law, ordinary and necessary expenses of carrying on a trade or business generally are deductible.[548] However, the Code expressly provides that certain business expenses that otherwise might be treated as ordinary and necessary are nondeductible.

These nondeductible expenses include bribes, kickbacks, and other payments that are illegal under Federal or State law.[549] Specified types of payments that are not illegal, but are of such nature that the Congress has determined that deductibility would frustrate a public policy objective, also are made nondeductible.

One such specified type of nondeductible payment that would frustrate public policy relates to illegal sales of drugs. Specifically, section 280E disallows deductions in connection with the trade or business of trafficking in controlled substances.

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[547] Projected earnings is determined by the average annual earnings of the issuing corporation only, unless the issuing corporation has acquired control (as defined in section 368(c)), or has acquired substantially all the properties of, the acquired corporation, in which cases projected earnings is determined by reference to the average annual earnings of issuing corporation and the acquired corporation.

Average annual earnings is, for any corporation, the amount of its earnings and profits for any 3-year period ending with the last day of a taxable year of the issuing corporation, computed without reduction for interest, deprecation or amortization, federal tax liability, or distributions treated as dividends under section 301(c)(1) (other than from the acquired to the issuing corporation) and reduced to an annual average under Treasury regulations.

[548] Sec. 162(a).

[549] Sec. 162(c).

Description of Proposal

The proposal expands the section 280E definition of nondeductible expenses to include amounts paid or incurred in carrying on a trade or business if such trade or business is a felony under Federal law or the law of any State in which such trade or business is conducted.

Effective Date

The proposal applies to amounts paid or incurred after the date of the enactment in taxable years ending after the date of the enactment.

29. Limitation on Deduction for FDIC Premiums (sec. 3129 of the discussion draft and sec. 162 of the Code)

Present Law

Corporations generally

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income. The taxable income of a C corporation[550] generally is comprised of gross income less allowable deductions. A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[551]

Corporations that make a valid election pursuant to section 1362 of subchapter S of Chapter 1 of the Code, referred to as S corporations, are taxed differently. In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through to shareholders its items of income and loss. The shareholders separately take into account their shares of these items on their individual income tax returns.

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[550] Corporations subject to tax are commonly referred to as C corporations after subchapter C of the Code, which sets forth corporate tax rules. Certain specialized entities that invest primarily in real estate related assets (Real Estate Investment Trusts) or in stock and securities (Regulated Investment Companies) and that meet other requirements, generally including annual distribution of 90 percent of their income, are allowed to deduct their distributions to shareholders, thus generally paying little or no corporate-level tax despite otherwise being subject to subchapter C.

[551] Sec. 162(a). However, certain exceptions apply. No deduction is allowed for 1) any charitable contribution or gift that would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section; 2) any illegal bribe, illegal kickback, or other illegal payment; 3) certain lobbying and political expenditures; 4) any fine or similar penalty paid to a government for the violation of any law; 5) two-thirds of treble damage payments under the antitrust laws; 6) certain foreign advertising expenses; 7) certain amounts paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person; or 8) certain applicable employee remuneration.

Banks, thrifts, and credit unions

In general

Financial institutions are subject to the same Federal income tax rules and rates as are applied to other corporations or entities, with specified exceptions

C corporation banks and thrifts

A bank is generally taxed for Federal income tax purposes as a C corporation. For this purpose a bank generally means a corporation, a substantial portion of whose business is receiving deposits and making loans and discounts, or exercising certain fiduciary powers.[552] A bank for this purpose generally includes domestic building and loan associations, mutual stock or savings banks, and certain cooperative banks that are commonly referred to as thrifts.[553]

S corporation banks

A bank is generally eligible to elect S corporation status under section 1362, provided it meets the other requirements for making this election and it does not use the reserve method of accounting for bad debts as described in section 585.[554]

Special bad debt loss rules for small banks

Section 166 provides a deduction for any debt that becomes worthless (wholly or partially) within a taxable year. The reserve method of accounting for bad debts was repealed in 1986[555] for most taxpayers, but is allowed under section 585 for any bank (as defined in section 581) other than a large bank. For this purpose, a bank is a large bank if for the taxable year (or for any preceding taxable year after 1986) the average adjusted basis of all its assets (or the assets of the controlled group of which it was a member) exceeds $500 million. Deductions for reserves are taken in lieu of a worthless debt deduction under section 166. Accordingly, a small bank is able to take deductions for additions to a bad debt reserve. Additions to the reserve are determined under an experience method that looks to the ratio of (1) total bad debts sustained during a taxable year to (2) the total bad debts over the five preceding taxable years. A large bank is allowed a deduction for specific bad debts charged off during a taxable year.

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[552] Sec. 581.

[553] See Treas. Reg. sec. 1.581-1 ("in order to be a bank as defined in section 581, an institution must be a corporation for Federal tax purposes") and Treas. Reg. sec. 1.581-(2)(a) ("While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, or a cooperative bank…there are certain exceptions and special rules [for such institutions]").

[554] Sec. 1361(b)(2).

[555] Tax Reform Act of 1986, Pub. L. No. 99-514.

Credit unions

Credit unions are exempt from Federal income taxation.[556] The exemption is based on their status as not-for-profit mutual or cooperative organizations (without capital stock) operated for the benefit of their members, who generally must share a common bond. The definition of common bond has been expanded to permit greater utilization of credit unions.[557] While significant differences between the rules under which credit unions and banks operate have existed in the past, most of those differences have disappeared over time.[558]

FDIC premiums

The Federal Deposit Insurance Corporation ("FDIC") provides deposit insurance for banks and savings institutions. To maintain its status as an insured depository institution, a bank must pay semiannual assessments into the deposit insurance fund. Assessments for deposit insurance are treated as ordinary and necessary business expenses. These assessments, also known as premiums, are deductible once the all events test for the premium is satisfied.[559]

Description of Proposal

No deduction is allowed for the applicable percentage of any FDIC premium paid or incurred by the taxpayer. For taxpayers with total consolidated assets of $50 billion or more, the applicable percentage is 100 percent. Otherwise, the applicable percentage is the ratio of the excess of total consolidated assets over $10 billion to $40 billion. For example, for a taxpayer with total consolidated assets of $20 billion, no deduction is allowed for 25 percent of FDIC premiums. The proposal does not apply to taxpayers with total consolidated assets (as of the close of the taxable year) that do not exceed $10 billion.

FDIC premium means any assessment imposed under section 7(b) of the Federal Deposit Insurance Act.[560] The term total consolidated assets has the meaning given such term under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[561]

[556] Sec. 501(c)(14). For a discussion of the history of and reasons for Federal tax exemption, see United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, available at http://www.ustreas.gov/press/releases/report3070.htm.

[557] The Credit Union Membership Access Act, Pub. L. No. 105-219, allows multiple common bond credit unions. The legislation in part responds to *National Credit Union Administration v. First National Bank & Trust Co.*, 522 U.S. 479 (1998), which interpreted the permissible membership of tax-exempt credit unions narrowly.

[558] The Treasury Department has concluded that any remaining regulatory differences do not raise competitive equity concerns between credit unions and banks. Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, p. 2, available at http://www.ustreas.gov/press/releases/report3070.htm.

[559] Technical Advice Memorandum 199924060, March 5, 1999, and Rev. Rul. 80-230, 1980-2 C.B. 169, 1980.

[560] 12 U.S.C. sec. 1817(b).

For purposes of determining a taxpayer's total consolidated assets, members of an expanded affiliated group are treated as a single taxpayer. An expanded affiliated group means an affiliated group as defined in section 1504(a) (related to consolidated returns) determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears and without regard to the exceptions from the definition of includible corporation for insurance companies and foreign corporations. A partnership or any other entity other than a corporation is treated as a member of an expanded affiliated group if such entity is controlled by members of such group.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

30. Repeal of percentage depletion (sec. 3130 of the discussion draft and secs. 613 aud 613A of the Code)

Present Law

In geueral

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset is being expended to produce income.[562] Certain costs incurred prior to drilling an oil or gas property or extracting minerals are recovered through the depletion deduction.[563] These include the cost of acquiring the lease or other interest in the property. In certain instances, the cost of land used in production also is recovered through the depletion deduction.[564]

Depletion is available to any person having an economic interest in a producing property.[565] An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital.[566] Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in

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[561] Pub. L. No. 111-203.

[562] In the context of mineral extraction, depreciable assets are generally used to extract depletable assets. For example, natural gas gathering lines, used to collect and deliver natural gas, have a class life of 14 years and a depreciation recovery period of seven years.

[563] Treas. Reg. sec. 1.612-4.

[564] Treas. Reg. sec. 1.612-1(b).

[565] Treas. Reg. sec. 1.611-1(b)(1).

[566] *Ibid.*

the mineral deposit, however, does not acquire an economic interest merely by possessing an economic or pecuniary advantage derived from production through a contractual relation.[567]

Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.[568] Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year.[569] Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.[570]

Under the percentage depletion method, a percentage, varying from five percent to 22 percent, of the taxpayer's gross income from a producing property is allowed as a deduction in each taxable year.[571] The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.[572] Such producers and royalty owners generally may claim percentage depletion at a rate of 15 percent.[573]

The amount deducted generally may not exceed 50 percent (100 percent in the case of oil and gas properties) of the taxable income from the property in any taxable year.[574] Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income for the year (determined before such deduction, as well as before any deduction allowable under section 199, and adjusted for certain loss carrybacks and trust distributions).[575] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire and/or develop the property.[576]

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[567] *Ibid.*

[568] Secs. 611 - 613.

[569] Treas. Reg. sec. 1.611-2(a)(1).

[570] Treas. Reg. sec. 1.611-2(b)(2).

[571] Sec. 613.

[572] Sec. 613A(c).

[573] Sec. 613A(c)(1).

[574] Sec. 613(a). For marginal production, discussed *infra*, this limitation is suspended for taxable years beginning after December 31, 1997, and before January 1, 2008, and for taxable years beginning after December 31, 2008, and before January 1, 2012.

[575] Sec. 613A(d)(1).

[576] In the case of iron ore and coal (including lignite), a corporate preference reduces the amount of percentage depletion calculated by 20 percent of the amount of percentage depletion in excess of the adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year). Sec. 291(a)(2).

A taxpayer is required to determine the depletion deduction for each property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question.[577]

Limitation on oil and gas percentage depletion to independent producers and royalty owners

As stated above, percentage depletion of oil and gas properties generally is not permitted, except for independent producers and royalty owners, certain fixed-price gas contracts, and natural gas from geopressured brine. For purposes of the percentage depletion allowance, an independent producer is any producer that is not a "retailer" or "refiner." A retailer is any person that directly, or through a related person, sells oil or natural gas (or a derivative thereof): (1) through any retail outlet operated by the taxpayer or related person, or (2) to any person that is obligated to market or distribute such oil or natural gas (or a derivative thereof) under the name of the taxpayer or the related person, or that has the authority to occupy any retail outlet owned by the taxpayer or a related person.[578]

Bulk sales of crude oil and natural gas to commercial or industrial users, and bulk sales of aviation fuel to the Department of Defense, are not treated as retail sales.[579] Further, if the combined gross receipts of the taxpayer and all related persons from the retail sale of oil, natural gas, or any product derived therefrom do not exceed $5 million for the taxable year, the taxpayer will not be treated as a retailer.[580]

A refiner is any person that directly or through a related person engages in the refining of crude oil in excess of an average daily refinery run of 75,000 barrels during the taxable year.[581]

Percentage depletion for eligible taxpayers is allowed for up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas.[582] For producers of both oil and natural gas, this limitation applies on a combined basis. All production owned by businesses under common control and members of the same family must be aggregated;[583] each group is then treated as one producer in applying the 1,000-barrel limitation.

[577] Sec. 613(a); Treas. Reg. sec. 1.611-1(a)(1).

[578] Sec. 613A(d)(2).

[579] *Ibid.*

[580] *Ibid.*

[581] Sec. 613A(d)(4).

[582] Sec. 613A(c).

[583] Sec. 613A(c)(8).

In addition to independent producers and royalty owners, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine, are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

Prior to the enactment of the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act"), if an interest in a proven oil or gas property was transferred (subject to certain exceptions), the production from such interest did not qualify for percentage depletion.[584] The 1990 Act repealed the limitation on claiming percentage depletion on transferred properties effective for property transfers occurring after October 11, 1990.

Percentage depletion on marginal production

The 1990 Act also created a special percentage depletion provision for oil and gas production from so-called marginal properties held by independent producers or royalty owners.[585] Under this provision, the statutory percentage depletion rate is increased (from the general rate of 15 percent) by one percent for each whole dollar that the average price of crude oil for the immediately preceding calendar year is less than $20 per barrel. In no event may the rate of percentage depletion under this provision exceed 25 percent for any taxable year. The increased rate applies for the taxpayer's taxable year that immediately follows a calendar year for which the average crude oil price falls below the $20 floor. To illustrate the application of this provision, the average price of a barrel of crude oil for calendar year 1999 was $15.56.[586] Thus, the percentage depletion rate for production from marginal wells was increased to 19 percent for taxable years beginning in 2000. Since the price of oil currently is above the $20 floor, there is no increase in the statutory depletion rate for marginal production (and has not been since 2000).[587]

The Code defines the term "marginal production" for this purpose as domestic crude oil or domestic natural gas which is produced during any taxable year from a property which (1) is a stripper well property for the calendar year in which the taxable year begins, or (2) is a property substantially all of the production from which during such calendar year is heavy oil (*i.e.*, oil that has a weighted average gravity of 20 degrees API or less, corrected to 60 degrees Fahrenheit).[588] A stripper well property is any oil or gas property that produces a daily average of 15 or fewer

[584] Pub. L. No. 101-508.

[585] Sec. 613A(c)(6).

[586] See Notice 2000-50, 2000-38 I.R.B. 291, September 18, 2000.

[587] See Notice 2013-53, 2013-36 I.R.B. 173, September 3, 2013.

[588] Sec. 613A(c)(6)(D).

equivalent barrels of oil and gas per producing oil or gas well on such property in the calendar year during which the taxpayer's taxable year begins.[589]

The determination of whether a property qualifies as a stripper well property is made separately for each calendar year. The fact that a property is or is not a stripper well property for one year does not affect the determination of the status of that property for a subsequent year. Further, a taxpayer makes the stripper well property determination for each separate property interest (as defined under section 614) held by the taxpayer during a calendar year. The determination is based on the total amount of production from all producing wells that are treated as part of the same property interest of the taxpayer. A property qualifies as a stripper well property for a calendar year only if the wells on such property were producing during that period at their maximum efficient rate of flow.[590]

If a taxpayer's property consists of a partial interest in one or more oil- or gas-producing wells, the determination of whether the property is a stripper well property or a heavy oil property is made with respect to total production from such wells, including the portion of total production attributable to ownership interests other than the taxpayer's interest.[591] If the property satisfies the requirements of a stripper well property, then the benefits of this provision apply with respect to the taxpayer's allocable share of the production from the property.[592] The deduction is allowed for the taxable year that begins during the calendar year in which the property so qualifies.

The allowance for percentage depletion on production from marginal oil and gas properties is subject to the 1,000-barrel-per-day limitation discussed above. Unless a taxpayer elects otherwise, marginal production is given priority over other production for purposes of utilization of that limitation.

Percentage depletion for hard mineral fossil fuel properties

Percentage depletion is available for taxpayers with an economic interest in a coal mine or other hard mineral fossil fuel property such as lignite or oil shale properties. The depletion rate for coal and lignite is 10 percent.[593] For oil shale, the rate generally is 15 percent, but the rate drops to 7.5 percent for shale used or sold for use in the manufacture of sewer pipe or brick or as sintered or burned lightweight aggregates.[594]

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[589] Sec. 613A(c)(6)(E).

[590] See Conference Report to accompany H.R.5835, Omnibus Budget Reconciliation Act of 1990, H.R. Rep. No. 101-964, October 27, 1990, p. 1127.

[591] *Ibid.*

[592] Sec. 613A(c)(6)(G)(ii).

[593] Sec. 613(b)(4).

[594] Secs. 613(b)(2)(B) and (b)(5).

As noted above, the percentage depletion deduction is limited to 50 percent of the taxable income from the property (determined before depletion and the deduction under section 199). Additionally, a corporation's percentage depletion deduction with respect to coal or lignite properties is reduced by 20 percent of the excess of the percentage depletion deduction over the adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year).[595]

The excess of percentage depletion over cost depletion is a tax preference in computing a taxpayer's alternative minimum taxable income.[596]

Description of Proposal

The proposal repeals percentage depletion under sections 613 and 613A. Cost depletion, however, remains available under section 611.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

31. Repeal of passive activity exception for working interests in oil and gas property (sec. 3131 of the discussion draft and sec. 469 of the Code)

Present Law

The passive loss rules generally limit deductions and credits from passive trade or business activities.[597] A passive activity for this purpose is a trade or business activity in which the taxpayer owns an interest, but in which the taxpayer does not materially participate.[598] A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial.[599] Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income.[600] Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year.[601] The suspended losses from a passive activity are allowed in

[595] Sec. 291(a)(2).

[596] Sec. 57(a)(1).

[597] Sec. 469. These rules were enacted in 1986 to curtail tax shelters. They apply to individuals, estates and trusts, and closely-held corporations.

[598] Sec. 469(c).

[599] Sec. 469(h). Regulations provide more detailed standards for material participation. See Treas. Reg. secs. 1.469-5 and -5T.

[600] Secs. 469(a) and (d).

[601] Sec. 469(b).

full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person.[602]

Losses from certain working interests in oil and gas property are not limited under the passive loss rule.[603] Thus, losses and credits from such interests can be used to offset other income of the taxpayer without limitation under the passive loss rule. Specifically, a passive activity does not include a working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest.[604] This rule applies without regard to whether the taxpayer materially participates in the activity.[605] If the taxpayer has a loss from a working interest in any oil or gas property that is treated as not from a passive activity, then net income from the property for any succeeding taxable year is treated as income of the taxpayer that is not from a passive activity.[606]

In general, a working interest is an interest with respect to an oil and gas property that is burdened with the cost of development and operation of the property.[607] Rights to overriding royalties, production payments, and the like, do not constitute working interests, because they are not burdened with the responsibility to share expenses of drilling, completing, or operating oil and gas property. Similarly, contract rights to extract or share in oil and gas, or in profits from extraction, without liability to share in the costs of production, do not constitute working interests. Income from such interests generally is considered to be portfolio (*i.e.*, passive) income.

When the taxpayer's form of ownership limits the liability of the taxpayer, the interest possessed by such taxpayer is not a working interest for purposes of the passive loss provision.[608] Thus, for purposes of the passive loss rules, an interest owned by a limited partnership is not treated as a working interest with regard to any limited partner, and an interest owned by an S corporation is not treated as a working interest with regard to any shareholder.[609] The same

[602] Sec. 469(g).

[603] Sec. 469(c)(3). See also Treas. Reg. sec. 1.469-1T(e)(4). Under some circumstances, deductions relating to a working interest may be subject to limitation under other provisions in the Internal Revenue Code (*e.g.*, sec. 465). Such limitations are applied prior to and independently of the passive loss rule. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

[604] Sec. 469(c)(3)(A).

[605] Sec. 469(c)(4).

[606] Sec. 469(c)(3)(B).

[607] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

[608] Sec. 469(c)(3)(A); Treas. Reg. sec. 1.469-1T(e)(4)(i)(B). See also Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

[609] Treas. Reg. sec. 1.469-1T(e)(4)(v). However, the fact that an interest is not treated as a working interest for purposes of the passive loss rules due to the taxpayer's form of ownership has no effect on whether it

result follows with respect to any form of ownership that is substantially equivalent in its effect on liability to a limited partnership interest or interest in an S corporation, even if different in form.

When an interest is not treated as a working interest because the taxpayer's form of ownership limits his liability, the general rules regarding material participation apply to determine whether the interest is treated as a passive activity.[610] Thus, for example, a limited partner's interest generally is treated as a passive activity. In the case of a shareholder in an S corporation, the general facts and circumstances test for material participation applies and the working interest exception does not apply, because the form of ownership limits the taxpayer's liability.

A special rule applies in any case where, for a prior taxable year, net losses from a working interest in a property were treated by the taxpayer as not from a passive activity.[611] In such a case, any net income realized by the taxpayer from the property (or from any substituted basis property, *e.g.*, property acquired in a section 1031 like kind exchange for such property) in a subsequent year also is treated as active. Under this rule, for example, if a taxpayer claims losses for a year with regard to a working interest and then, after the property to which the interest relates begins to generate net income, transfers the interest to an S corporation in which he is a shareholder, or to a partnership in which he has an interest as a limited partner, his interest with regard to the property continues to be treated as not passive.[612]

Description of Proposal

The proposal repeals the exception for passive losses from working interests in oil and gas properties. Thus, working interests in oil and gas properties are fully subject to the passive loss rules.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

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qualifies as a working interest for any other purpose under the Internal Revenue Code. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

[610] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

[611] See sec. 469(c)(3)(B); Treas. Reg. sec. 1.469-2(c)(6). See also Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

[612] This rule applies whether or not the working interest would have been treated as passive in the absence of the provision treating working interests as per se active, *i.e.*, if material participation were relevant in this context. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

32. Repeal of special rules for gain or loss on timber, coal, or domestic iron ore (sec. 3132 of the discussion draft and sec. 631 of the Code)

Present Law

Timber

In general, proceeds from the sale of inventoriable goods are taxed as ordinary income for Federal income tax purposes.[613] However, a taxpayer disposing of timber held for more than one year is eligible to elect capital gains treatment in the following situations. First, if the taxpayer sells or exchanges timber that is a capital asset[614] or property used in the trade or business,[615] the gain generally is long-term capital gain; however, if the timber is held for sale to customers in the taxpayer's business, the gain will be ordinary income. Second, if the taxpayer disposes of the timber and either retains an economic interest in such timber or makes an outright sale of such timber, the gain is eligible for capital gain treatment.[616] Third, if the taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment.[617]

Coal or domestic iron ore

Similar to proceeds from the sale of inventoriable goods, royalties generally are taxed as ordinary income for Federal income tax purposes. However, the Code provides a special rule that treats royalties from certain dispositions of coal or domestic iron ore as capital gains. Specifically, in the case of the disposal of coal (including lignite), or iron ore mined in the United States, held for more than one year prior to disposal by the owner in a form under which the owner retains an economic interest in such coal or iron ore, the excess of the amount realized from the sale over the adjusted depletable basis of the coal or iron ore plus certain disallowed deductions is treated as the sale of depreciable property used in the owner's trade or business (*i.e.*, the sale of section 1231 property).[618] For these purposes, an owner means any person who owns an economic interest in coal or iron ore in place, including a lessee or sublessor thereof.[619]

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[613] Sec. 1221(a)(1).

[614] Sec. 1221.

[615] Sec. 1231.

[616] Sec. 631(b).

[617] Sec. 631(a). For purposes of determining the gain attributable to such cutting, and the cost of the cut timber for purposes of the taxpayer's income from later sales of the timber or timber products, the fair market value of the timber on the first day of the taxable year in which the timber is used.

[618] Secs. 631(c) and 1231(b)(2).

[619] Sec. 631(c).

The exception does not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal or iron ore.[620]

Section 1231 generally provides that if recognized gains on the sale or exchange of property used in a taxpayer's trade or business,[621] plus certain gains on involuntary conversions, exceed losses from such sales, exchanges, or conversions, the gain is long-term capital gain.[622] If losses exceed gains, the losses are treated as ordinary losses. The net ordinary losses are subject to certain recapture provisions. Thus, if the owner's section 1231 gains, including royalties from coal or iron ore disposals described in section 631(c), exceed its section 1231 losses, the royalties will be treated as long-term capital gains.

Section 631(c) is not elective. Thus, if a taxpayer meets the requirements of the section, royalties from the disposal of coal or iron ore will be treated as the disposition of section 1231 property. An owner may not claim percentage depletion with respect to coal or iron ore that is subject to section 631(c) if for the taxable year of the sale the maximum tax rate for capital gains or losses is less than the maximum tax rate for ordinary income.[623]

Description of Proposal

This proposal repeals section 631 such that gains or losses from the sale or exchange of timber, coal, or domestic iron ore will not receive capital gain treatment.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

33. Repeal of like-kind exchanges (sec. 3133 of the discussion draft and sec. 1031 of the Code)

Present Law

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a trade or

[620] Sec. 631(c).

[621] Property used in the trade or business generally means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than one year. Section 1231 property does not include inventory or property held for sale to customers in the ordinary course of the taxpayer's business. However, section 1231 property includes coal to which section 631 applies, even if such coal is held as inventory or for sale to the taxpayer's customers in the ordinary course of the taxpayer's business.

[622] Special recapture rules apply for non-recaptured section 1231 losses. See sec. 1231(d).

[623] Under section 631(c), royalty income is reduced by the adjusted depletion basis of the coal disposed of plus administrative costs disallowed under section 272. The adjusted depletion basis is the same amount as would have been the cost depletion allowance under section 612.

business or for investment.[624] In general, section 1031 does not apply to any exchange of stock in trade or other property held primarily for sale; stocks, bonds or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action.[625] Section 1031 also does not apply to certain exchanges involving livestock[626] or involving foreign property.[627]

The nonrecognition of gain in a like-kind exchange applies only to the extent that like-kind property is received in the exchange. Thus, if an exchange of property would meet the requirements of section 1031, but for the fact that the property received in the transaction consists not only of the property that would be permitted to be exchanged on a tax-free basis, but also other property or money, then the gain to the recipient of the other property or money is to be recognized, but not in an amount exceeding the fair market value of such other property or money.[628] Additionally, any gain realized on a section 1031 exchange must be recognized to the extent that the gain is subject to the recapture provisions of sections 1245 and 1250.[629] No losses may be recognized from a like-kind exchange.[630]

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange[631] is equal to the basis of the property transferred. This basis is increased to the extent of any gain recognized due to the receipt of other property or money in the like-kind exchange, and decreased to the extent of any money received by the taxpayer.[632] The holding

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[624] Sec. 1031(a)(1).

[625] Sec. 1031(a)(2).

[626] Sec. 1031(e).

[627] Sec. 1031(h).

[628] Sec. 1031(b). For example, if a taxpayer holding land A having a basis of $40,000 and a fair market value of $100,000 exchanges the property for land B worth $90,000 plus $10,000 in cash, the taxpayer would recognize $10,000 of gain on the transaction, which would be includable in income. The remaining $50,000 of gain would be deferred until the taxpayer disposes of land B in a taxable sale or exchange.

[629] Secs. 1245(b)(4) and 1250(d)(4).

[630] Sec. 1031(c).

[631] The property to be received in the exchange must be received not more than 180 days after the date on which the taxpayer relinquishes the original property (but in no event later than the due date (including extensions) of the taxpayer's income tax return for the taxable year in which the transfer of the relinquished property occurs). Sec. 1031(a)(3)(B). In addition, the taxpayer must identify the property to be received within 45 days after the date on which the taxpayer transfers the property relinquished in the exchange. Sec. 1031(a)(3)(A).

[632] Sec. 1031(d). Thus, in the example noted above, the taxpayer's basis in B would be $40,000 (the taxpayer's transferred basis of $40,000, increased by $10,000 in gain recognized, and decreased by $10,000 in money received).

period of qualifying property received includes the holding period of the qualifying property transferred, but the nonqualifying property received is required to begin a new holding period.[633]

Description of Proposal

The proposal repeals the provision providing for nonrecognition of gain in the case of like-kind exchanges.

Effective Date

The proposal generally applies to transfers after December 31, 2014. However, an exception to repeal is provided for any transfer subject to a written binding contract entered into before January 1, 2015, where such transfer is completed before January 1, 2017.

34. Restriction on trade or business property treated as similar or related in service to involuntarily converted property in disaster areas (sec. 3134 of the discussion draft and sec. 1033 of the Code)

Present Law

Generally, a taxpayer realizes gain to the extent the sales price (and any other consideration received) exceeds the taxpayer's basis in the property.[634] The realized gain is subject to current income tax unless the recognition of the gain is deferred or excluded from income under a special tax provision.

Section 1033 provides an exception to this rule in the case of certain involuntary conversions of property.[635] Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period.[636] If the taxpayer receives money (*e.g.*, insurance proceeds) and acquires qualified replacement property within the prescribed time period, the taxpayer's basis in the replacement property generally is the cost of such property, reduced by the amount of gain not recognized.[637]

[633] Sec. 1223(1).

[634] Sec. 1001.

[635] Such a conversion may occur, for example, as a result of the property's destruction (in whole or in part). Sec. 1033(a).

[636] For property held for productive use in a trade or business (or for investment located in a disaster area) and compulsorily or involuntarily converted as a result of a Federally declared disaster, tangible property of a type held for productive use in a trade or business shall be treated as property similar or related in service or use to the converted property. Sec. 1033(h)(2). The term "Federally declared disaster" means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. Secs. 1033(h)(3) and 165(h)(3)(C).

[637] Sec. 1033(b).

The applicable period for the taxpayer to replace the converted property begins with the date of the disposition of the converted property (or if earlier, the earliest date of the threat or imminence of requisition or condemnation of the converted property) and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized (the "replacement period").[638]

Special rules extend the replacement period for certain real property[639] and principal residences damaged by a Federally declared disaster[640] to three years and four years, respectively, after the close of the first taxable year in which gain is realized. Similarly, the replacement period for livestock sold on account of drought, flood, or other weather-related conditions is extended from two years to four years after the close of the first taxable year in which any part of the gain on conversion is realized.[641]

Description of Proposal

With respect to property held for productive use in a trade or business or for investment located in a disaster area, the proposal modifies the rules related to property compulsorily or involuntarily converted as a result of a Federally declared disaster. Specifically, the proposal provides gain deferral for such trade or business or investment property that was compulsorily or involuntarily converted as a result of a Federally declared disaster only in instances where the replacement property has a class life equal to, or less than, the property that was involuntarily converted.

Effective Date

The proposal applies to disasters declared after December 31, 2014.

35. Repeal of rollover of publicly traded securities gain into specialized small business investment companies (sec. 3135 of the discussion draft and sec. 1044 of the Code)

Present Law

Under present law, a corporation or individual may elect to roll over tax-free any capital gain realized on the sale of publicly-traded securities to the extent of the taxpayer's cost of purchasing common stock or a partnership interest in a specialized small business investment company ("SSBIC") within 60 days of the sale. The amount of gain that an individual may elect to roll over under this provision for a taxable year is limited to $50,000 or (2) $500,000 reduced by the gain previously excluded under this provision. For corporations, these limits are $250,000 and $1 million, respectively.

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[638] Sec. 1033(a)(2)(B).

[639] Sec. 1033(g)(4).

[640] Sec. 1033(h)(1)(B).

[641] Sec. 1033(e)(2).

Description of Proposal

The proposal repeals this provision.

Effective Date

The proposal applies to sales after December 31, 2014.

36. Termination of special rules for gain from certain small business stock (sec. 3136 of the discussion draft and secs. 1045 and 1202 of the Code)

Present Law

Exclusion of gain on sale of small business stock

In general

Individuals generally may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.[642] The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet certain active trade or business requirements.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[643] Seven percent of the excluded gain is an alternative minimum tax preference;[644] the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

Temporary increases in exclusion

The percentage exclusion for qualified small business stock acquired after February 17, 2009, and on or before September 27, 2010, is increased to 75 percent.

For stock acquired after September 27, 2010, and before January 1, 2014, the percentage exclusion for qualified small business stock sold by an individual is increased to 100 percent and the minimum tax preference does not apply.

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[642] Sec. 1202.

[643] Sec. 1(h).

[644] Sec. 57(a)(7).

Rollover of gain from sale of small business stock

An individual may elect to rollover gain from the sale of qualified small business stock held more than six months where other qualified small business stock is purchased during the 60 day period beginning on the date of sale.[645]

Description of Proposal

The proposal repeals the exclusion for gain on the sale of small business stock and repeals the rollover provision.

Effective Date

The repeal of the exclusion applies to stock issued after the date of enactment.

The repeal of the rollover provision applies to sales and exchanges after that date.

37. Certain self-created property not treated as a capital asset (sec. 3137 of the discussion draft and sec. 1221 of the Code)

Present Law

In general, property held by a taxpayer (whether or not connected with his trade or business) is considered a capital asset.[646] Certain assets, however, are specifically excluded from the definition of capital asset. Such excluded assets are: inventory property, property of a character subject to depreciation (including real property),[647] certain self-created intangibles, accounts or notes receivable acquired in the ordinary course of business (*e.g.*, for providing services or selling property), publications of the U.S. Government received by a taxpayer other than by purchase at the price offered to the public, commodities derivative financial instruments held by a commodities derivatives dealer unless clearly identified as a capital asset, hedging transactions clearly identified as such, and supplies regularly used or consumed by the taxpayer in the ordinary course of business.[648]

Self-created intangibles subject to the exception are copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property which is held either by the

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[645] Sec. 1045. Under present law, the percentage of gain excluded from gross income on the sale of the replacement stock is unclear where the exclusion percentage applicable to the original stock is different than the exclusion percentage that would ordinarily apply to stock acqnired at the time the replacement stock was purchased.

[646] Sec. 1221(a).

[647] The net gain from the sale, exchange, or involuntary conversion of certain property used in the taxpayer's trade or business (in excess of depreciation recapture) is treated as long-term capital gain. Sec. 1231. However, net gain from such property is treated as ordinary income to the extent that losses from such property in the previous five years were treated as ordinary losses. Sec. 1231(c).

[648] Sec. 1221(a)(1)-(8).

taxpayer who created the property, or (in the case of a letter, memorandum, or similar property) a taxpayer for whom the property was produced. For the purpose of determining gain, a taxpayer with a substituted or transferred basis from the taxpayer who created the property, or for whom the property was created, also is subject to the exception.[649] However, a taxpayer may elect to treat musical compositions and copyrights in musical works as capital assets.[650]

Since the intent of Congress is that profits and losses arising from everyday business operations be characterized as ordinary income and loss, the general definition of capital asset is narrowly applied and the categories of exclusions are broadly interpreted.[651]

Description of Proposal

This proposal amends section 1221(a)(3), resulting in the exclusion of a patent, invention, model or design (whether or not patented), a secret formula or process which 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 (or for whom the property was created) from the definition of a "capital asset." Thus, gains or losses from the sale or exchange of a patent, invention, model or design (whether or not patented), or a secret formula or process which 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 (or for whom the property was created) will not receive capital gain treatment.

The proposal also repeals the elective capital treatment for musical compositions and copyrights in musical works. Thus, gains or losses from the sale or exchange of musical compositions and copyrights in musical works will not receive capital gain treatment.

Effective Date

The proposal applies to dispositions after December 31, 2014.

38. Repeal special rule for sale or exchange of patents (sec. 3138 of the discussion draft and sec. 1235 of the Code)

Present Law

Section 1235 provides that a transfer[652] of all substantial rights to a patent, or an undivided interest therein which includes a part of all of such rights, by any holder shall be

[649] Sec. 1221(a)(3).

[650] Sec. 1221(b)(3). Thus, if a taxpayer who owns musical compositions or copyrights in musical works that the taxpayer created (or if a taxpayer to which the musical compositions or copyrights have been transferred by the works' creator in a substituted basis transaction) elects the application of this provision, gain from a sale of the compositions or copyrights is treated as capital gain, not ordinary income.

[651] *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 52 (1955).

[652] A transfer by gift, inheritance, or devise is not included.

considered the sale or exchange of a capital asset held for more than one year, regardless of whether or not payments in consideration of such transfer are (1) payable periodically over a period generally conterminous with the transferee's use of the patent or (2) contingent upon the productivity, use, or disposition of the property transferred.[653]

A holder is defined as (1) any individual whose efforts created such property, or (2) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither the employer of such creator nor related (as defined) to such creator.[654]

Description of Proposal

The proposal repeals section 1235. Thus, the holder of a patented invention may not transfer his or her rights to the patent and treat amounts received as proceeds from the sale of a capital asset. It is intended that the determination of whether a transfer is a sale or exchange of a capital asset that produces capital gain, or a transaction that produces ordinary income, will be determined under generally applicable principles.[655]

Effective Date

The proposal applies to dispositions after December 31, 2014.

39. Depreciation recapture on gain from disposition of certain depreciable realty (sec. 3139 of the discussion draft and sec. 1250 of the Code)

Present Law

Upon disposition of most property used in a business on which depreciation or amortization deductions were taken, the treatment of the resulting gain or loss as ordinary or capital depends on whether there is a net gain or a net loss under section 1231. If the netting of gains and losses results in a net gain, then, subject to the depreciation recapture rules, long-term capital gain treatment results.[656] If the netting of gains and losses results in a loss, the loss is fully deductible against ordinary income.[657]

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[653] Sec. 1235(a).

[654] Sec. 1235(b).

[655] See also section 3137 of the discussion draft, "Certain self-created property not treated as a capital asset."

[656] Sec. 1231(a)(1).

[657] Sec. 1231(a)(2).

The depreciation recapture rules require taxpayers to recognize ordinary income in an amount equal to all or a portion of the gain realized as a result of the disposition of property. The purpose of the rules is to limit a taxpayer's ability to reduce ordinary income via depreciation deductions and then receive capital gain treatment for the portion of any gain on the disposition of the depreciated property that resulted from the taking of depreciation deductions. There are two regimes that dictate depreciation recapture, sections 1245 and 1250.[658]

Depreciable personal property, whether tangible or intangible, and certain depreciable real property (typically real property that performs specific functions in a business, but not buildings or structural components of buildings) disposed of at a gain are known as section 1245 property.[659] When a taxpayer disposes of section 1245 property, the taxpayer must recapture the gain on disposition of the property as ordinary income to the extent of earlier depreciation or amortization deductions taken with respect to the asset.[660] Any remaining gain recognized upon the sale of section 1245 property is treated as section 1231 gain.

Depreciable real property, other than that included within the definition of section 1245 property, disposed of at a gain is known as section 1250 property.[661] Gain on the disposition of section 1250 property is treated as ordinary income, rather than capital gain, only to the extent of the excess of post-1969 depreciation allowances over the depreciation that would have been available under the straight-line method.[662] However, if section 1250 property is held for one year or less, all depreciation is recaptured, regardless of whether it exceeds the depreciation that would have been available under the straight-line method. Special rules phase out the recapture for certain types of property held over a specified period of time.[663] Further, for corporations, the amount treated as ordinary income on the disposition of section 1250 property is increased by 20 percent of the additional amount that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property.[664]

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[658] Cost recovery deductions taken under the Accelerated Cost Recovery System ("ACRS") (for property placed in service after 1980 and before 1987 (before August 31, 1986, if the taxpayer so elected)) generally are subject to recapture; however, properties are not necessarily classified as section 1245 or 1250 property in the same manner as similar properties placed in service before or after ACRS.

[659] Sec. 1245(a)(3).

[660] Sec. 1245(a)(1).

[661] Sec. 1250(c).

[662] Sec. 1250(a)(1).

[663] Sec. 1250(a)(1)(B). The special phase-out rule applies to residential rental property, certain types of subsidized housing, and property for which rapid depreciation of rehabilitation expenditures was claimed under section 167(k).

[664] Sec. 291(a)(1).

Description of Proposal

Under the proposal, a taxpayer must recapture the gain on disposition of section 1250 property as ordinary income to the extent of earlier depreciation deductions taken with respect to the asset. Recapture of depreciation attributable to periods before January 1, 2015, is limited to the depreciation adjustments only to the extent that they exceed the depreciation that would have been available under the straight-line method. However, if section 1250 property is held for one year or less, all depreciation is recaptured, regardless of whether it exceeds the depreciation that would have been available under the straight-line method.

Effective Date

The proposal applies to dispositions after December 31, 2014.

C. Reform of Business Credits

1. Repeal credit for alcohol used as a fuel, etc. (sec. 3201 of the discussion draft and sec. 40 of the Code)

Present Law

Section 40 of the Internal Revenue Code consists of the sum of four income tax credits: (1) the alcohol mixture credit, (2) the alcohol credit, (3) in the case of an eligible small producer, the small ethanol producer credit, plus (4) the second generation biofuel producer credit. All but the second generation biofuel producer credit, expired on December 31, 2011. The second generation biofuel producer credit expired on December 31, 2013.

The alcohol mixture credit also was available as an excise tax credit or payment. The excise tax credits and payments were coordinated with the Section 40 income tax credit, so that the income tax credit was reduced by any benefit received as an excise tax credit or payment. The excise tax credit and payment incentives for alcohol fuel also expired December 31, 2011.

Description of Proposal

The proposal repeals all of section 40 (the alcohol mixture credit, the alcohol credit, the small ethanol producer credit, plus the second generation biofuel producer credit). The proposal also removes from the Code the related excise tax credit and payment provisions and makes conforming amendments.

Effective Date

The proposal is effective for fuel sold or used after December 31, 2013.

2. Repeal of credit for biodiesel and renewable diesel used as fuel (sec. 3202 of the discussion draft and sec. 40A, 6426 and 6427(e) of the Code)

Present Law

The biodiesel fuels credit is the sum of three credits: (1) the biodiesel mixture credit ($1.00 per gallon of biodiesel used by the taxpayer in the production of a qualified biodiesel mixture), (2) the biodiesel credit ($1.00 per gallon of biodiesel that is not in a mixture with diesel fuel), and (3) the small agri-biodiesel producer credit (10 cents per gallon for up to 15 million gallons of agri-biodiesel produced by small producers). The credits may be taken as income tax credits and the biodiesel mixture credit also may be taken as an excise tax payment or credit. The excise tax credits and payments were coordinated with the income tax credit for biodiesel mixture, so that the income tax credit was reduced by any benefit received as an excise tax credit or payment.

For purposes of the Code, renewable diesel generally is afforded the same incentives as biodiesel, except there is no small producer credit for renewable diesel.

The income tax, excise tax and payment provisions related to biodiesel and renewable diesel expired on December 31, 2013.

Description of Proposal

The proposal repeals all biodiesel and renewable diesel incentives (income tax, excise tax and payment provisions[665]) and makes related conforming amendments.

Effective Date

The proposal is effective for fuel sold or used after December 31, 2013.

3. Research credit modified and made permanent (sec. 3203 of the discussion draft and sec. 41 of the Code)

Present Law

General rule

For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[666] Thus, the research credit is generally available with respect to incremental increases in qualified research. An alternative simplified research credit (with a 14 percent rate and a different base amount) may be claimed in lieu of this credit.[667]

A 20-percent research tax credit also is available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.[668] This separate credit computation commonly is referred to as the basic research credit.[669]

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.[670] This separate credit computation commonly is

[665] See section 3201(b) of the discussion draft ("repeal of corresponding excise tax credits").

[666] Sec. 41(a)(1).

[667] Sec. 41(c)(5).

[668] Sec. 41(a)(2).

[669] Sec. 41(e).

[670] Sec. 41(a)(3).

referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

The research credit, including the basic research credit and the energy research credit, expired for amounts paid or incurred after December 31, 2013.[671]

Computation of allowable credit

Except for energy research payments, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. In general, the base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all other taxpayers (so called start-up firms).[672] In computing the research credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses. Slightly different rules apply in calculating the basic research credit, which generally has a base period that extends from 1981 through 1983.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.[673] Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands. Under these rules, qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.[674]

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[671] Sec. 41(h).

[672] The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. Sec. 41(c)(3)(B).

[673] Sec. 41(f)(1).

[674] Sec. 41(f)(3).

Alternative simplified credit

The alternative simplified research credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years.[675] The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.[676] An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.[677]

Eligible expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[678] Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of section 174,[679] but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.[680] In addition, research does not qualify for the credit if: (1) conducted after the beginning of commercial production of the business component; (2) related to the adaptation of an existing business component to a particular customer's requirements; (3) related to the duplication of an

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[675] Sec. 41(c)(5)(A).

[676] Sec. 41(c)(5)(B).

[677] Sec. 41(c)(5)(C).

[678] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

[679] For a discussion of section 174, see section 3108 of the discussion draft, "Amortization of research and experimental expenditures."

[680] Sec. 41(d)(3).

existing business component from a physical examination of the component itself or certain other information; (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control; (5) related to software developed primarily for internal use by the taxpayer; (6) conducted outside the United States, Puerto Rico, or any U.S. possession; (7) in the social sciences, arts, or humanities; or (8) funded by any grant, contract, or otherwise by another person (or government entity).[681]

Relation to deduction

Deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[682] Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.[683]

Description of Proposal

The proposal makes permanent the alternative simplified method[684] for calculating the research credit and increases the rate to 15 percent. That is, the research credit is equal to 15 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to 10 percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. The proposal repeals the traditional 20-percent research credit calculation method.

The proposal also makes permanent the basic research credit, but reduces the credit rate to 15 percent and changes the base period from a fixed period to a three-year rolling average. The proposal repeals the energy research credit.

The proposal eliminates the research credit with respect to research related to computer software. In addition, the proposal removes from the definition of qualified research expenses amounts paid for supplies in the conduct of qualified research. The proposal also eliminates the special rules in the research credit that allow, in certain cases, for contract research expenses to exceed 65 percent of the amount actually paid for such expenses.

Finally, the proposal eliminates a taxpayer's ability to claim a reduced research credit amount in lieu of reducing research and development deductions otherwise allowed.

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[681] Sec. 41(d)(4).

[682] Sec. 280C(c).

[683] Sec. 280C(c)(3).

[684] The discussion draft refers to "the alternative simplified method" as "the incremental research credit."

Effective Date

The proposal to make various components of the research credit permanent is effective for amounts paid or incurred after December 31, 2013. The other elements of the proposal are effective for taxable years beginning after December 31, 2013.

4. Modification of low-income housing tax credit (sec. 3204 of the discussion draft and sec. 42 of the Code)

Present Law

In general

The low-income housing tax credit ("LIHTC") may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels.[685] The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The applicable percentage is designed to produce a credit with a present value equal to a fixed percentage of the qualified basis of the building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building. Eligible basis is generally adjusted basis at the close of the first taxable year of the credit period.

Qualified low-income housing project

To qualify for the low-income housing tax credit, the incomes of the tenants must satisfy certain targeting rules. Under the LIHTC rules, a project is a qualified low-income housing project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified low-income housing project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). The owner must elect to apply either the 20-50 test or the 40-60 test. Operators of qualified low-income housing projects must annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test. In practice, many projects have every unit satisfy the income targeting rules so that the entire project qualifies for the credit.

Present value credit

In general

The calculation of the applicable percentage is designed to produce a credit with a present value equal to: (1) 70 percent of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is not Federally subsidized (the "70-percent credit"); or (2) 30 percent of the building's qualified basis in the case of newly constructed or substantially

[685] Sec. 42.

rehabilitated housing that is Federally subsidized and existing housing that is substantially rehabilitated (the "30-percent credit"). For example, in a zero-interest-rate environment, a building eligible for a 70-percent credit has an annual applicable percentage of seven percent for each of the ten years of the credit period. As interest rates rise, the seven-percent applicable percentage also rises to preserve the present value of the credit.

Where existing housing is substantially rehabilitated, the existing housing is eligible for the 30-percent credit and the qualified rehabilitation expenses (if not Federally subsidized) are eligible for the 70-percent credit.

Special rule

Under a special rule the applicable percentage is set at a minimum of nine percent for newly constructed non-Federally subsidized buildings placed in service after July 30, 2008 with respect to credit allocations made before January 1, 2014.

Calculation of the applicable percentage

The credit percentage for a low-income building is set for the earlier of: (1) the month the building is placed in service; or (2) at the election of the taxpayer, (a) the month the taxpayer and the housing credit agency enter into a binding agreement with respect to such building for a credit allocation, or (b) in the case of a tax-exempt bond-financed project for which no credit allocation is required, the month in which the tax-exempt bonds are issued.

These credit percentages (used for the 70-percent credit and 30-percent credit) are adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the applicable Federal rates for mid-term and long-term obligations for the month the building is placed in service.[686] The discounting formula assumes that each credit is received on the last day of each year and that the present value is computed on the last day of the first year. In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building.

Substantial rehabilitation requirement

Rehabilitation expenditures paid or incurred by a taxpayer with respect to a low-income building are treated as a separate building and may be eligible for the 70-percent credit if they satisfy the otherwise applicable credit rules. To qualify for the credit, the rehabilitation expenditures must equal the greater of an amount that is (1) at least 20 percent of the adjusted basis of the building being rehabilitated; or (2) at least $6,000 per low-income unit in the building being rehabilitated. The $6,000 amount is indexed for inflation, so it is $6,500 in 2014.

[686] Under present law, the discount rate is 72 percent of the average of the mid-term and long-term applicable Federal rates. This assumes a 28-percent tax rate, the highest individual income tax rate at the time of the creation of the low-income housing tax credit.

At the election of the taxpayer, a special rule applies allowing the 30-percent credit to both existing buildings and rehabilitation expenditures if the second prong (*i.e.*, at least $6,000 of rehabilitation expenditures per low-income unit) of the rehabilitation expenditures test is satisfied. This special rule applies only in the case where the taxpayer acquired the building and immediately prior to that acquisition the building was owned by or on behalf of a government unit.

Enhanced credit for buildings in high-cost areas

Generally, buildings located in three types of high-cost areas (*i.e.*, qualified census tracts, difficult development areas and buildings designated by the State housing credit agency as requiring the enhanced credit in order for such buildings to be financially feasible) are eligible for an enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credits are increased to a 91-percent and 39-percent credit, respectively. The mechanism for this increase is through an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building. A further requirement for the enhanced credit in qualified census tracts and difficult development areas is that the portions of each metropolitan statistical area or nonmetropolitan statistical area designated as difficult to develop areas cannot exceed an aggregate area having 20 percent of the population of such statistical area. Buildings designated by the State housing credit agency as requiring the enhanced credit in order for such buildings to be financially feasible are not subject to the limitation limiting high cost areas to 20 percent of the population of each metropolitan statistical area or nonmetropolitan statistical area.

Recapture

The compliance period for any building is the period beginning on the first day of the first taxable year of the credit period of such building and ending 15 years from such date.

The penalty for any building subject to the 15-year compliance period failing to remain part of a qualified low-income project (due, for example, to noncompliance with the minimum set aside requirement, or the gross rent requirement, or other requirements with respect to the units comprising the set aside) is recapture of the accelerated portion of the credit, with interest, for all prior years.

Allocation of credits

A low-income housing tax credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. Generally, the aggregate credit authority provided annually to each State for calendar year 2014 is $2.30 per resident, with a minimum annual cap of $2,635,000 for certain small population States.[687] These amounts are indexed for inflation. Projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit do not require an

[687] Rev. Proc. 2013-35, 2013-47 I.R.B. 537 (November 18, 2013).

allocation of the low-income housing credit, but the related use of tax-exempt bonds is subject to limitation.

Description of Proposal

Allocation of qualified basis rather than credits

Under the proposal, a low-income housing tax credit is only allowed if the owner of a qualified building receives an allocation of qualified basis, as opposed to housing credits under present law, from the State or local housing credit agency. Generally, the aggregate basis authority provided annually to each State for calendar year 2015 is $31.20 per resident, with a minimum annual cap of $36.3 million for certain small population States. These amounts are indexed annually for inflation in increments of $0.20 and $100,000, respectively.

The enhanced credits for 130 percent of the otherwise applicable basis of buildings in high-cost areas are repealed.

The proposal repeals the part of the calculation of the State housing credit ceiling that allows unused housing credit carryovers to be allocated among certain States (the so called national reallocation pool).

The proposal repeals the special rule for States with constitutional home rule cities.

Credit period

The proposal changes the credit period from 10 years to 15 years. The credit recapture rules are repealed. As the credit period and compliance period are both 15 years, there is no accelerated portion of the credit to recapture.

Applicable percentage

As a result of the lengthening of the credit period, the applicable percentage for determining the 70-percent credit is reduced relative to present law. However, the applicable percentage is determined in such a way as to maintain a credit with a present value equal to 70 percent of the building's qualified basis. The discount rate used to determine the applicable percentage is the applicable discount percentage of the average of the mid-term and long-term applicable Federal rates. The applicable discount percentage is the number of percentage points by which 100 percent exceeds the highest corporate income tax rate for a taxable year which begins in such month.[688]

The proposal repeals the 30-percent credit, and related rules, for qualified basis of a building that is not a new building or any building that is Federally subsidized.[689] Rehabilitation

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[688] This reflects the increased usage of the LIHTC by corporations rather than individuals since the creation of the credit.

[689] Including sections 42(b)(1)(B)(ii), (d)(5)(A), (f)(5), (h)(4), (k)(2)(m)(1)(D), and (m)(2)(D).

expenditures that are substantial are treated as a separate new building as under present law and are eligible for the 70-percent credit.

Modification of rules against preferential treatment

The proposal repeals the exception to the general public use requirement for preferences that favor tenants who are involved in artistic or literary activities and adds an exception for veterans.

Selection criteria

The proposal modifies the selection criteria that a qualified allocation plan must include to remove the energy efficiency and historic nature criteria.

Effective Date

The proposal applies to allocations after December 31, 2014.

5. Repeal of enhanced oil recovery credit (sec. 3205 of the discussion draft and sec. 43 of the Code)

Present Law

A 15-percent credit is available for expenses associated with an enhanced oil recovery ("EOR") project. Qualified EOR costs consist of the following designated expenses associated with an EOR project: (1) amounts paid for depreciable tangible property; (2) intangible drilling and development expenses; (3) tertiary injectant expenses; and (4) construction costs for certain Alaskan natural gas treatment facilities. An EOR project is generally a project that involves increasing the amount of recoverable domestic crude oil through the use of one or more tertiary recovery methods (as defined in section 193(b)(3)), such as injecting steam or carbon dioxide into a well to effect oil displacement. The credit is reduced as the price of oil exceeds a certain threshold and is currently phased-out.

Description of Proposal

The proposal repeals the enhanced oil recovery credit.

Effective Date

The proposal is effective on the date of enactment.

6. Modification and repeal of electricity produced from certain renewable resources (sec. 3206 of the discussion draft and sec. 45 of the Code)

Present Law

Renewable electricity production credit

A production credit is available for electricity produced from certain renewable resources during the 10-year period beginning after the renewable power facility has been placed in service. The full credit rate is 1.5 cents per kilowatt-hour (adjusted for inflation; 2.3 cents per kilowatt-hour for 2013) and is available for power produced at qualified wind, closed-loop biomass, and geothermal facilities. A credit equal to one-half the full credit rate (1.1 cents per kilowatt hour for 2013) is available for power produced at open-loop biomass, small irrigation power, landfill gas, trash combustion, marine/hydrokinetic, and certain hydropower facilities. The credit expired for facilities the construction of which began after December 31, 2013.

Election to claim energy credit in lieu of renewable electricity production credit

A taxpayer may make an irrevocable election to have certain property which is part of a qualified renewable power facility be treated as energy property eligible for a 30-percent investment credit under section 48. For this purpose, qualified renewable power facilities are facilities otherwise eligible for the renewable electricity production credit with respect to which no credit under section 45 has been allowed. A taxpayer electing to treat a facility as energy property may not claim the renewable electricity production credit. The eligible basis for the investment credit for taxpayers making this election is the basis of the depreciable (or amortizable) property that is part of a facility capable of generating electricity eligible for the renewable electricity production credit. No credit is available for facilities the construction of which began after December 31, 2013.

Refined coal production credit

A production credit of $4.375 per ton (adjusted for inflation; $6.59 per ton for 2013) is available for refined coal produced at a qualified facility during the 10-year period beginning on the date such facility has been placed in service. Refined coal is defined as a synthetic fuel produced from coal (including lignite) or high-carbon fly ash that when burned emits 20 percent less nitrogen oxide and 40 percent less sulfur dioxide or mercury compared to feedstock coal predominantly available in the marketplace as of January 1, 2003. The refined coal must be sold to a third party with the reasonable expectation that it will be used for the purpose of producing steam. Qualified refined coal facilities must be placed in service before January 1, 2010.

Description of Proposal

The proposal eliminates the credit rate inflation adjustments for the renewable electricity and refined coal production tax credits. Thus, for renewable electricity, the full credit rate is 1.5 cents per kilowatt-hour and the half credit rate is 0.75 cents per kilowatt-hour. For refined coal, the credit rate reverts to $4.375 per ton.

The proposal also clarifies that for purposes of determining whether the construction of a qualified renewable power facility (including modifications, improvements, additions, or the construction of other related property) is treated as beginning before January 1, 2014, there must be a continuous program of construction that begins before such date and ends on the date such property is placed in service.

Finally, the proposal repeals the section 45 credit (including the credits for renewable electricity and refined coal) in its entirety for electricity and coal produced and sold after December 31, 2024.

Effective Date

With respect to the inflation adjustment, the proposal is effective for electricity and refined coal produced and sold after December 31, 2014. The clarification of the rules for determining whether construction has begun is effective for taxable years beginning before on or after the date of enactment. The repeal of the credit is effective for electricity and coal produced and sold after December 31, 2024.

7. Indian employment credit (sec. 3207 of the discussion draft and sec. 45A of the Code)

Present Law

In general, a credit against income tax liability is allowed to employers for the first $20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees.[690] The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to $20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed. An "Indian reservation" is a reservation as defined in section 3(d) of the Indian Financing Act of 1974[691] or section 4(10) of the Indian Child Welfare Act of 1978.[692] For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma"

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[690] Sec. 45A.

[691] Pub. L. No. 93-262.

[692] Pub. L. No. 95-608.

as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

An employee is not treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of $30,000, as adjusted for inflation in the manner described (which is $45,000 for 2013). In addition, an employee will not be treated as a qualified employee under certain specific circumstances, such as where the employee is related to the employer (in the case of an individual employer) or to one of the employer's shareholders, partners, or grantors. Similarly, an employee will not be treated as a qualified employee where the employee has more than a five percent ownership interest in the employer. Finally, an employee will not be considered a qualified employee to the extent the employee's services relate to gaming activities or are performed in a building housing such activities.

The wage credit is available for wages paid or incurred in taxable years that begin on or before December 31, 2013.

Description of Proposal

This proposal repeals the Indian employment credit and provides conforming amendments to preserve the definition of the term "Indian tribe."

Effective Date

The proposal applies to taxable years beginning after December 31, 2013.

8. Repeal of credit for portion of employer Social Security taxes paid with respect to employee cash tips (sec. 3208 of the discussion draft and sec. 45B of the Code)

Present Law

Employee tip income is treated as employer-provided wages subject to taxes under the Federal Insurance Contributions Act ("FICA").[693] Employees are required to report the amount of tips received.

A business tax credit is provided equal to an employer's FICA taxes paid on tips in excess of those treated as wages for purposes of meeting the minimum wage requirements of the Fair Labor Standards Act (the "FLSA") as in effect on January 1, 2007.[694] The credit applies

[693] FICA taxes consist of social security and hospital taxes imposed on employers and employees with respect to wages paid to employees under sections 3101-3128.

[694] As of January 1, 2007, the Federal minimum wage under the FLSA was $5.15 per hour. In the case of tipped employees, the FLSA provided that the minimum wage could be reduced to $2.13 per hour (that is, the employer is only reqnired to pay cash eqnal to $2.13 per hour) if the combination of tips and cash income equaled the Federal minimum wage.

only with respect to FICA taxes paid on tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption if the tipping of employees delivering or serving food or beverages by customers is customary. The credit is available whether or not the employee reports the tips on which the employer FICA taxes were paid. No deduction is allowed for any amount taken into account in determining the tip credit. A taxpayer may elect not to have the credit apply for a taxable year.

Description of Proposal

The proposal repeals the credit for FICA taxes an employer pays on tips.

Effective Date

The proposal is effective for tips received for services performed after December 31, 2014.

9. Repeal of credit for clinical testing expenses for certain drugs for rare diseases or conditions (sec. 3209 of the discussion draft and sec. 45C of the Code)

Present Law

Present law provides a 50-percent business tax credit for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as "orphan drugs."[695] Qualified clinical testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration ("FDA") but before the drug has been approved for sale by the FDA.[696] A rare disease or condition is defined as one that (1) affects less than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from sales in the United States of the drug.[697]

Amounts included in computing the credit under this section are excluded from the computation of the research credit under section 41.[698]

Description of Proposal

This proposal repeals the credit for qualified clinical testing expenses.

[695] Sec. 45C.

[696] Sec. 45C(b).

[697] Sec. 45C(d).

[698] Sec. 45C(c).

Effective Date

The proposal applies to amounts paid or incurred in taxable years beginning after December 31, 2014.

10. Repeal of credit for small employer pension plan startup costs (sec. 3210 of the discussion draft and sec. 45E of the Code)

Present Law

Present law provides a nonrefundable income tax credit for qualified start-up costs of an eligible small employer that adopts a new qualified retirement plan, SIMPLE IRA plan, or simplified employee pension plan, provided that the plan covers at least one nonhighly compensated employee. Qualified start-up costs are expenses connected with the establishment or administration of the plan or retirement-related education for employees with respect to the plan. The credit is the lesser of $500 per year or 50 percent of the qualified start-up costs. The credit applies for up to three years beginning with the year the plan is first effective, or, at the election of the employer, the preceding year.

An eligible employer is an employer that, for the preceding year, had no more than 100 employees with compensation of $5,000 or more. In addition, the employer must not have had a plan covering substantially the same employees as the new plan during the three years preceding the first year for which the credit would apply. Members of controlled groups and affiliated service groups are treated as single employers for purposes of these requirements.

Description of Proposal

The proposal repeals the credit for qualified start-up costs of an eligible small employer.

Effective Date

The proposal is effective for costs paid or incurred after December 31, 2014, with respect to plans first effective after that date.

11. Repeal of credit for employer-provided childcare (sec. 3211 of the discussion draft and section 45F of the Code)

Present Law

Taxpayers are eligible for a tax credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. The maximum total credit that may be claimed by a taxpayer may not exceed $150,000 per taxable year. The credit is part of the general business credit.

Qualified child care expenses include costs paid or incurred: (1) to acquire, construct, rehabilitate or expand property that is to be used as part of the taxpayer's qualified child care facility;[699] (2) for the operation of the taxpayer's qualified child care facility, including the costs of training and certain compensation for employees of the child care facility, and scholarship programs; or (3) under a contract with a qualified child care facility to provide child care services to employees of the taxpayer. To be a qualified child care facility, the principal use of the facility must be for child care (unless it is the principal residence of the taxpayer), and the facility must meet all applicable State and local laws and regulations, including any licensing laws.

Description of Proposal

The proposal repeals the credit for qualified child care expenditures.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

12. Repeal of railroad track maintenance credit (sec. 3212 of the discussion draft and sec. 45G of the Code)

Present Law

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during taxable years beginning before January 1, 2014.[700] The credit is limited to the product of $3,500 times the number of miles of railroad track (1) owned or leased by an eligible taxpayer as of the close of its taxable year, and (2) assigned to the eligible taxpayer by a Class II or Class III railroad that owns or leases such track at the close of the taxable year.[701] Each mile of railroad track may be taken into account only once, either by the owner of such mile or by the owner's assignee, in computing the per-mile limitation. The credit also may reduce a taxpayer's tax liability below its tentative minimum tax.[702] Basis of the railroad track must be reduced (but not below zero) by an amount equal to 100 percent of the taxpayer's qualified railroad track maintenance tax credit determined for the taxable year.[703]

Qualified railroad track maintenance expenditures are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class

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[699] In addition, a depreciation deduction (or amortization in lieu of depreciation) must be allowable with respect to the property and the property must not be part of the principal residence of the taxpayer or any employee of the taxpayer.

[700] Secs. 45G(a) and (f).

[701] Sec. 45G(b)(1).

[702] Sec. 38(c)(4).

[703] Sec. 45G(e)(3).

II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).[704]

An eligible taxpayer means any Class II or Class III railroad, and any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to a Class II or Class III railroad, but only with respect to miles of railroad track assigned to such person by such railroad under the provision.[705]

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.[706]

Description of Proposal

This proposal repeals the credit for qualified railroad track maintenance expenditures.

Effective Date

The proposal applies to taxable years beginning after December 31, 2013.

13. Repeal of credit for production of low sulfur diesel fuel (sec. 3213 of the discussion draft and sec. 45H of the Code)

Present Law

A small business refiner may claim a credit of five cents per gallon for each gallon of low sulfur diesel fuel produced during the taxable year that is in compliance with the Highway Diesel Fuel Sulfur Control Requirements of the EPA. A small business refiner is a crude oil refiner that has no more than 1,500 individuals engaged in refinery operations on any given day and that had an average daily domestic refinery run or average retained production of not more than 205,000 barrels for the one-year period ending on December 31, 2002.

The total production credit claimed by the taxpayer is limited to 25 percent of the capital costs incurred to come into compliance with the EPA diesel fuel requirements. The percentage limitation phases down pro rata for refiners that had runs in 2002 exceeding 155,000 barrels but less than 205,000 barrels.

Costs qualifying for the credit are those costs paid or incurred with respect to any facility of a small business refiner during the period beginning on January 1, 2003 and ending on the earlier of the date that is one year after the date on which the taxpayer must comply with the applicable EPA regulations or December 31, 2009. The taxpayer's basis in property with respect to which the credit applies is reduced by the amount of the production credit claimed. Although

[704] Sec. 45G(d).

[705] Sec. 45G(c).

[706] Sec. 45G(e)(1).

the period for incurring qualified expenditures ended on December 31, 2009, a taxpayer may claim the production credit until the 25 percent limit is reached.

Description of Proposal

The proposal repeals the credit for production of low sulfur diesel fuel.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

14. Repeal of credit for producing oil and gas from marginal wells (sec. 3214 of the discussion draft and sec. 45I of the Code)

Present Law

The Code provides a $3-per-barrel credit for the production of crude oil and a $0.50 credit per 1,000 cubic feet of qualified natural gas production. In both cases, the credit is available only for production from a "qualified marginal well."

A qualified marginal well is defined as domestic well: (1) production from which is treated as marginal production for purposes of the Code percentage depletion rules; or (2) that during the taxable year had average daily production of not more than 25 barrel equivalents and produces water at a rate of not less than 95 percent of total well effluent. The maximum amount of production on which credit could be claimed is 1,095 barrels or barrel equivalents.

The credit is not available to production occurring if the reference price of oil exceeds $18 ($2.00 for natural gas). The credit is reduced proportionately as for reference prices between $15 and $18 ($1.67 and $2.00 for natural gas). Currently the credit is totally phased out.

In the case of production from a qualified marginal well which is eligible for the credit allowed under section 45K for the taxable year, no marginal well credit is allowable unless the taxpayer elects not to claim the credit under section 45K with respect to the well. The credit is treated as a general business credit. Unused credits can be carried back for up to five years rather than the generally applicable carryback period of one year. The credit is indexed for inflation.

Description of Proposal

The proposal repeals the credit for producing oil from marginal wells.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

15. Repeal of credit for production from advanced nuclear power facilities (sec. 3215 of the discussion draft and sec. 45J of the Code)

Present Law

A production tax credit available for the production of nuclear power from new facilities that use modern designs and have received an allocation from the Secretary (who may allocate up 6,000 megawatts of credit-eligible capacity). The credit rate is 1.8 cents per kilowatt-hour for the eight year period starting when the facility was placed in service. Qualified facilities must be placed in service by December 31, 2020.

Description of Proposal

The proposal repeals the advanced nuclear power production tax credit.

Effective Date

The proposal is effective for electricity produced and sold after December 31, 2014.

16. Repeal of credit for producing fuel from a nonconventional source (sec. 3216 of the discussion draft and sec. 45K of the Code)

Present Law

Certain fuels produced in the United States from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation)[707] per barrel or Btu oil barrel equivalent ("non-conventional source fuel credit"). Qualified fuels include: oil produced from shale and tar sands; gas produced from geopressured brine, Devonian shale, coal seams, tight formations, or biomass; and liquid, gaseous, or solid synthetic fuels produced from coal (including lignite). The non-conventional source fuel credit provision also includes a credit for certain coke or coke gas produced at qualified facilities. The credit has expired, except for coke or coke gas produced before December 30, 2013, at certain qualified facilities.

Description of Proposal

The proposal repeals the credit for nonconventional source fuel.

Effective Date

The proposal is effective for fuel produced and sold after December 31, 2013.

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[707] The inflation adjustment is generally calculated using 1979 as the base year. The credit for coke or coke gas is indexed for inflation using 2004 as the base year instead of 1979.

17. Repeal of energy efficient new homes credit (sec. 3217 of the discussion draft and sec. 45l of the Code)

Present Law

A credit is available through 2013 for homes placed in service that exceed certain efficiency standards. The credit is $1,000 for homes that exceed the standard by 30 percent and $2,000 for homes that exceed the standard by 50 percent.

Description of Proposal

The proposal repeals the credit for energy efficient new homes.

Effective Date

The proposal is effective for new homes acquired after December 31, 2013.

18. Repeal of energy efficient appliance credit (sec. 3218 of the discussion draft and sec. 45M of the Code)

Present Law

Credits are available through 2013 for certain energy-efficient consumer appliances, such as dishwashers, clothes washers, and refrigerators. Credit amounts vary between $50 and $225 depending on the type and efficiency of the eligible appliance.

Description of Proposal

The proposal repeals the credit for energy efficient appliances.

Effective Date

The proposal is effective for appliances produced after December 31, 2013.

19. Repeal of mine rescue team training credit (sec. 3219 of the discussion draft and sec. 45N of the Code)

Present Law

An eligible employer may claim a general business credit against income tax with respect to each qualified mine rescue team employee equal to the lesser of: (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of the qualified mine rescue team employee (including the wages of the employee while attending the program); or (2) $10,000.[708] A qualified mine rescue team employee is any full-time employee of the taxpayer who is a miner eligible for more than six months of a taxable year

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[708] Sec. 45N(a).

to serve as a mine rescue team member by virtue of either having completed the initial 20 hour course of instruction prescribed by the Mine Safety and Health Administration's Office of Educational Policy and Development, or receiving at least 40 hours of refresher training in such instruction.[709]

An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States.[710] The term "wages" has the meaning given to such term by section 3306(b)[711] (determined without regard to any dollar limitation contained in that section).[712]

No deduction is allowed for the portion of the expenses otherwise deductible that is equal to the amount of the credit.[713] The credit does not apply to taxable years beginning after December 31, 2013.[714] Additionally, the credit is not allowable for purposes of computing the alternative minimum tax.[715]

Description of Proposal

This proposal repeals the credit for qualified mine rescue team training expenses.

Effective Date

The proposal applies to taxable years beginning after December 31, 2013.

20. Repeal of agricultural chemicals security tax credit (sec. 3220 of the discussion draft and sec. 45O of the Code)

Present Law

The Code provides a 30-percent credit for qualified chemical security expenditures for the taxable year with respect to eligible agricultural businesses. The credit is a component of the general business credit.[716]

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709 Sec. 45N(b).

710 Sec. 45N(c).

711 Section 3306(b) defines wages for purposes of Federal Unemployment Tax.

712 Sec. 45N(d).

713 Sec. 280C(e).

714 Sec. 45N(e).

715 Sec. 38(c).

716 Sec. 38(b)(1).

The credit is limited to $100,000 per facility; this amount is reduced by the aggregate amount of the credits allowed for the facility in the prior five years. In addition, each taxpayer's annual credit is limited to $2,000,000.[717] The credit only applies to expenditures paid or incurred before December 31, 2012. The taxpayer's deductible expense is reduced by the amount of the credit claimed.

Description of Proposal

The proposal repeals the agriculture chemicals security credit.

Effective Date

The proposal is effective for amounts paid or incurred after December 31, 2012.

21. Repeal of credit for carbon dioxide sequestration (sec. 3221 of the discussion draft and section 45Q of the Code)

Present Law

A credit is available for the sequestration of industrial source carbon dioxide produced at qualified U.S. facilities. Qualified facilities must capture at least 500,000 metric tons of carbon dioxide per year. The credit rate is $10 per ton for carbon dioxide used first as a tertiary injectant and then disposed of in secure geological storage and $20 per ton for carbon dioxide disposed of in secure geological storage without being first used as tertiary injectant. The credit expires at the end of the year in which the Secretary determines that 75 million tons of carbon dioxide have been captured and sequestered.

Description of Proposal

The proposal repeals the credit for carbon dioxide sequestration.

Effective Date

The proposal is effective for credits determined for taxable years beginning after December 31, 2014.

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[717] The term taxpayer includes controlled groups under rules similar to the rules set out in section 41(f)(1) and (2).

22. Repeal of credit for employee health insurance expenses of small employers (sec. 3222 of the discussion draft and sec. 45R of the Code)

Present Law

In general

An eligible small employer may be eligible for a tax credit for nonelective contributions to purchase health insurance for its employees.[718] An eligible small employer for this purpose generally is an employer with no more than 25 full-time equivalent employees ("FTEs") during the employer's taxable year, whose average annual wages do not exceed $50,000.[719] However, the full amount of the credit is available only to an employer with 10 or fewer FTEs whose average annual wages do not exceed $25,000.

An employer's FTEs are calculated by dividing the total hours worked by all employees during the employer's tax year (up to 2,080 for any employee) by 2,080 (and rounding down to the nearest whole number of FTEs). Average annual wages are determined by dividing the total wages paid by the employer by the number of FTEs (and rounding down to the nearest $1,000).

For purposes of the credit, the employer is determined by applying the aggregation rules for controlled groups, groups under common control, and affiliated service groups.[720] In addition, for purposes of the credit, the term "employee" includes a leased employee, i.e., an individual who is not an employee of the employer, who provides services to the employer pursuant to an agreement between the employer and another person (a "leasing organization") and under the primary direction or control of the employer, and who has performed such services on a substantially full-time basis for at least one year.[721]

Self-employed individuals (including partners and sole proprietors), two-percent shareholders of an S corporation, and five-percent owners of the employer are not employees for purposes of the credit with the result that they are disregarded in determining number of FTEs, average annual wages, and nonelective contributions for employees' health insurance. Family members of these individuals and any member of the individual's household who is a dependent for tax purposes are also not employees for purposes of the credit. In addition, the hours of service worked by and wages paid to a seasonal worker of an employer are not taken into

[718] A nonelective contribution is an employer contribution other than an employer contribution pursuant to a salary reduction arrangement. Therefore, any amount contributed pursuant to a salary reduction arrangement under a cafeteria plan within the meaning of section 125 is not a nonelective contribution for purposes of the credit.

[719] Wages for this purpose is defined as under the Federal Insurance Contributions Act ("FICA"), sections 3101-3128, without regard to the dollar limit on FICA wages under section 3121(a). The wage amounts relevant for purposes of the credit are indexed to the Consumer Price Index for Urban Consumers ("CPI-U") for years beginning after 2013.

[720] Sec. 414(b), (c), (m) and (o).

[721] Sec. 414(n)(2).

account in determining number of FTEs and average annual wages unless the worker works for the employer on more than 120 days during the taxable year.

The employer contributions must be provided under an arrangement that requires the eligible small employer to make, on behalf of each employee who enrolls in qualifying health insurance offered by the employer, a nonelective contribution equal to a uniform percentage (not less than 50 percent) of the premium cost of the qualifying health insurance (described below).

The credit is available only to offset actual tax liability and is claimed on the employer's tax return. The credit is a general business credit and generally can be carried back for one year and carried forward for 20 years. The credit is available for tax liability under the alternative minimum tax. The dollar amount of the credit reduces the amount of employer contributions the employer may deduct as a business expense.

Years credit available and qualifying health insurance

An initial credit is available for any taxable year beginning in 2010, 2011, 2012, or 2013. Qualifying health insurance for claiming the credit for this first phase of the credit is health insurance coverage as defined for purposes of the group health plan requirements under the Code, which is generally health insurance coverage offered by an insurance company licensed under State law.

For taxable years beginning after 2013, the credit is available only for nonelective contributions for premiums for qualified health plans offered by the employer through an American Health Benefit Exchange and is available for a maximum credit period of two consecutive taxable years beginning with the first taxable year in which the employer (or any predecessor) offers one or more qualified health plans to its employees through an American Health Benefit Exchange. The maximum two-year credit period does not take into account any taxable years beginning before 2014.

Calculation of credit amount

Only nonelective contributions by the employer are taken into account in calculating the credit. The credit is equal to the lesser of the following two amounts multiplied by an applicable credit percentage: (1) the amount of contributions the employer made on behalf of the employees during the taxable year for the qualifying health insurance and (2) the amount of contributions the employer would have made during the taxable year if each employee with the qualifying health insurance had enrolled in insurance with a benchmark premium (as described below). As discussed above, the credit is available only if nonelective contributions are a uniform percentage of at least 50 percent of the premium cost of the qualifying health insurance.

For the first phase of the credit (taxable years beginning in 2010, 2011, 2012, or 2013), the applicable credit percentage is generally 35 percent, and the benchmark premium is the average premium for the small group market (i.e., insurance coverage provided by small employers) in the employer's State, as determined by the Secretary of Health and Human Services ("HHS"). For taxable years beginning after 2013, the applicable credit percentage is generally 50 percent, and the benchmark premium is the average premium for the small group market in the rating area in which the employee enrolls for coverage, as determined by the Secretary of HHS.

The credit is reduced for an employer with between 10 and 25 FTEs ("FTE phase-out"). The credit is also reduced for an employer for whom the average annual wages per FTE is between $25,000 and $50,000 ("average annual wages phase-out"). For an employer with both more than 10 FTEs and average annual wages in excess of $25,000, the reduction is the sum of the amount of the two reductions.

Tax-exempt organizations

For tax-exempt organizations, the applicable credit percentage during the first phase of the credit (taxable years beginning in 2010, 2011, 2012, or 2013) is limited to 25 percent and the applicable credit percentage during the second phase (taxable years beginning after 2013) is limited to 35 percent. In addition, instead of a general business credit, the credit is a refundable credit limited to the amount of the payroll taxes of the employer during the calendar year in which the taxable year begins.[722]

Description of Proposal

The proposal repeals the credit for a small employer that pays health insurance premiums for its employees.

Effective Date

The proposal is effective for amounts paid or incurred for taxable years beginning after December 31, 2014.

23. Repeal of rehabilitation credit (sec. 3223 of the discussion draft and sec. 47 of the Code)

Present Law

Present law provides a two-tier tax credit for rehabilitation expenditures.[723]

A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

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[722] For this purpose, "payroll taxes" means: (1) the amount of income tax required to be withheld from its employees' wages under section 3402; (2) the amount of hospital insurance tax under section 3101(b) required to be withheld from its employees' wages under section 3102; and (3) the amount of the hospital insurance tax under section 3111(b) imposed on the employer.

[723] Sec. 47.

A 10-percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

Description of Proposal

The proposal repeals the rehabilitation credit.

Effective Date

The proposal generally is effective for amounts paid after December 31, 2014. A transition rule provides that in the case of qualified rehabilitation expenditures (within the meaning of present law), with respect to any building acquired by the taxpayer before January 1, 2015, and with respect to which the 24-month period selected by the taxpayer (under section 47(c)(1)(C)) begins before January 1, 2015, the provision is effective for amounts paid after December 31, 2016.

24. Repeal of energy credit (sec. 3224 of the discussion draft and sec. 48 of the Code)

Present Law

A business tax credit ranging from 10 to 30 percent of the basis of property placed in service is allowed for certain solar, geothermal, wind, fuel cell, microturbine, and combined heat and power property. The 30 percent credit expires for property placed in service after December 31, 2016. Beginning in 2017, the credit is 10 percent, and is available only for certain geothermal and solar property.

Description of Proposal

The proposal repeals the energy credit.

Effective Date

The proposal is effective for property placed in service after December 31, 2016.

25. Repeal of qualifying advanced coal project credit (sec. 3225 of the discussion draft and sec. 48A of the Code)

Present Law

An investment credit is available for projects that use integrated gasification combined cycle (IGCC) or other advanced coal-based electricity generation technologies. Credits are allocated by the Secretary. First round allocations are capped at $800 million for IGCC projects and $500 million for other projects. Second round allocations are capped at $1.25 billion. Second round projects must generally sequester 65 percent of total carbon dioxide emissions (70 percent in the case of reallocated credits). The credit rate is 20 percent for first round IGCC projects, 15 percent for other first round projects, and 30 percent for second round projects. All credits have been fully allocated.

Description of Proposal

The proposal repeals the credit for qualifying advanced coal projects.

Effective Date

The proposal is effective for credit allocations and reallocations occurring after December 31, 2014.

26. Repeal of qualifying gasification project credit (sec. 3226 of the discussion draft and section 48B of the Code)

Present Law

An investment credit is available for qualified projects that use gasification technology. Qualified projects convert coal, petroleum residue, biomass, or other materials recovered for their energy content into a synthesis gas for direct use or subsequent chemical or physical conversion. Credits are allocated by the Secretary. First round allocations are capped at $350 million. Second round allocations are capped at $250 million. First round projects are generally limited to industrial applications; second round projects include projects designed to produce motor fuels. Second round projects must generally sequester 65 percent of total carbon dioxide emissions. The credit rate is 20 percent for first round projects and 30 percent for second round projects. All credits have been fully allocated.

Description of Proposal

The proposal repeals the qualifying gasification project credit.

Effective Date

The proposal is effective for credit allocations and reallocations occurring after December 31, 2014.

27. Repeal of qualifying advanced energy project credit (sec. 3227 of the discussion draft and section 48C of the Code)

Present Law

A 30-percent investment credit is available for qualifying advanced energy projects. A qualifying advanced energy project is a project that re-equips, expands, or establishes a manufacturing facility for the production: (1) property designed to be used to produce energy from the sun, wind, or geothermal deposits (within the meaning of section 613(e)(2)), or other renewable resources; (2) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric motor vehicles; (3) electric grids to support the transmission of intermittent sources of renewable energy, including storage of such energy; (4) property designed to capture and sequester carbon dioxide; (5) property designed to refine or blend renewable fuels (but not fossil fuels) or to produce energy conservation technologies (including energy-conserving lighting technologies and smart grid technologies); (6) new qualified plug-in electric drive motor vehicles, qualified plug-in electric vehicles, or components which are designed specifically for use with such vehicles, including electric motors, generators, and power control units, or (7) other advanced energy property designed to reduce greenhouse gas emissions as may be determined by the Secretary. Qualified property does not include property designed to manufacture equipment for use in the refining or blending of any transportation fuel other than renewable fuels.

Credits are allocated by the Secretary and are capped at $2.3 billion. All credits have been fully allocated. Credits for projects that fail to meet certain benchmarks may be reallocated by the Secretary.

Description of Proposal

The proposal repeals the qualifying advanced energy project credit.

Effective Date

The proposal is effective for credit allocations and reallocations occurring after December 31, 2014.

28. Repeal of qualifying therapeutic discovery project credit (sec. 3228 of the discussion draft and sec. 48D of the Code)

Present Law

In general

Under present law, a taxpayer is eligible for a 50 percent nonrefundable investment tax credit for qualified investments in qualifying therapeutic discovery projects.[724] Qualified

[724] Sec. 48D.

investments must be made in a taxable year beginning in 2009 and 2010 and the total amount of credits allocated for the program for the two-year period 2009 through 2010 is $1 billion.[725] The Secretary, in consultation with the Secretary of Health and Human Services, awards certifications for qualified investments.[726] The credit is available only to companies having 250 or fewer employees.[727]

A "qualifying therapeutic discovery project" is a project which is designed to develop a product, process, or therapy to diagnose, treat, or prevent diseases and afflictions by: (1) conducting pre-clinical activities, clinical trials, clinical studies, and research protocols, or (2) by developing technology or products designed to diagnose diseases and conditions, including molecular and companion drugs and diagnostics, or to further the delivery or administration of therapeutics.[728]

The qualified investment for any taxable year is the aggregate amount of the costs paid or incurred in such year for expenses necessary for, and directly related to, the conduct of a qualifying therapeutic discovery project.[729] The qualified investment for any taxable year with respect to any qualifying therapeutic discovery project does not include any cost for: (1) remuneration for an employee described in section 162(m)(3), (2) interest expense, (3) facility maintenance expenses, (4) a service cost identified under Treas. Reg. sec. 1.263A-1(e)(4), or (5) any other expenditure as determined by the Secretary as appropriate to carry out the purposes of the provision.[730]

Companies must apply to the Secretary to obtain certification for qualifying investments.[731] The Secretary, in determining qualifying projects, will consider only those projects that show reasonable potential to: (1) result in new therapies to treat areas of unmet medical need or to prevent, detect, or treat chronic or acute disease and conditions; (2) reduce long-term health care costs in the United States; or (3) significantly advance the goal of curing cancer within a 30-year period.[732] Additionally, the Secretary will take into consideration which projects have the greatest potential to: (1) create and sustain (directly or indirectly) high quality,

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[725] Secs. 48D(b)(5) and (d)(1)(B).

[726] Sec. 48D(d)(1)(A).

[727] Sec. 48D(c)(2). The number of employees is determined taking into account all businesses of the taxpayer at the time it submits an application, and is determined taking into account the rules for determining a single employer under section 52(a) or (b) or section 414(m) or (o).

[728] Sec. 48D(c)(1).

[729] Sec. 48D(b)(1).

[730] Sec. 48D(b)(3).

[731] The Secretary must take action to approve or deny an application within 30 days of the submission of such application. Sec. 48D(d)(2).

[732] Sec. 48D(d)(3)(A).

high paying jobs in the United States; and (2) advance the United States' competitiveness in the fields of life, biological, and medical sciences.[733]

Qualified therapeutic discovery project expenditures do not qualify for the research credit, orphan drug credit, or bonus depreciation.[734] If a credit is allowed for an expenditure related to property subject to depreciation, the basis of the property is reduced by the amount of the credit.[735] Additionally, expenditures taken into account in determining the credit are nondeductible to the extent of the credit claimed that is attributable to such expenditures.

Election to receive grant in lieu of tax credit

Taxpayers may elect to receive credits that have been allocated to them in the form of Treasury grants equal to 50 percent of the qualifying investment.[736] Any such grant is not includible in the taxpayer's gross income.

In making grants under this section, the Secretary is to apply rules similar to the rules of section 50.[737] In applying such rules, if an investment ceases to be a qualified investment, the Secretary shall provide for the recapture of the appropriate percentage of the grant amount in such manner as the Secretary determines appropriate. The Secretary shall not make any grant under this section to: (1) any Federal, State, or local government (or any political subdivision, agency, or instrumentality thereof); (2) any organization described in section 501(c) and exempt from tax under section 501(a); (3) any entity referred to in section 54(j)(4); or (4) any partnership or other pass-thru entity any partner (or other holder of an equity or profits interest) of which is described in paragraph (1), (2), or (3).

Description of Proposal

This proposal repeals the credit for qualified therapeutic discovery projects.

Effective Date

The proposal applies to allocations and reallocations after December 31, 2014.

[733] Sec. 48D(d)(3)(B).

[734] Sec. 48D(c)(2). Any expenses for the taxable year that are qualified research expenses under section 41(b) are taken into account in determining base period research expenses for purposes of computing the research credit under section 41 for subsequent taxable years.

[735] Sec. 48D(e)(1).

[736] Sec. 48D(f).

[737] Sec. 9023 of the Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148, enacted March 23, 2010.

29. Repeal of the work opportunity tax credit (sec. 3229 of the discussion draft and sec. 51 of the Code)

Present Law

In general

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer (two years in the case of an individual in the long-term family assistance recipient category).

Targeted groups eligible for the credit

Generally, an employer is eligible for the credit only for qualified wages paid to members of a targeted group.

(1) Families receiving TANF

An eligible recipient is an individual certified by a designated local employment agency (*e.g.*, a State employment agency) as being a member of a family eligible to receive benefits under the Temporary Assistance for Needy Families Program ("TANF") for a period of at least nine months part of which is during the 18-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the TANF.

(2) Qualified veteran

There are five subcategories of qualified veterans: (1) veterans who were eligible to receive assistance under a supplemental nutritional assistance program (for at least a three month period during the year prior to the hiring date) ; (2) veterans who are entitled to compensation for a service connected disability, who are hired within one year of discharge; (3) veterans who are entitled to compensation for a service connected disability, and who have been unemployed for an aggregate of at least six months during the one year period ending on the hiring date; (4) veterans who were unemployed for at least four weeks but less than six months (whether or not consecutive) during the one-year period ending on the date of hiring; and (5) veterans who were unemployed for at least six months (whether or not consecutive) during the one-year period ending on the date of hiring.

A veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not a qualified veteran if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

(3) Qualified ex-felon

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any State or Federal law; and (2) having a hiring date within one year of release from prison or the date of conviction.

(4) Designated community residents

A designated community resident is an individual certified as being at least age 18 but not yet age 40 on the hiring date and as having a principal place of abode within an empowerment zone, enterprise community, renewal community or a rural renewal community. For these purposes, a rural renewal county is a county outside a metropolitan statistical area (as defined by the Office of Management and Budget) which had a net population loss during the five-year periods 1990-1994 and 1995-1999. Qualified wages do not include wages paid or incurred for services performed after the individual moves outside an empowerment zone, enterprise community, renewal community or a rural renewal community.

(5) Vocational rehabilitation referral

A vocational rehabilitation referral is an individual who is certified by a designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing: (a) vocational rehabilitation services under an individualized, written plan for employment under a State plan approved under the Rehabilitation Act of 1973; (b) under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code; or (c) an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(6) Qualified summer youth employee

A qualified summer youth employee is an individual: (1) who performs services during any 90-day period between May 1 and September 15; (2) who is certified by the designated local agency as being 16 or 17 years of age on the hiring date; (3) who has not been an employee of that employer before; and (4) who is certified by the designated local agency as having a principal place of abode within an empowerment zone, enterprise community, or renewal community. As with designated community residents, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone, enterprise community, or renewal community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

(7) Qualified food and nutrition recipient

A qualified food and nutrition recipient is an individual at least age 18 but not yet age 40 certified by a designated local employment agency as being a member of a family receiving assistance under a food and nutrition program under the Food and Nutrition Act of 2008 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food and nutrition assistance under section 6(o) of the Food and Nutrition Act of 2008, the six-month requirement is replaced with a requirement that the family has been receiving food and nutrition assistance for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food and nutrition assistance program under the Food and Nutrition Act of 2008.

(8) Qualified SSI recipient

A qualified SSI recipient is an individual designated by a local agency as receiving supplemental security income ("SSI") benefits under Title XVI of the Social Security Act for any month ending within the 60-day period ending on the hiring date.

(9) Long-term family assistance recipients

A qualified long-term family assistance recipient is an individual certified by a designated local agency as being: (1) a member of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) a member of a family that has received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit)[738] if the individual is hired within two years after the date that the 18-month total is reached; or (3) a member of a family who is no longer eligible for family assistance because of either Federal or State time limits, if the individual is hired within two years after the Federal or State time limits made the family ineligible for family assistance.

Qualified wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

For purposes of the credit, generally, wages are defined by reference to the FUTA definition of wages contained in section 3306(b) (without regard to the dollar limitation therein contained). Special rules apply in the case of certain agricultural labor and certain railroad labor.

[738] The welfare-to-work tax credit was consolidated into the work opportunity tax credit in the Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, for qualified individuals who begin to work for an employer after December 31, 2006.

Calculation of the credit

The credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages). Except for long-term family assistance recipients, no credit is allowed for second-year wages.

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of $10,000 for qualified first-year wages and 50 percent of the first $10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of $10,000) attributable to service rendered by a member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $9,000 (40 percent of the first $10,000 of qualified first-year wages plus 50 percent of the first $10,000 of qualified second-year wages).

In the case of a qualified veterans, the credit is calculated as follows: (1) in the case of a qualified veteran who was eligible to receive assistance under a supplemental nutritional assistance program (for at least a three month period during the year prior to the hiring date) the employer is entitled to a maximum credit of 40 percent of $6,000 of qualified first-year wages; (2) in the case of a qualified veteran who is entitled to compensation for a service connected disability, who is hired within one year of discharge, the employer is entitled to a maximum credit of 40 percent of $12,000 of qualified first-year wages; (3) in the case of a qualified veteran who is entitled to compensation for a service connected disability, and who has been unemployed for an aggregate of at least six months during the one year period ending on the hiring date, the employer is entitled to a maximum credit of 40 percent of $24,000 of qualified first-year wages; (4) in the case of a qualified veteran unemployed for at least four weeks but less than six months (whether or not consecutive) during the one-year period ending on the date of hiring, the maximum credit equals 40 percent of $6,000 of qualified first-year wages; and (5) in the case of a qualified veteran unemployed for at least six months (whether or not consecutive) during the one-year period ending on the date of hiring, the maximum credit equals 40 percent of $14,000 of qualified first-year wages.

Expiration

The work opportunity tax credit is not available with respect to wages paid to individuals who begin work for an employer after December 31, 2013.

Description of Proposal

This proposal repeals the work opportunity tax credit.

Effective Date

The proposal is effective for amounts paid or incurred to individuals who begin work for the employer after December 31, 2013.

30. Repeal of deduction for certain unused business credits (sec. 3230 of the discussion draft and sec. 196 of the Code)

Present Law

The general business credit ("GBC") consists of various individual tax credits allowed with respect to certain qualified expenditures and activities.[739] In general, the various individual tax credits contain provisions that prohibit "double benefits," either by denying deductions in the case of expenditure-related credits or by requiring income inclusions in the case of activity-related credits. Unused credits may be carried back one year and carried forward 20 years.[740]

Section 196 allows a deduction to the extent that certain portions of the GBC expire unused after the end of the carry forward period. In general, 100 percent of the unused credit is allowed as a deduction in the taxable year after such credit expired. However, with respect to the investment credit determined under section 46 (other than the rehabilitation credit) and the research credit determined under section 41(a) (for a taxable year beginning before January 1, 1990), section 196 limits the deduction to 50 percent of such unused credits.[741]

Description of Proposal

This proposal repeals the deduction for certain unused business credits.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

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[739] Sec. 38.

[740] Sec. 39.

[741] Sec. 196(d).

D. Accounting Methods

1. Limitation on use of cash method of accounting (sec. 3301 of the discussion draft and secs. 448 and 451 of the Code)

Present Law

Taxpayers using the cash receipts and disbursements method of accounting (the "cash method") generally recognize items of income when actually or constructively received and items of expense when paid. Taxpayers using an accrual method of accounting generally accrue items of income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[742] Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all events have occurred that fix the right to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[743] An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.[744]

A C corporation, a partnership that has a C corporation as a partner, or a tax-exempt trust with unrelated business income generally may not use the cash method of accounting. Exceptions are made for farming businesses, qualified personal service corporations, and the aforementioned entities to the extent their average annual gross receipts do not exceed $5 million for all prior years (including the prior taxable years of any predecessor of the entity) (the "gross receipts test"). The cash method of accounting may not be used by any tax shelter. In addition, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor.[745] Such taxpayers generally are required to keep inventories and use an accrual method of accounting with respect to inventory items.[746]

A farming business is defined as a trade or business of farming, including operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, timber, or ornamental trees.[747] Such farming businesses are not precluded from using the cash method regardless of whether they meet the gross receipts test.[748]

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[742] See, *e.g.*, sec. 451.

[743] See, *e.g.*, sec. 461.

[744] See, *e.g.*, sec.166.

[745] Treas. Reg. secs. 1.446-1(c)(2) and 1.471-1.

[746] Sec. 471; *Ibid.*

[747] Sec. 448(d)(1).

[748] However, section 447 requires certain farming business to use an accrual method of accounting. For farmers, nurserymen, and florists not required by section 447 to capitalize preproductive period expenses, section

A qualified personal service corporation is a corporation: (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates, or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether they meet the gross receipts test.

Accrual method taxpayers are not required to include in income that portion of any amounts to be received for the performance of services in the fields of health, law, engineering, architecture, accounting actuarial science, performing arts, or consulting, that, on the basis of experience, will not be collected (the "nonaccrual experience method").[749] The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Description of Proposal

The proposal both expands and restricts the universe of taxpayers that may use the cash method of accounting.

Under the proposal, the cash method of accounting may only be used by natural persons *(i.e.*, sole proprietors) and taxpayers other than tax shelters that satisfy the gross receipts test. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed $10 million for the three prior taxable-year period to use the cash receipts and disbursements method, so long as use of such method clearly reflects income.[750]

The proposal eliminates the exceptions for qualified personal service corporations. Thus, personal service corporations generally are precluded from using the cash method unless such personal service corporation satisfies the gross receipts test. However, the proposal retains the exception for farming business such that farming businesses are not precluded from using the cash method regardless of whether they meet the gross receipts test.

Under the proposal, the rules for the nonaccrual experience method are retained and are moved from section 448 to new subsection (j) under section 451.

In the case of any taxpayer required by this section to change its method of accounting for any taxable year, such change is treated as initiated by the taxpayer and made with the consent of the Secretary.

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352 of the Revenue Act of 1978 (Pub. L. No. 95-600) provides that such taxpayers are not required to inventory growing crops.

[749] Sec. 448(d)(5).

[750] Consistent with present law, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481. Any resulting increase in income is taken into account over four taxable years beginning with the earlier of the taxpayer's elected taxable year[751] or the taxpayer's first taxable year beginning after December 31, 2018, using the following schedule: (1) first taxable year in such period, 10 percent; (2) second such taxable year, 15 percent; (3) third such taxable year, 25 percent; and (4) fourth such taxable year, 50 percent. For taxpayers with a final taxable year beginning before December 31, 2018, the present-law operative rules of section 481 apply (*e.g.*, the full amount of the section 481 adjustment required to be included under this proposal is included with the final return).

2. Rules for determining whether taxpayer has adopted a method of accounting (sec. 3302 of the discussion draft and sec. 446 of the Code)

Present Law

Section 446 generally allows a taxpayer to select the method of accounting to be used to compute taxable income, provided that such method clearly reflects the income of the taxpayer. The term "method of accounting" includes not only the overall method of accounting used by the taxpayer, but also the accounting treatment of any one item.[752] Permissible overall methods of accounting include the cash receipts and disbursements method ("cash method"), an accrual method, or any other method (including a hybrid method) permitted under regulations prescribed by the Secretary of the Treasury.[753] Examples of any one item for which an accounting method may be adopted include cost recovery,[754] revenue recognition,[755] and timing of deductions.[756] For each separate trade or business, a taxpayer is entitled to adopt any permissible method, subject to certain restrictions.[757]

A taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for such year.[758] Except as otherwise provided, section 446(e)

[751] "Elected taxable year" means such taxable year as the taxpayer may elect (as prescribed by the Secretary) which begins after December 31, 2014, and is before the taxpayer's second taxable year beginning after December 31, 2018.

[752] Treas. Reg. sec. 1.446-1(a)(1).

[753] Sec. 446(c).

[754] See, *e.g.*, secs. 167 and 168.

[755] See, *e.g.*, secs. 451 and 460.

[756] See, *e.g.*, secs. 461 and 467.

[757] Sec. 446(d); Treas. Reg. sec. 1.446-1(d).

[758] Treas. Reg. sec. 1.446-1(e)(1).

requires taxpayers to secure consent of the Secretary before changing a method of accounting. The regulations under this section provide rules for determining: (1) what a method of accounting is, (2) how an adoption of a method of accounting occurs, and (3) how a change in method of accounting is effectuated.[759]

A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions (*e.g.*, cash method or an accrual method) or a change in the treatment of any material item used in such overall plan (*e.g.*, timing of deduction of prepaid insurance). A material item is any item that involves the proper time for the inclusion of the item in income or taking of a deduction.[760] A change in method of accounting does not include a correction of a mathematical or posting error, or an error in the computation of tax liability.[761] Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. A change in method of accounting also does not include a change in treatment resulting from a change in underlying facts.

There are instances where taxpayers change their method of accounting without securing consent of the Secretary. Additionally, there are instances where taxpayers adopt an impermissible method of accounting. In such instances, the IRS has taken the position that a taxpayer's method of accounting is adopted (1) when a permissible method of accounting is used on a single tax return or (2) when the same impermissible method of accounting has been used on two or more consecutive tax returns.[762]

Description of Proposal

The proposal codifies the current IRS position and provides that a method of accounting is considered as adopted by the taxpayer (1) when a permissible method of accounting is used on a single tax return or (2) when the same impermissible method of accounting has been used on two or more consecutive tax returns. No inference is intended as to present law.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

[759] Treas. Reg. sec. 1.446-1(e).

[760] Treas. Reg. sec. 1.446-1(e)(2)(ii)(a).

[761] Treas. Reg. sec. 1.446-1(e)(2)(ii)(b).

[762] Rev. Rul. 90-38, 1990-1 C.B. 57.

3. Certain special rules for taxable year of inclusion (sec. 3303 of the discussion draft and sec. 451 of the Code)

Present Law

In general

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting.[763] If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount whether or not the taxpayer makes the demand and actually receives the payment.[764]

In general, for a cash basis taxpayer, an amount is included in income when actually or constructively received.[765] For an accrual basis taxpayer, an amount generally is recognized (and included in income) the earlier of when such amount is earned by, due to, or received by the taxpayer, unless an exception permits deferral or exclusion.[766]

A number of exceptions that exist to permit deferral of income relate to advance payments. Advance payment situations arise when amounts are received by the taxpayer in advance of when goods or services are provided by the taxpayer to its customer. The exceptions often allow tax deferral to mirror financial accounting deferral (*e.g.*, income is recognized as the goods are provided or the services are performed).[767]

Special rule for crop insurance proceeds or disaster payments

Under a special rule, in the case of insurance proceeds received as a result of destruction or damage to crops, a cash method taxpayer may elect to include such proceeds in income for the taxable year following the taxable year of destruction or damage, if the taxpayer establishes that the income from such crops would have been reported in the following taxable year.[768] For this purpose, payments for which these elections are available include disaster assistance received as a result of destruction or damage to crops caused by drought, flood, or other natural disaster, or the inability to plant crops because of such a disaster, under any Federal law (including payments

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[763] Sec. 451(a).

[764] See Treas. Reg. sec. 1.451-2.

[765] See sec. 451 and Treas. Reg. sec. 1.451-1.

[766] *Ibid.*

[767] For examples of provisions permitting deferral of advance payments, see Treas. Reg. sec. 1.451-5 and Rev. Proc. 2004-34 (2004-1 C.B. 991), as modified and clarified by Rev. Proc. 2011-18 (2011-5 I.R.B. 443) and Rev. Proc. 2013-29 (2013-33 I.R.B. 141).

[768] Sec. 451(d).

received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988).

Special rule for proceeds from livestock sold on account of drought, flood, or other weather-related conditions

A similar special provision exists for a cash method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought, flood, or other weather-related conditions in excess of the number the taxpayer would sell if the taxpayer followed its usual business practices. Such a taxpayer may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale.[769] This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance.

Special rule for sales or dispositions to implement Federal Energy Regulatory Commission or State electric restructuring policy

Another such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period[770] (the "reinvestment property").[771] If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by a qualified electric utility to an independent transmission company prior to January 1, 2014.[772] A qualified electric utility is defined as an electric utility, which as of the date of the qualifying electric transmission transaction, is vertically integrated in that it is both (1) a transmitting utility (as defined in the Federal Power Act[773]) with respect to the transmission

[769] Sec. 451(e).

[770] The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

[771] Sec. 451(i).

[772] Sec. 451(i)(3).

[773] Sec. 3(23), 16 U.S.C. sec. 796, defines "transmitting utility" as any electric utility, qualifying cogeneration facility, qualifying small power production facility, or Federal power marketing agency that owns or operates electric power transmission facilities that are used for the sale of electric energy at wholesale.

facilities to which the election applies, and (2) an electric utility (as defined in the Federal Power Act[774]).[775]

In general, an independent transmission company is defined as: (1) an independent transmission provider[776] approved by the Federal Energy Regulatory Commission ("FERC"); (2) a person (i) who the FERC determines under section 203 of the Federal Power Act[777] (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider no later than four years after the close of the taxable year in which the transaction occurs; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).[778]

Exempt utility property is defined as: (1) property used in the trade or business of (i) generating, transmitting, distributing, or selling electricity or (ii) producing, transmitting, distributing, or selling natural gas; or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1).[779] Exempt utility property does not include any property that is located outside of the United States.[780]

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the reinvestment property may be purchased by any member of the affiliated group (in lieu of the taxpayer).[781]

Description of Proposal

The proposal revises the rules associated with the recognition of income. Specifically, the proposal requires a taxpayer to recognize income no later than the taxable year in which such income is taken into account as income on an audited financial statement or another financial

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[774] Sec. 3(22), 16 U.S.C. sec. 796, defines "electric utility" as any person or State agency (including any municipality) that sells electric energy; such term includes the Tennessee Valley Authority, but does not include any Federal power marketing agency.

[775] Sec. 451(i)(6).

[776] For example, a regional transmission organization, an independent system operator, or an independent transmission company.

[777] 16 U.S.C. sec. 824b.

[778] Sec. 451(i)(4).

[779] Sec. 451(i)(5).

[780] Sec. 451(i)(5)(C).

[781] Sec. 451(i)(7).

statement under rules specified by the Secretary,[782] but provides an exception for long-term contract income to which section 460 applies.[783]

The proposal also codifies the current deferral method of accounting for advance payments for goods and services provided by the IRS under Revenue Procedure 2004-34.[784] That is, the proposal allows taxpayers to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes.[785]

The proposal repeals the special rule for crop insurance proceeds or disaster payments. Similar to insurance proceeds or disaster payments received by taxpayers unrelated to destruction or damage of crops, taxpayers that use the cash method of accounting must include crop insurance proceeds and disaster payments in income when received.

The proposal also repeals the special rule for proceeds from livestock sold on account of drought, flood, or other weather-related conditions. As a result of repealing the special rule, taxpayers using the cash method of accounting are required to include amounts received from the sale of livestock in income when received.

Further, the proposal repeals the special rule for sales or dispositions to implement FERC or State electric restructuring policy. That is, gains resulting from a qualifying electric transmission transaction must be recognized in accordance with generally applicable revenue recognition principles.

Effective Date

The proposal repealing the special rule for crop insurance proceeds and disaster payments generally applies to destruction and damage to crops or natural disasters occurring after December 31, 2014. However, in the case of inability to plant crops because of a natural disaster, the proposal applies to natural disasters occurring after December 31, 2014.

The proposal repealing the special rule for proceeds from livestock sold on account of drought, flood, or other weather-related conditions applies to sales and exchanges after December 31, 2014.

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[782] For example, under the proposal, any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes.

[783] The proposal is intended to work in conjunction with the proposal for new subsection (j) under section 451, the nonaccrual experience method. For a discussion of the nonaccrual experience method, see the description of section 3301 of the discussion draft, "Limitation on use of cash method of accounting."

[784] 2004-1 C.B. 991, as modified and clarified by Rev. Proc. 2011-18 (2011-5 I.R.B. 443) and Rev. Proc. 2013-29 (2013-33 I.R.B. 141).

[785] Thus, the proposal is intended to override the exception in Treasury Regulation section 1.451-5.

The proposal repealing the special rule for sales or dispositions to implement FERC or State electric restructuring policy applies to sales and dispositions after December 31, 2013.

The remaining proposals apply to taxable years beginning after December 31, 2014 and application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

4. Installment sales (sec. 3304 of the discussion draft and secs. 453 and 453A of the Code)

Present Law

An accrual method taxpayer generally is required to recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[786] However, taxpayers are permitted to recognize as gain on a disposition of property only that proportion of payments received in a taxable year which is the same as the proportion that the gross profit bears to the total contract price (the "installment method").[787] That is, the installment method of accounting generally allows a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business ("dealer dispositions") and sales in which the taxpayer receives indebtedness that is readily tradeable are not eligible for the installment method. However, exceptions from the prohibition to use the installment method for dealer dispositions are available for sales of timeshares and residential lots (if an election to pay interest under section 453(l)(2)(B) is made) and for sales of property that is used or produced in the trade or business of farming.[788]

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds[789] of such indebtedness are treated as a payment on the obligation, triggering the recognition of income.[790] Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments. The pledge rule does not apply to sales by an individual of personal use property,[791] to sales of property used or produced in the trade or business of farming, to sales of timeshares and residential lots where the taxpayer

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[786] See, *e.g.*, sec. 451.

[787] Sec. 453.

[788] Sec. 453(l)(2).

[789] The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

[790] Sec. 453A(d).

[791] For this purpose, "personal use property" means any property substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an activity described in section 212. Secs. 453A(b)(3)(A) and 1275(b)(3).

elects to pay interest under section 453(l)(2)(B), or to dispositions where the sales price does not exceed $150,000.

The amount of benefit that may be obtained through the use of the installment method is limited by the imposition of an interest charge on the tax deferral attributable to the portion of the installment obligations that arise during and remain outstanding at the close of the taxable year that exceed $5 million.[792] Dispositions where the sales price does not exceed $150,000 are not taken into account for the purpose of this $5 million threshold. Interest accrues at the same rate as applies to underpayments of income tax and is treated as interest expense for other Federal income tax purposes.[793] An exception from the imposition of an interest charge is provided for installment obligations arising from the disposition by an individual of personal use property or of any property used or produced in the trade or business of farming.[794] Another exception applies to obligations arising from sales of timeshares and residential lots; however, a separate interest charge applies as described above.[795]

Description of Proposal

The proposal repeals the present law exceptions to the dealer disposition rules for farm property and timeshares and residential lots. Thus, under the proposal, installment method treatment is not available for any dealer disposition of real or personal property.

The proposal also repeals the present law $5 million floor for the imposition of the special rule for interest payments under section 453A such that interest is imposed on the tax deferral attributable to obligations outstanding at year-end where the sales price for such disposition exceeds $150,000.

Further, the proposal repeals the exception from interest on installment obligations related to the sales of farm property. The proposal also repeals the special interest rules for timeshares and residential lots.

Effective Date

The proposal applies to sales and other dispositions after December 31, 2014.

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[792] Sec. 453A(a)(1).

[793] Secs. 453A(c)(2) and (c)(5). The underpayment interest rate is the statutory rate under section 6621(a)(2) and is equal to the Federal short-term rate plus three percentage points.

[794] Sec. 453A(b)(3).

[795] Secs. 453A(b)(4) and 453(l)(3).

5. Repeal of special rule for prepaid subscription income (sec. 3305 of the discussion draft and sec. 455 of the Code)

Present Law

An accrual method taxpayer generally is required to recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[796] However, eligible taxpayers using an accrual method of accounting for subscription income[797] may elect to recognize income associated with prepaid subscriptions[798] in the year during which the liability exists. For this purpose, "liability" means a liability to furnish or deliver a newspaper, magazine, or other periodical.[799] Thus, if elected,[800] prepaid subscription income may be allocated over the subscription's term.

Description of Proposal

The proposal repeals the special rules for prepaid subscription income. Thus, any prepayment received by a taxpayer associated with a subscription to a newspaper, magazine, or other periodical is included in income in accordance with the generally applicable rules for taxable year of inclusion.[801]

Effective Date

The proposal applies to payments received after December 31, 2014.

6. Repeal of special rule for prepaid dues income of certain membership organizations (sec. 3306 of the discussion draft and sec. 456 of the Code)

Present Law

An accrual method taxpayer generally is required to recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be

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[796] See, *e.g.*, sec. 451.

[797] See sec. 455(c)(1) and Treas. Reg. sec. 1.455-2(e).

[798] Prepaid subscription income is defined as any amount (includible in gross income) received in connection with, and directly attributable to, a liability extending beyond the close of the taxable year of receipt and that is income from a subscription to a newspaper, magazine, or other periodical. Sec. 455(d)(1).

[799] For this purpose, "liability" means a liability to furnish or deliver a newspaper, magazine, or other periodical. Sec. 455(d)(2).

[800] See sec. 455(c). See also Treas. Reg. secs. 1.455-2 and 1.455-6, and Appendix section 17.01 of Rev. Proc. 2011-14, 2011-4 I.R.B. 330.

[801] See sec. 451. For a discussion of a proposal concerning section 451, see the description of section 3303 of the discussion draft, "Certain special rules for taxable year of inclusion."

determined with reasonable accuracy.[802] However, accrual method taxpayers[803] qualifying as membership organizations[804] may elect[805] to recognize income associated with prepaid dues[806] in the year during which the liability exists. For this purpose, "liability" means a liability to render services or make available membership privileges over a period of time which does not exceed 36 months.[807] Thus, a qualifying taxpayer may elect to include prepaid dues in income ratably over the period over which the taxpayer is obligated to render services or provide membership privileges, up to a maximum of 36 months.

Description of Proposal

The proposal repeals the special rule for prepaid dues income of certain membership organizations. Thus, any prepayment received by a taxpayer (qualifying as a membership organization) in connection with, and directly attributable to, a liability to render services or make available membership privileges is included in accordance with the generally applicable rules for taxable year of inclusion.[808]

Effective Date

The proposal applies to payments received after December 31, 2014.

7. Repeal of special rule for magazines, paperbacks, and records returned after the close of the taxable year (sec. 3307 of the discussion draft and sec. 458 of the Code)

Present Law

A taxpayer generally is required to include an item in income no later than the time of its receipt, unless the item properly is accounted for in a different period under the taxpayer's

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[802] See, *e.g.*, sec. 451.

[803] Sec. 456(c)(1). A membership organization using a hybrid method of accounting may only make an election under section 456 if the combination of its hybrid method and section 456 election does not result in a material distortion of income. See Treas. Reg. sec. 1.456-2(e).

[804] A membership organization is a corporation, association, federation, or other organization organized without capital stock of any kind and where no part of the net earnings is distributable to any member. Sec. 456(e)(3).

[805] See sec. 456(c). See also Treas. Reg. secs. 1.456-2 and 1.456-6.

[806] Prepaid dues income is defined as any amount (includible in gross income) received by a membership organization in connection with, and directly attributable to, a liability to render services or make available membership privileges over a period of time extending beyond the close of the taxable year of receipt. Sec. 456(e)(1).

[807] Sec. 456(e)(2).

[808] See sec. 451. For a discussion of a proposal concerning section 451, see the discussion of section 3303 of the discussion draft, "Certain special rules for taxable year of inclusion."

method of accounting.[809] Taxpayers selling merchandise who use an accrual method of accounting generally must include sales proceeds in income for the taxable year when all events have occurred which fix the right to receive income and the amount can be determined with reasonable accuracy.[810]

In some cases, the seller expects that accrued sales income will be reduced on account of events subsequent to the date of sale, such as returns of unsold merchandise for credit or refund pursuant to a preexisting agreement or understanding between the seller and the purchaser. In these instances, the reduction in sales income generally may be recognized only in the taxable year during which the subsequent event, such as the return of unsold merchandise, occurs.[811] Deductions or exclusions based on estimates of future losses, expenses, or reductions in income ordinarily generally are not allowed for Federal income tax purposes.[812]

Publishers and distributors of magazines, paperbacks, and records often sell more copies of their merchandise than it is anticipated will be sold to consumers. This overstocking is part of a mass-marketing promotion technique, which relies in part on conspicuous display of the merchandise and the ability of the retailer promptly to satisfy consumer demand. Publishers usually bear the cost of such mass-marketing promotion by agreeing to repurchase unsold copies of merchandise from distributors, who in turn agree to repurchase unsold copies from retailers. These unsold items commonly are referred to as returns.

For taxpayers who account for sales of magazines, paperbacks, or records on an accrual method, section 458 provides an election to exclude from gross income for a taxable year the income attributable to unsold merchandise returned within a certain time (the "merchandise return period") after the close of the taxable year.[813] In the case of magazines, the merchandise return period extends for two months and 15 days after the close of the taxable year in which the sales were made.[814] In the case of paperbacks and records, the merchandise return period extends for four months and 15 days after the close of the taxable year in which the sales were made.[815] Once an election is made, a taxpayer's use of section 458 is treated as a method of

[809] Sec. 451(a).

[810] See Treas. Reg. sec. 1.451-1(a).

[811] See sec. 461. See also Treas. Reg. secs. 1.461-1(a)(2)(i) and 1.461-4(g)(3).

[812] See, *e.g.*, Treas. Reg. sec. 1.446-1(c)(1)(ii)(B).

[813] See also Treas. Reg. sec. 1.458-2.

[814] Sec. 458(b)(7)(A)(i). See also Treas. Reg. sec. 1.458-1(b)(5)(i). Section 458(b)(7)(B) and Treas. Reg. sec. 1.458-1(b)(5)(ii) allow an electing taxpayer to select a shorter merchandise return period than that otherwise applicable.

[815] Sec. 458(b)(7)(A)(ii). See also Treas. Reg. sec. 1.458-1(b)(5)(i). Section 458(b)(7)(B) and Treas. Reg. sec. 1.458-1(b)(5)(ii) allow an electing taxpayer to select a shorter merchandise return period than that otherwise applicable.

accounting[816] and must be continued until the taxpayer secures the consent of the Secretary to revoke such election.[817]

Description of Proposal

The proposal repeals the special rule for the recognition of income attributable to magazines, paperbacks, and records returned after close of the taxable year in which the sales were made. Thus, taxpayers must recognize revenue for the sale of magazines, paperbacks, and records in accordance with section 451. Further, taxpayers may claim a deduction for any returned items in accordance with section 461.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

8. Modification of rules for long-term contracts (sec. 3308 of the discussion draft and sec. 460 of the Code)

Present Law

Percentage-of-completion method

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method.[818] Under this method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year.[819] The percentage of completed during the taxable year is determined by comparing costs allocated to the contract and incurred before the end of the taxable year with the estimated total contract costs.[820] Costs allocated to the contract typically include all costs (including depreciation) that directly benefit or are incurred by reason of the taxpayer's long-term contract activities.[821] The allocation of costs to a contract is made in accordance with regulations.[822] Costs incurred with

[816] Sec. 458(c)(4).

[817] Sec. 458(c)(3).

[818] Sec. 460(a).

[819] See Treas. Reg. sec. 1.460-4. This calculation is done on a cumulative basis. Thus, the amount included in gross income in a particular year is that proportion of the expected contract price that the amount of costs incurred through the end of the taxable year bears to the total expected costs, reduced by the amounts of gross contract price included in gross income in previous taxable years.

[820] Sec. 460(b)(1).

[821] See sec. 460(c).

[822] Treas. Reg. sec. 1.460-5.

respect to the long-term contract are deductible in the year incurred, subject to general accrual method of accounting principles and limitations.[823]

Upon the completion of a long-term contract, a taxpayer must pay (or receive as a refund) interest computed under the look-back method to the extent that taxes in a prior contract year were underpaid (or overpaid) due to the use of estimated contract price and costs rather than the actual contract price and costs.[824]

A long-term contract is defined as any contract for the manufacture, building, installation, or construction of property when such contract is not completed within the same taxable year in which the contract was entered into.[825] However, a contract for the manufacture of property is not considered a long-term contract unless the contract involves the manufacture of (1) any unique item of a type which is not normally included in the finished goods inventory of the taxpayer, or (2) any item which normally requires more than 12 calendar months to complete.[826]

Exceptions to the percentage-of-completion method

There are a number of types of long-term contracts excepted from the requirement to use the percentage-of-completion method to compute taxable income: (1) home and residential construction contracts; (2) small construction contracts; and (3) ship construction contracts. For the portion of the long-term contract income excluded from the percentage-of-completion method, taxable income is determined under the taxpayer's exempt contract method. Permissible exempt contract methods include the completed contract method, the exempt-contract percentage-of-completion method, the percentage-of-completion method, or any other permissible method.[827]

Home and residential construction contracts

One exception from the requirement to use the percentage-of-completion method is provided for home construction contracts.[828] For this purpose, a home construction contract means any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of, or the installation

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[823] Treas. Reg. secs. 1.460-4(b)(2)(iv) and 1.460-1(b)(8).

[824] Sec. 460(b)(2). The rate of interest for both underpayments and overpayments is the rate applicable to overpayments of tax under section 6621. Secs. 460(b)(2)(C) and (b)(7).

[825] Sec. 460(f)(1). See also Treas. Reg. sec. 1.460-1(b)(1).

[826] Sec. 460(f)(2).

[827] Treas. Reg. sec. 1.460-4(c)(1).

[828] Secs. 460(e)(1)(A) and (e)(6).

of any integral component to, or improvements of, real property with respect to dwelling units[829] contained in buildings containing four or fewer dwelling units,[830] and improvements to real property directly related to (and located on the site of) such dwelling units.[831] Thus, long-term contract income from home construction contracts must be reported consistently using the taxpayer's exempt contract method.

A partial exception is provided that allows residential construction contracts to use the 70/30 percentage-of-completion/capitalized cost method ("PCCM").[832] Residential construction contracts are home construction contracts, as defined above, except that the building or buildings being constructed contain more than four dwelling units.[833] Under the 70/30 PCCM, 70 percent of a taxpayer's long-term contract income is required to be computed using the percentage-of-completion method while the remaining 30 percent is exempt from the requirement.[834] The exempt 30 percent of long-term contract income must be reported by consistently using the taxpayer's exempt contract method.[835]

Small construction contracts

Another exception from the requirement to use the percentage-of-completion method is provided for certain construction contracts ("small construction contracts"). Contracts within this exception are those contracts for the construction or improvement of real property if the contract: (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (2) is performed by a taxpayer whose average annual gross receipts for the prior three taxable years do not exceed $10 million.[836] Thus, long-term contract income from small construction contracts must be reported consistently using the taxpayer's exempt contract method.[837]

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829 As defined in section 168(e)(2)(A)(ii).

830 For this purpose, each townhouse or rowhouse is treated as a separate building. Sec. 460(e)(6)(A).

831 Secs. 460(e)(4) and (e)(6). See also Treas. Reg. sec. 1.460-3(b)(2).

832 Sec. 460(e)(5).

833 Sec. 460(e)(6)(B). See also Treas. Reg. sec. 1.460-3(c).

834 Treas. Reg. sec. 1.460-4(e).

835 *Ibid.*

836 Secs. 460(e)(1)(B) and (e)(4).

837 Since such contracts involve the construction of real property, they are subject to the interest capitalization rules without regard to their duration. See Treas. Reg. sec. 1.263A-8.

Ship construction contracts

Additional exceptions from the requirement to use the percentage-of-completion method are provided for qualified ship construction contracts and qualified naval ship contracts, as defined below. The taxable income from those contracts are allowed to be determined using the 40/60 PCCM.[838] Under the 40/60 PCCM, 40 percent of a taxpayer's long-term contract income is required to be computed using the percentage-of-completion method while the remaining 60 percent is exempt from the requirement.[839] The exempt 60 percent of long-term contract income must be reported consistently using the taxpayer's exempt contract method.

A qualified ship construction contract is defined as any contract for the construction in the United States of not more than five ships if such ships will not be constructed (directly or indirectly) for the Federal government and the taxpayer reasonably expects to complete such contract within five years of the contract commencement date.[840]

A qualified naval ship contract is defined as any contract or portion thereof that is for the construction in the United States of one ship or submarine for the Federal Government if the taxpayer reasonably expects the acceptance date[841] will occur no later than nine years after the construction commencement date (the date on which the physical fabrication of any section or component of the ship or submarine begins in the taxpayer's shipyard).[842]

Description of Proposal

The proposal repeals the exception from the required use of the percentage-of-completion method for determining taxable income from home construction contracts, as well as the partial exception for residential construction contracts (*i.e.*, the 70/30 PCCM). However, the exception for certain small construction contracts is retained. Thus, taxable income for home construction contracts generally must be accounted for using the percentage-of-completion method, unless the taxpayer meets the present-law exception for small construction contracts.

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[838] Treas. Reg. sec. 1.460-4(e).

[839] Sec. 10203(b)(2)(B) of the Revenue Act of 1987, Pub. L. No. 100-203 (1987); and sec. 708 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).

[840] Sec. 10203(b)(2)(B) of the Revenue Act of 1987, Pub. L. No. 100-203 (1987). See also Treas. Reg. sec. 1.460-2(d).

[841] The term "acceptance date" means the date one year after the date on which the Federal Government issues a letter of acceptance or other similar document for the ship or submarine. Sec. 708(c)(2) of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).

[842] Sec. 708 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004). The construction commencement date must occur after October 22, 2004. In addition, qualified naval ship contracts may only be accounted for using the 40/60 PCCM during the five taxable year period beginning with the taxable year in which construction commences. The cumulative reduction in tax resulting from the provision over the five-year period is recaptured and included in the taxpayer's tax liability in the sixth year.

The proposal also repeals the 40/60 PCCM exception for qualified ship construction contracts and qualified naval ship contracts. Thus, the taxable income under these contracts generally must be accounted for using the percentage-of-completion method.

Effective Date

The proposal applies to contracts entered into after December 31, 2014.

9. Nuclear decommissioning reserve funds (sec. 3309 of the discussion draft and sec. 468A of the Code)

Present Law

In general

Under general tax accounting rules, taxpayers using an accrual method of accounting generally may not deduct items of expense before all events have occurred that fix the right to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[843] However, the Deficit Reduction Act of 1984[844] contains an exception under which a taxpayer responsible for decommissioning a nuclear powerplant may elect[845] to deduct contributions made to a Nuclear Decommissioning Reserve Fund (hereinafter referred to as a "Fund") for future decommissioning costs when such amounts are paid into the Fund.[846] Taxpayers who do not elect this provision are subject to the general tax accounting rules for timing of the deduction.

Nuclear Decommissioning Reserve Fund

To qualify as a Fund, two requirements must be met. First, the taxpayer must establish a separate Fund with respect to each nuclear powerplant to which such election applies.[847] Second, the Fund must be used exclusively for the payment of decommissioning costs, taxes on Fund income, administrative costs of the Fund, and for making investments (to the extent that a portion of the Fund is not currently needed to pay the aforementioned costs).[848]

Accumulations in a Fund are limited to the amount required to fund decommissioning costs of a nuclear powerplant for the period during which the Fund is in existence. For this

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[843] See, *e.g.*, sec. 461 and Treas. Reg. sec. 1.461-1(a)(2).

[844] Sec. 91(c)(1) of Pub. L. No. 98-369 (1984).

[845] See Treas. Reg. sec. 1.468A-7 for election procedures.

[846] Sec. 468A.

[847] Sec. 468A(e)(1).

[848] Sec. 468A(e)(4).

purpose, decommissioning costs are considered to accrue ratably over a nuclear powerplant's estimated useful life. To prevent accumulations of funds over the remaining life of a nuclear powerplant in excess of those required to pay future decommissioning costs of such nuclear powerplant and to ensure that contributions to a Fund are not deducted more rapidly than level funding (taking into account an appropriate discount rate), taxpayers must obtain a ruling from the IRS to establish the maximum annual contribution that may be made to a Fund (the "ruling amount").[849] In certain instances (*e.g.*, change in estimate), a taxpayer is required to obtain a new ruling amount to reflect updated information.

Contributions to a Fund are deductible in the year paid into the Fund, to the extent such amounts do not exceed the ruling amount.[850] A taxpayer is permitted to make contributions to a Fund in excess of the ruling amount in one circumstance. Specifically, a taxpayer is permitted to contribute up to the present value of total nuclear decommissioning costs with respect to a nuclear powerplant previously excluded under section 468A(d)(2)(A).[851] An amount that is permitted to be contributed under this special rule is determined using the estimate of total decommissioning costs used for purposes of determining the taxpayer's most recent ruling amount.[852] Any amount transferred to the qualified fund under this special rule is allowed as a deduction over the remaining useful life of the nuclear powerplant.[853] If a qualified fund that has received amounts under this rule is transferred to another person, the transferor is permitted a deduction for any remaining deductible amounts at the time of transfer.[854]

This provision requires that a taxpayer apply for a new ruling amount with respect to a nuclear powerplant in any tax year in which the powerplant is granted a license renewal, extending its useful life.[855]

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[849] Sec. 468A(d).

[850] Taxpayers are required to include in gross income customer charges for decommissioning costs (sec. 88).

[851] Sec. 468A(f)(1). For example, if $100 is the present value of the total decommissioning costs of a nuclear powerplant, and if under present law the qualified fund is only permitted to accumulate $75 of decommissioning costs over such plant's estimated useful life (because the qualified fund was not in existence during 25 percent of the estimated useful life of the nuclear powerplant), a taxpayer could contribute $25 to the qualified fund under this component of the provision.

[852] See sec. 468A(f)(3).

[853] Sec. 468A(f)(2). A taxpayer recognizes no gain or loss on the contribution of property to a qualified fund under this special rule. The qualified fund takes a transferred (carryover) basis in such property. Correspondingly, a taxpayer's deduction (over the estimated life of the nuclear powerplant) is to be based on the adjusted tax basis of the property contributed rather than the fair market value of such property. See sec. 468A(f)(2)(D).

[854] Sec. 468A(f)(2)(C).

[855] Treas. Reg. sec. 1.468A-3(f)(1)(iv).

The Fund is treated as a corporation, and income of the Fund is taxed at a reduced rate of 20 percent for taxable years beginning after December 31, 1995.[856] Amounts withdrawn from a Fund by a taxpayer to pay for decommissioning costs are included in such taxpayer's income, but the taxpayer also is entitled to a deduction for decommissioning costs as economic performance for such costs occurs.[857]

A Fund may be transferred in connection with the sale, exchange, or other transfer of the nuclear powerplant to which it relates. If the transferee meets certain requirements,[858] the transfer is treated as a nontaxable transaction. No gain or loss is recognized on the transfer of the Fund and the transferee takes the transferor's basis in the Fund.[859] The transferee generally is required to obtain a new ruling amount from the IRS.[860]

Nonqualified nuclear decommissioning funds

Federal and State regulators may require utilities to set aside funds for nuclear decommissioning costs in excess of the amount allowed as a deductible contribution to a Fund. In addition, taxpayers may have set aside funds prior to the effective date of the qualified fund rules.[861] The treatment of amounts set aside for decommissioning costs prior to 1984 varies. Some taxpayers may have received no tax benefit while others may have deducted such amounts or excluded such amounts from income. Since 1984, taxpayers have been required to include in gross income customer charges for decommissioning costs,[862] and a current deduction has not been allowed for amounts set aside to pay for decommissioning costs except through the use of a Fund. Income earned in a nonqualified fund is taxable to such fund's owner as it is earned.

Description of Proposal

The proposal eliminates the preferential rate for Nuclear Decommissioning Reserve Funds such that earnings of a Fund are taxed at the maximum rate under section 11 *(i.e.*, the maximum rate for corporations).

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856 As originally enacted in 1984, a qualified fund paid tax on its earnings at the top corporate rate and, as a result, there was no present-value tax benefit of making deductible contributions to a qualified fund. Also, as originally enacted, the funds in the trust could be invested only in certain low risk investments. Subsequent amendments to the provision have reduced the rate of tax on a qualified fund to 20 percent and removed the restrictions on the types of permitted investments that a qualified fund can make.

857 Sec. 468A(c).

858 Treas. Reg. sec. 1.468A-6(b).

859 Treas. Reg. sec. 1.468A-6(c).

860 Treas. Reg. sec. 1.468A-6(e)(2).

861 These funds are generally referred to as "nonqualified funds."

862 Sec. 88.

The proposal also requires that, if any distribution is made from the Fund and not used in accordance with the rules prescribed in section 468A(e)(4), the balance of the Fund is to be included in gross income for such year.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

10. Repeal of last-in, first-out method of inventory (sec. 3310 of the discussion draft and secs. 471, 472, 473 and 474 of the Code)

Present Law

In general

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer.[863] In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the first-in, first-out ("FIFO") method, which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the last-in, first-out ("LIFO") method, which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

LIFO

In general

Under the LIFO method, it is assumed that the last items entered into the inventory are the first items sold. Because the most recently acquired or produced units are deemed to be sold first, cost of goods sold is valued at the most recent costs; the effect of cost fluctuations is reflected in the ending inventory, which is valued at the historical costs rather than the most recent costs.[864] Compared to FIFO, LIFO produces net income that more closely reflects the difference between sale proceeds and current market cost of inventory. When costs are rising, the LIFO method results in a higher measure of cost of goods sold and, consequently, a lower

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[863] Sec. 471(a) and Treas. Reg. sec. 1.471-1.

[864] Thus, in periods during which a taxpayer produces or purchases more goods than the taxpayer sells (an inventory increment), a LIFO method taxpayer generally records the inventory cost of such excess (and separately tracks such amount as the "LIFO layer" for such period), adds it to the cost of inventory at the beginning of the period, and carries the total inventory cost forward to the beginning inventory of the following year. Sec. 472(b).

measure of income when compared to the FIFO method. The inflationary gain experienced by the business in its inventory generally is not reflected in income, but rather, remains in ending inventory as a deferred gain until a future period in which the quantity of items sold exceeds purchases.[865]

Dollar-value LIFO

Under a variation of the LIFO method, known as dollar-value LIFO, inventory is measured not in terms of number of units but rather in terms of a dollar-value relative to a base cost. Dollar-value LIFO allows the pooling of dissimilar items into a single inventory calculation. Thus, depending upon the taxpayer's method for defining an item, LIFO may be applied to a taxpayer's entire inventory in a single calculation even if the inventory is made up of different physical items. For example, a single dollar-value LIFO calculation can be performed for an inventory that includes both yards of fabric and sewing needles. This effectively permits the deferral of inflationary gain to continue even as the inventory mix changes or certain goods previously included in inventory are discontinued by the business.

Simplified rules for certain small businesses

In 1986, Congress enacted a simplified dollar-value LIFO method for certain small businesses.[866] In doing so, Congress acknowledged that the LIFO method generally is considered to be an advantageous method of accounting, and that the complexity and greater cost of compliance associated with LIFO, including dollar-value LIFO, discouraged smaller taxpayers from using LIFO.[867]

To qualify for the simplified method, a taxpayer must have average annual gross receipts of $5 million or less for the three preceding taxable years.[868] Under the simplified method, taxpayers are permitted to calculate inventory values by reference to changes in published price indexes rather than comparing actual costs to base period costs.

Special rules for qualified liquidations of LIFO inventories

In certain circumstances, reductions in inventory levels may be beyond the control of the taxpayer. Section 473 mitigates the adverse effects in certain specified cases by allowing a

[865] Accordingly, in periods during which the taxpayer sells more goods than the taxpayer produces or purchases (an inventory decrement), a LIFO method taxpayer generally determines the cost of goods sold of the amount of the decrement by treating such sales as occurring out of the most recent LIFO layer (or most recent LIFO layers, if the amount of the decrement exceeds the amount of inventory in the most recent LIFO layer) in reverse chronological order.

[866] Sec. 474(a).

[867] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514)* (JCS-10-87), May 4, 1987, p. 482.

[868] Sec. 474(c).

taxpayer to claim a refund of taxes paid on LIFO inventory profits resulting from the liquidation of LIFO inventories if the taxpayer purchases replacement inventory within a defined replacement period. The provision generally applies when a decrease in inventory is caused by reduced supply due to government regulation or supply interruptions due to the interruption of foreign trade.

Description of Proposal

The proposal repeals the LIFO inventory accounting method. Taxpayers that currently use a LIFO method are required to revalue their beginning LIFO inventory using the FIFO (or other permissible) method in the first taxable year beginning after December 31, 2014.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481. Any resulting increase in income is taken into account over four taxable years beginning with the earlier of the taxpayer's elected taxable year[869] or the taxpayer's first taxable year beginning after December 31, 2018, using the following schedule: (1) first taxable year in such period, 10 percent; (2) second such taxable year, 15 percent; (3) third such taxable year, 25 percent; and (4) fourth such taxable year, 50 percent. For taxpayers with a final taxable year beginning before December 31, 2018, the present-law operative rules of section 481 apply (*e.g.*, the full amount of the section 481 adjustment required to be included under this proposal is included with the final return).

For closely-held entities, only 20 percent (28 percent in the case of a C corporation) of the net positive section 481 adjustment is required to be included in income beginning with the same taxable year using the same schedule described above. A closely-held entity is any domestic corporation or domestic partnership that (1) is not a financial institution which uses the reserve method of accounting for bad debts in accordance with section 585, an insurance company subject to tax under subchapter L, a corporation or partnership to which an election under section 936 applies, or a DISC or former DISC; (2) does not have more than 100 shareholders or partners; and (3) does not have as a shareholder or partner a person (other than an estate, a trust described in section 1361(c)(2), or an exempt organization described in section 1361(c)(6)) who is not an individual. Special rules apply for tiered structures. Anti-abuse rules are provided to prevent transfers of inventory from non-closely-held entities to closely-held entities.

[869] "Elected taxable year" means such taxable year as the taxpayer may elect (as prescribed by the Secretary) which begins after December 31, 2014 and is before the taxpayer's second taxable year beginning after December 31, 2018.

11. Repeal of lower of cost or market method of inventory (sec. 3311 of the discussion draft and sec. 471 of the Code)

Present Law

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer.[870] In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the first-in, first-out ("FIFO") method, which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the last-in, first-out ("LIFO") method, which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

Treasury regulations provide that taxpayers that maintain inventories under section 471 may determine the value of ending inventory under the cost method or the lower-of-cost-or-market ("LCM") method.[871] Under the LCM method, the value of each article in ending inventory is written down if its market value is less than its cost.[872] Additionally, subnormal goods, defined as goods that are unsalable at normal prices or in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or similar causes, may be written down to bona fide net selling price, under either the cost or LCM method.[873]

Description of Proposal

The proposal repeals the LCM method. The proposal also prohibits any write down for subnormal goods. Thus, taxpayers valuing their inventory under section 471 generally are not permitted to value their inventory below cost.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481. Any

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[870] Sec. 471(a) and Treas. Reg. sec. 1.471-1.

[871] Treas. Reg. sec. 1.471-2(c). See Treas. Reg. sec. 1.471-3 for the rules on valuing inventories under the cost method, and Treas. Reg. sec. 1.471-4 for the rules on valuing inventories under the LCM method. Taxpayers valuing their inventory under section 472 (using a LIFO method) must maintain such inventories at cost.

[872] Treas. Reg. sec. 1.471-4(c).

[873] Treas. Reg. sec. 1.471-2(c).

resulting increase in income is taken into account over four taxable years beginning with the earlier of the taxpayer's elected taxable year[874] or the taxpayer's first taxable year beginning after December 31, 2018, using the following schedule: (1) first taxable year in such period, 10 percent; (2) second such taxable year, 15 percent; (3) third such taxable year, 25 percent; and (4) fourth such taxable year, 50 percent. For taxpayers with a final taxable year beginning before December 31, 2018, the present-law operative rules of section 481 apply (*e.g.*, the full amount of the section 481 adjustment required to be included under this proposal is included with the final return).

12. Modification of rules for capitalization and inclusion in inventory costs of certain expenses (sec. 3312 of the discussion draft and sec. 263A of the Code)

<u>Present Law</u>

<u>In general</u>

The uniform capitalization ("UNICAP") rules, which were enacted as part of the Tax Reform Act of 1986,[875] require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.[876] For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

<u>Exceptions from UNICAP</u>

Section 263A provides a number of exceptions to the general capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have $10 million or less of average annual gross receipts for the preceding three-taxable year period;[877] such taxpayers are not required to include additional section 263A costs in inventory.

Another exception exists for taxpayers who raise, harvest, or grow trees.[878] Under this exception, section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the UNICAP rules do not apply to taxpayers in certain farming

[874] "Elected taxable year" means such taxable year as the taxpayer may elect (as prescribed by the Secretary) which begins after December 31, 2014 and is before the taxpayer's second taxable year beginning after December 31, 2018.

[875] Sec. 803(a) of Pub. L. No. 99-514 (1986).

[876] Sec. 263A.

[877] Sec. 263A(b)(2)(B).

[878] Sec. 263A(c)(5).

businesses (unless the taxpayer is required to use an accrual method of accounting under sec. 447 or 448(a)(3)).[879]

Freelance authors, photographers, and artists also are exempt from section 263A for any qualified creative expenses.[880] Qualified creative expenses are defined as amounts paid or incurred by an individual in the trade or business of being a writer, photographer, or artist. However, such term does not include any expense related to printing, photographic plates, motion picture files, video tapes, or similar items.

Description of Proposal

The proposal expands the exception from the UNICAP rules for certain small taxpayers. Specifically, a taxpayer that produces or acquires real or tangible personal property and satisfies the average annual gross receipts test also is not subject to section 263A. Thus, taxpayers with average annual gross receipts of $10 million or less for the preceding three-taxable year period are exempt from the UNICAP rules, regardless of whether they produce real or tangible personal property or acquire real or personal property for resale.

Additionally, the proposal eliminates certain exceptions from section 263A. The proposal repeals the exception for taxpayers who raise, harvest, or grow trees such that the trees and real property underlying the trees are subject to the UNICAP rules under section 263A. Further, the proposal repeals the exception for freelance authors, photographers, and artists such that their qualified creative expenses are subject to capitalization under section 263A.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

13. Modification of income forecast method (sec. 3313 of the discussion draft and sec. 167 of the Code)

Present Law

In general

Section 167, in general, allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or held for the production of income. Specifically, section 167 provides special rules for some tangible and intangible assets including the cost of motion picture films, sound recordings, copyrights, books, and patents.[881]

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[879] Sec. 263A(d).

[880] Sec. 263A(h).

[881] See secs. 167(g)(6), and 168(f)(3) and (4).

Certain interests or rights acquired separately

The recovery period for certain interests or rights (*e.g.*, a patent or copyright), not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof,[882] generally is determined by the usefulness of the asset to the taxpayer. To the extent a certain interest or right is known to be of use for only a limited period of time, the length of which can be estimated with reasonable accuracy, such an intangible asset may be recovered over the useful life of the asset.[883] For certain interests or rights with an undeterminable useful life, a 15-year safe harbor amortization period may be available.[884]

Income forecast method

The cost of motion picture films or video tapes, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.[885] In the case of certain musical works and copyrights with respect to musical compositions placed in service during taxable years beginning after December 31, 2005 and before January 1, 2011, a temporary election was available which provided a 5-year amortization period (beginning with the month in which the property was placed in service).[886] Under the income forecast method, a property's depreciation deduction for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the gross income generated by the property during the year, and the denominator of which is the total forecasted or estimated gross income expected to be generated prior to the close of the tenth taxable year after the year the property is placed in service.[887] Any costs that are not recovered by the end of the tenth taxable year after the property is placed in service may be taken into account as depreciation in that year.[888]

In general, the adjusted basis of property that may be taken into account under the income forecast method only includes amounts that satisfy the economic performance standard of section 461(h).[889] An exception to this rule applies to participations and residuals.[890] Solely for

[882] Secs. 167(f)(2) and 197(e)(4)(B), (C), and (D).

[883] Treas. Reg. sec. 1.167(a)-3(a).

[884] Treas. Reg. sec. 1.167(a)-3(b). See Treas. Reg. sec. 1.167(a)-14 for rules governing the amortization of certain intangibles that are excluded from section 197 including certain computer software and certain other separately acquired rights, such as rights to receive tangible property or services, patents and copyrights, certain mortgage servicing rights, and rights of fixed duration or amount.

[885] Sec. 167(g)(6).

[886] Sec. 167(g)(8).

[887] Sec. 167(g)(1).

[888] Sec. 167(g)(1)(C).

[889] Sec. 167(g)(1)(B).

purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service (even if economic performance has not yet occurred) if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service. For this purpose, participations and residuals are defined as costs the amount of which, by contract, varies with the amount of income earned in connection with such property.

The inclusion of participations and residuals in adjusted basis beginning in the year the property is placed in service applies only for purposes of calculating the allowable depreciation deduction under the income forecast method. For all other purposes, the general basis rules of sections 1011 and 1016 apply. Thus, in calculating the adjusted basis for determining gain or loss on the sale of income forecast property, participations and residuals are treated as increasing the taxpayer's basis only when such items are properly taken into account under the taxpayer's method of accounting.[891]

Alternatively, rather than accounting for participations and residuals as a cost of the property under the income forecast method of depreciation, the taxpayer may deduct those payments as they are paid, consistent with the *Associated Patentees*[892] decision.[893] This may be done on a property-by-property basis and must be applied consistently with respect to a given property thereafter.[894]

In addition, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or receive) interest based on a recalculation of depreciation under a "look-back" method.[895]

The look-back method is applied in any recomputation year by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code.

[890] Sec. 167(g)(7). For property placed in service after October 22, 2004, taxpayers may choose to include participations and residuals in the adjusted basis of the property for the taxable year the property is placed in service.

[891] For example, in the case of participations or residuals to which section 404(a)(5) or 404(b)(1) applies, such participations or residuals do not increase the taxpayer's basis until the amount is included in the gross income of the participant.

[892] *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945).

[893] Sec. 167(g)(7)(D).

[894] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005.

[895] Sec. 167(g)(2). An exception is allowed under section 167(g)(3) for any property with a cost basis of $100,000 or less.

Except as provided in Treasury regulations, a recomputation year is the third and tenth taxable year after the taxable year the property is placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years.

Description of Proposal

This proposal amends various aspects of the income forecast method. Specifically, the income forecast recovery period is extended from 10 years to 20 years, and the recomputation years are modified to be the fifth, tenth, fifteenth, and twentieth (previously, the third and tenth).

This proposal also modifies the rules regarding the treatment of participations and residuals. The previously elective treatment for participations and residuals is repealed. Instead, participations and residuals are explicitly excluded from the basis of the related property and generally deductible in the year paid.

The proposal includes a new safe harbor. Under new section 167(g)(8), a taxpayer may elect to recover the costs of qualifying property ratably over 20 years, instead of calculating annual depreciation amounts using the income forecast method.

The proposal repeals the expired special five-year amortization rule for certain musical works and copyrights with respect to musical compositions.

The proposal also directs the Secretary of the Treasury to revise Treasury Regulation section 1.167(a)-3(b), the 15-year safe-harbor for certain intangibles, to allow taxpayers to treat qualifying assets as having a useful life equal to 20 years (and not 15 years).

Effective Date

The proposal applies to property placed in service after December 31, 2014.

14. Repeal of averaging of farm income (sec. 3314 of the discussion draft and sec. 1301 of the Code)

Present Law

Section 1301 provides special income averaging rules for individuals[896] engaged in a farming business[897] or fishing business.[898] Under section 1301, such an individual may elect to average the taxable income attributable to the farming or fishing business over a three-year period.

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[896] The term "individual" does not include any estate or trust. Sec. 1301(b)(2).

[897] The term "farming business" has the meaning given such term by section 263A(e)(4). Sec. 1301(b)(3).

[898] The term "fishing business" means the conduct of commercial fishing as defined in section 3 of the Magnuson-Stevens Fishery Conservation and Management Act (16 U.S.C. sec. 1802). Sec. 1301(b)(4).

Description of Proposal

This proposal repeals the special rule allowing the averaging of farming or fishing income under section 1301.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

15. Treatment of patent or trademark infringement awards (sec. 3315 of the discussion draft and new sec. 91 of the Code)

Present Law

Gross income

Taxable income of a business generally is comprised of gross income less allowable deductions.[899] Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.[900] Gross income does not, however, include return of capital (to the extent of the taxpayer's basis in such capital).[901]

"Origin of the claim"

The tax treatment of amounts received for infringement of any patent or trademark (whether by reason of judgment or settlement) is determined with respect to the "nature of the claims involved and the basis of the recovery."[902] Courts have developed an "origin of the claim" test to determine whether the amounts are compensation for a loss of profits or damage done to a capital asset. For cases in which a taxpayer receives an award based on a loss of profits, the damages replace profits that would have been ordinary income and likewise are treated as ordinary income. On the other hand, for cases in which the amount represents damages for injury to capital, the money received is treated as conversion of capital assets into cash (often resulting in a reduction in the basis of the capital asset and/or capital gain treatment).[903] However, when the award amount represents loss of profits as well as injury to capital assets, such amount is bifurcated and each portion is treated accordingly (*e.g.*, the portion

[899] Sec. 63.

[900] Sec. 61.

[901] Sec. 1001.

[902] *OKC Corp. v. Commissioner*, 82 T.C. 638, 649 (1984) (citing *Lyeth v. Hoey*, 305 U.S. 188 (1938)).

[903] *Freda v. Commissioner*, 656 F.3d 570 (7th Cir. 2011); *Messer v. Commissioner*, 438 F.2d 774 (3d Cir. 1971); *Durkee v. Commissioner*, 162 F.2d 184 (6th Cir. 1947).

associated with loss of profits is included as ordinary income, and the portion associated with injury to capital assets generally reduces the basis of the injured assets and/or is capital gain).[904]

In most infringement cases, the award is compensation for the taxpayer's loss of profits.[905] The *Mathy* court concluded that "[w]hat a patent owner loses from infringement is the acquisition of 'a just and deserved gain' from the exploitation of the invention embodied in his patent."[906] The "just and deserved gains," if earned by the taxpayer in the absence of infringement, would be taxed as ordinary income. Therefore, in cases where damages are calculated on the basis of loss of profits, the award generally is treated as ordinary income to the taxpayer.[907]

Where damages are awarded for injury to the taxpayer's patent or trademark, or to the goodwill of the taxpayer's business, the award is treated as a conversion of capital assets into cash.[908] As a preliminary matter, the taxpayer bears the burden of establishing that gain from a judgment or settlement amounts to a "sale or exchange" or "from the compulsory or involuntary conversion" of the asset.[909] In such instances where the burden of proof is met, the taxpayer may exclude from income amounts received up to the taxpayer's basis in the property.[910] The basis of the property then must be reduced (but not below zero) for any amounts excluded from income.[911] To the extent amounts received for damages exceed the basis of the property, such amounts are treated as long-term capital gain under section 1235,[912] or as section 1231 gain, subject to the recapture provisions of section 1245.

Description of Proposal

This proposal clarifies the treatment of patent and trademark infringement awards received by a taxpayer. The proposal states, in general, that amounts received for infringement

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904 *Levens v. Commissioner*, 10 T.C.M. 1083 (1951).

905 See *Mathy v. Commissioner*, 177 F.2d 259, 263 (1st Cir. 1949) ("*Mathy*").

906 *Ibid.* citing 3 *Walker on Patents* (Deller's Ed.) section 281.

907 See *Mathy v. Commissioner*, 177 F.2d 259 (1st Cir. 1949); *Kurlan v. Commissioner*, 343 F.2d 625 (2d Cir. 1965); *Collins v. Commissioner*, T.C. Memo 1959-174; *Estate of Longino v. Commissioner*, 32 T.C. 904 (1959); *Booker v. Commissioner*, 27 T.C. 932 (1957); Rev. Rul. 75-64, 1975-1 C.B. 16.

908 *Durkee v. Commissioner*, 162 F.2d 184 (6th Cir. 1947); *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944); *OKC Corp. v. Commissioner*, 82 T.C. 638 (1984).

909 *Kurlan v. Commissioner*, 343 F.2d 625, 629-30 (2d Cir. 1965); Sec 1231(a)(3).

910 See Rev. Rul. 81-277, 1981-2 C.B. 14.

911 *Ibid.*

912 See *Fawick v. Commissioner*, 52 T.C. 104 (1969), rev'd 436 F.2d 655 (6th Cir. 1971).

of any patent or trademark (whether by reason of judgment or settlement) shall be included in gross income as ordinary income.

In certain instances, the proposal permits a taxpayer to impair its capital, instead of including amounts in income. However, the taxpayer is required to demonstrate, to the satisfaction of the Secretary, that the amounts constitute damages received by reason of the reduction in the value of the taxpayer's property caused by the infringement. In such instances where the burden of proof is met, the taxpayer may exclude from income amounts received up to the taxpayer's basis in the property. The basis of the property then must be reduced (but not below zero) for any amounts excluded from income. To the extent amounts received for damages exceed the basis of the property, such amounts must be included in gross income as ordinary income.

Effective Date

The proposal applies to payments received pursuant to judgments and settlements after December 31, 2014.

16. Repeal of redundant rules with respect to carrying charges (sec. 3316 of the discussion draft and sec. 266 of the Code)

Present Law

Section 162 generally allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. A capital expenditure, however, generally is not currently deductible, but rather, recovered over an appropriate period. Section 263(a)(1) defines a capital expenditure as any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. A capital expenditure also includes any amount expended for restoring property or in making good the exhaustion thereof for which an allowance (for depreciation, amortization, or depletion) is or has been made.[913]

Section 266 permits a taxpayer to elect to charge certain taxes and carrying charges to capital account.[914] The regulations under section 266 enumerate the items, which are otherwise expressly deductible under subtitle A of the Code, which may be charged to capital under this section and included either in the original basis or as an adjustment to basis.[915] Such items chargeable to capital account include: (1) in the case of unimproved and unproductive real property: annual taxes, interest on a mortgage, and other carrying charges; (2) in the case of real property, whether improved or unimproved and whether productive or unproductive: interest on a loan, taxes of the owner of such real property measured by compensation paid to his employees, taxes of such owner imposed on the purchase of materials (or on the storage, use, or

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[913] Sec. 263(a)(2).

[914] See Treas. Reg. sec. 1.266-1(c) for the rules governing the making of an election under section 266.

[915] See Treas. Reg. sec. 1.266-1.

other consumption of materials), and other necessary expenditures; (3) in the case of personal property: taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to the plant or installing them therein, interest on a loan to purchase such property or to pay for transporting or installing the same, and taxes of the owner thereof imposed on the purchase of such property (or on the storage, use, or other consumption of such property) paid or incurred up to the later of the date of installation or the date when such property is first put into use by the taxpayer; and (4) any other otherwise deductible taxes and carrying charges with respect to property, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account.[916]

Description of Proposal

This proposal repeals the rules related to the optional capitalization of carrying charges under section 266.

Effective Date

The proposal applies to amounts paid or incurred after December 31, 2014.

17. Repeal of recurring item exception for spudding of oil and gas wells (sec. 3317 of the discussion draft and sec. 461(i) of the Code)

Present Law

Under general tax accounting rules, taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all events have occurred that fix the right to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[917] Section 461 sets forth various principles to be followed in determining the time when economic performance occurs. In general, for liabilities arising out of the provision of services or property to a taxpayer by another person, economic performance occurs as such person provides such services or property.[918] For liabilities arising out of the use of property by a taxpayer, economic performance occurs ratably over the period of time during which the taxpayer is entitled to use the property.[919] For liabilities arising out of goods or services provided by a taxpayer to another person, economic performance occurs as the

[916] Treas. Reg. sec. 1.266-1(b)(1).

[917] See, *e.g.*, sec. 461(h) and Treas. Reg. sec. 1.461-1(a)(2). The first two prongs of this general rule are generally referred to as the "all events test." However, a special rule provides that, except for certain recurring items, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test is not treated as met any earlier than when economic performance with respect to that item occurs. Sec. 461(h)(1).

[918] Sec. 461(h)(2)(A)(i) and (ii).

[919] Sec. 461(h)(2)(A)(iii); Treas. Reg. sec. 1.461-4(d)(3)(i).

taxpayer incurs costs in connection with the satisfaction of the liability.[920] For liabilities arising out of workers compensation, tort, breach of contract, and other liabilities designated in regulations,[921] economic performance occurs when and to the extent that payment is made to the person to whom the liability is owed.[922]

There is an exception for recurring items generally expected to be incurred from one taxable year to the next.[923] A taxpayer may take a recurring item into account in the taxable year during which the all events test is met if economic performance occurs on or before the earlier of the date the taxpayer files a timely return for such taxable year (including extensions) or the 15th day of the ninth calendar month following the close of such taxable year.[924] The exception applies where either the amount of the liability is not material, or the application of the exception results in a better matching of the liability with the income to which it relates.[925] The exception generally is not available to tax shelters.[926]

However, economic performance with respect to amounts paid for drilling an oil or gas well by a tax shelter during a taxable year is treated as having occurred within such taxable year if the drilling of the well commences before the close of the 90th day following the close of the taxable year.[927] For tax shelters which are partnerships, the section 704(d) limitation on the deduction is computed as if the taxpayer's adjusted basis in his partnership interest is determined without regard to any liability of the partnership and any amount borrowed by the partner with respect to such partnership where the borrowing is secured by any asset of the partnership or is arranged by the partnership or certain other persons.[928]

Description of Proposal

The proposal repeals the special economic performance rule with respect to amounts paid for drilling an oil and gas well by a tax shelter under section 461(i).

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920 Sec. 461(h)(2)(B); Treas. Reg. sec. 1.461-4(d)(4)(i).

921 Treas. Reg. sec. 1.461-4(g)(2)-(7).

922 Sec. 461(h)(2)(C) and (D); Treas. Reg. sec. 1.461-4(g)(1).

923 Sec. 461(h)(3).

924 Treas. Reg. sec. 1.461-5(b).

925 Treas. Reg. 1.461-5(b)(1)(iv).

926 Sec. 461(i)(1).

927 Sec. 461(i)(2)(A).

928 Secs. 461(i)(2)(B) and (C).

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

E. Financial Instruments

1. Treatment of certain derivatives (sec. 3401 of the discussion draft and new secs. 485 and 486 of the Code)

Present Law

In general

A derivative is a contract in which the amount of at least one contractual payment is calculated from the value of something (or a combination of things) that is fixed only after the contract is entered into. The thing that fixes the payment amount(s) and hence the derivative's value is called the underlying; examples include assets, liabilities, indices, and events. The most common forms of derivative are options, forwards, futures, and swaps. The taxation of derivatives has developed over a long period without consistent underlying policy. The tax rules apply differently depending on the form of the derivative, the type of taxpayer entering into it, the purpose of the transaction, and other factors. The rules are complex and may be uncertain in their application.

Options

An option is a derivative in which one party purchases the right to deliver or receive a specified thing to or from another party on a fixed date or over a fixed period of time in exchange for a payment whose value is fixed when the contract is entered into. The purchaser of the option is also called the holder; the seller of the option is also called the writer or issuer. When the option purchaser gives or receives the specified thing to the other party in exchange for the payment, the purchaser is said to exercise its right. The latest time the purchaser can exercise its right is called the expiration date. The thing that is delivered or that fixes the amount of payment at the expiration date is called the underlying. The payment by the purchaser for the option is called the premium, and the payment made for the thing at expiration is called the strike price. A European-style option is an option that can only be exercised at the expiration date. An American-style option is an option that can be exercised at any time prior to the expiration date.

A call option is an option in which the option purchaser has the right to buy a specified thing. A put option is an option in which the option purchaser has the right to sell a specified thing. Payment at the expiration date can take many forms. An option is called "physically settled" when the underlying is delivered from one party to the other. An option is called "cash settled" when one party pays cash equal to the difference between the strike price and the value of the underlying at the expiration date.

In general,[929] no tax consequences are recognized upon entering into an option contract, even though option premiums are paid without any possibility for recovery or return. The option purchaser's premium payment is nondeductible, and the option seller does not include the

[929] This discussion does not address options granted in connection with the performance of services.

premium payment in income.[930] If an option is sold, the premium is accounted for in calculating gain or loss on sale. For the purchaser of a put option, if the option is exercised, the premium reduces the amount received in the sale of the underlying. For the purchaser of a call option, if the option is exercised, the premium is part of the basis in the property acquired.

For an option purchaser, gain or loss attributable to the sale or exchange, or loss from failure to exercise an option, is gain or loss from property of the same character as the option's underlying.[931] An option is treated as sold or exchanged on the day it expires without exercise in determining whether the loss is short term or long term.[932] A seller of an option has ordinary income if the option is not exercised,[933] but if the option is with respect to "property," any gain or loss from closing or lapse is short term capital gain.[934] For this purpose, "property" includes stocks, securities, commodities, and commodity futures.[935] If an option purchaser exercises a cash settled option, then gain or loss is short term or long term depending on whether the option purchaser has held the option for more than one year.[936] If an option purchaser exercises a physically settled option, the holding period for the property delivered is calculated from the date the option is exercised.[937] Option purchasers may be treated differently depending on whether they hold cash settled or physically settled options, even though their economic positions may be similar.[938]

Timing and character results for options and the other derivatives described below may be different depending on the type of taxpayer entering into the option (for example, whether a dealer in securities), on the use of the option (for example, as a hedge), the underlying, the type of option (for example, whether governed by section 1256), or the application of other overriding rules (for example, the straddle rules).

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[930] Rev. Rul. 78-182, 1978-1 C.B. 265. Courts decided receipt of option premiums were nontaxable because it could not be determined if the premium were gain or return of capital till expiration. *Virginia Coal & Coke Co. v. Commissioner*, 37 BTA 195, aff'd, 99 F2d 919 (4th Cir. 1938), cert. denied, 307 U.S. 630 (1939).

[931] Sec. 1234(a).

[932] Sec. 1234(a)(2).

[933] Treas. Reg. sec. 1.1234-1(b).

[934] Sec. 1234(b).

[935] Sec. 1234(b)(2)(B).

[936] Rev. Rul. 88-31, 1988-1 C.B. 302.

[937] *Ibid.* The new holding period begins on the day the option is exercised if the underlying is stock or other securities acquired from the corporation that issued the securities. Sec. 1223(5). Otherwise, the holding period begins the day after the option is exercised. *Weir v. Commissioner*, 10 T.C. 996 (1948).

[938] An investor who holds a cash settled option for a period longer than one year and who exercises that option is eligible for long term capital gains. If an investor holds a physically settled option for a period longer than one year, exercises the option, and sells the underlying asset immediately, any capital gain on the transaction is short term capital gain to the investor.

Forwards

A forward is a derivative in which one party agrees to deliver a specified thing to another party on a fixed date in exchange for a payment whose value is fixed when the contract is entered into. The party agreeing to deliver the thing is called the short party; the party agreeing to pay is called the long party. The date on which the short party must deliver is called the delivery or expiration date. The thing that is delivered or that fixes the amount of payment at the expiration date is called the underlying. The payment by the long party at delivery is called the forward price. For most forwards, no payment is made when the contract is signed. For a prepaid forward, the long party pays the short party the forward price (discounted to present value on the date of the payment) at the time the parties enter into the contract.[939] A variable forward requires the short party to deliver an amount of property that varies according to a formula agreed to when the contract is signed.[940]

A forward is called "physically settled" if the underlying is delivered from one party to the other. A forward is called "cash settled" if one party pays cash equal to the difference between the forward price and the value of the underlying on the delivery date.

In general, no tax consequences are recognized on entering into a forward.[941] If a forward is physically settled, the short party recognizes gain or loss in the amount of the difference between the forward price and the short party's basis in the property in the year in which the delivery takes place.[942] The long party reflects the forward price as the basis in the property acquired; any gain or loss is deferred until a subsequent realization event.

In general, the character of the gain or loss with respect to a forward is the same as the character of the property delivered.[943] Gain or loss on the sale or exchange of a forward is long term capital gain or loss if the contract has been held for longer than the requisite holding period.[944] Cash settlement of a forward is treated as a sale or exchange.[945]

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939 See Notice 2008-2, 2008-1 C.B. 252.

940 See, for example, *Anschutz Co. v. Commissioner*, 664 F.3d 313 (10th Cir. 2011).

941 However, if the forward buyer obtains possession of the underlying property prior to the delivery date specified in the contract, the transaction may be considered "closed" for tax purposes, and the transfer of possession may be treated as a realization event. See, for example, *Commissioner v. Union P. R. Co.*, 86 F.2d 637 (2d Cir. 1936) and *Merrill v. Commissioner*, 40 T.C. 66 (1963).

942 Sec. 1001.

943 Sec. 1234A and Prop. Treas. Reg. sec. 1.1234A-1(c)(1).

944 *Carborundum Co. v. Commissioner*, 74 T.C. 730, 733-42 (1980); *American Home Products Corp. v. United States*, 220 Ct. Cl. 369, 383-87 (Ct. Cl. 1979); *Hoover Co. v. Commissioner*, 72 T.C. 206, 250 (1979), nonacq., 1980-2 C.B. 2.

945 *Estate of Israel v. Commissioner*, 108 T.C. 208, 217 (1997).

If a forward qualifies as a commodity futures contract not subject to section 1256,[946] the long party's holding period of the underlying includes the period in which the party held the contract.[947] For other physically settled forwards, the holding period of the underlying begins when the burdens and benefits of ownership are transferred from the short to the long party.[948] For short parties to physically settled securities forwards and commodities futures, section 1233 and the accompanying regulations provide rules regarding holding period determinations,[949] although these rules have been partially supplanted by section 1234B (governing certain securities futures contracts) and section 1256 (governing regulated commodities futures contracts). For transactions to which section 1233 still applies, a short party that physically delivers property to close a contract recognizes capital gain or loss on the transaction as short term or long term depending on the period for which the short party holds the property prior to delivery.[950] If a short party closes out a physically settled contract by purchasing the underlying asset and immediately delivering it to fulfill its contractual obligations, any capital gain or loss to the short party is short term capital gain or loss.[951]

Forwards for the sale of a single security or a narrow-based security index[952] are subject to a separate regime under section 1234B. Gain or loss attributable to the sale, exchange, or termination of a securities futures contract is considered gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the taxpayer's hands. Section 1234B also provides that gain or loss on a securities

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[946] The scope of section 1256 is discussed in detail below.

[947] Sec. 1223(7); see also Treas. Reg. sec. 1.1223-1(h). If the contract is physically settled and section 1256 does apply, then the taxpayer's holding period begins on the delivery date and does not include the prior period during which the taxpayer held the contract. Sec. 1256(c).

[948] Rev. Rul. 69-93, 1969-1 C.B. 139. In a case involving a physically settled forward for the sale of convertible debentures, one court held that the long party's holding period with respect to the debentures did not begin until delivery of the underlying debentures where: (1) the short party continued to receive interest payments on the debentures while the forward was open; (2) the short party was free to sell the debentures while the contract was open (provided that the short party delivered substantially identical property on the delivery date); and (3) the short party was free to use the debentures as security for other financial transactions. *Stanley v. United States*, 436 F. Supp. 581, 583 (N.D. Miss. 1977).

[949] Although the statutory text of section 1233 only makes reference to "short sales," the accompanying regulations indicate that section 1233 applies to forward contracts as well. See Treas. Reg. sec. 1.1233-1(c)(6) (example 6); see also *Hoover Co. v. Commissioner*, 72 T.C. 206, 249 (1979) (applying section 1233 to certain forward contracts).

[950] Sec. 1233(a)-(b).

[951] General Counsel Memorandum 39304, November 5, 1984.

[952] The term "narrow-based security index" includes indexes with nine or fewer component securities, indexes that are heavily weighted toward a small number of component securities, or indexes weighted toward securities with low trading volumes. 15 U.S.C. sec. 78c(a)(55). An option on a broad-based security index is treated as a nonequity option and is subject to section 1256.

futures contract, if capital, is treated as short term capital gain or loss regardless of the taxpayer's holding period.

Swaps and notional principal contracts

"Notional principal contract" is the term in the tax law closest to what is colloquially known as "swap." The tax term covers a narrower range of contracts than the colloquial term.[953] Treasury regulations define a notional principal contract as a financial instrument that provides for the payment of amounts by one party to another party at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[954] A specified index is defined as a fixed rate, price, or amount that must be based on objective financial information not in control of either party. A notional principal amount is defined as a specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract but is not borrowed or loaned between the parties.

Examples of notional principal contracts include interest rate swaps, currency swaps, and equity swaps.[955] Treasury regulations exclude certain instruments from the definition of notional principal contract including: (1) section 1256 contracts, (2) futures contracts, (3) forwards, (4) options, and (5) instruments or contracts that constitute indebtedness for Federal tax purposes.

For purposes of calculating the inclusion of income or expense flowing from a notional principal contract, the regulations divide payments exchanged by the parties to the contract into: (1) periodic payments (made at least annually); (2) termination payments (made at the end of the contract's life); and (3) nonperiodic payments (neither (1) nor (2)).[956] Taxpayers must recognize periodic and nonperiodic payments using a specified accrual method for the taxable year to which the payment relates, and must recognize a termination payment in the year the notional principal contract is extinguished, assigned, or terminated.[957] A swap with a significant[958] nonperiodic payment is treated as two transactions: an on-market level payment swap and a loan.[959] The loan must be accounted for independently of the swap. Treasury regulations

[953] An example of a contract that is encompassed within the term "swap" is a bullet swap, which is a single-payment swap; whether it constitutes a notional principal contract under current law is uncertain. For a discussion of proposed regulations addressing bullet swaps, see Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11), December 2, 2011, fn. 134.

[954] Treas. Reg. sec. 1.446-3(c)(1)(i).

[955] Treas. Reg. sec. 1.446-3(c)(1)(i).

[956] Treas. Reg. sec. 1.446-3(e), (f) and (h).

[957] *Ibid.*

[958] A term defined only indirectly through examples that leave a large area of uncertainty as to what constitutes a "significant" nonperiodic payment.

[959] See Treas. Reg. sec. 1.446-3(g)(6), example 3.

proposed in 2004 under section 1234A, contingent nonperiodic payments (such as a single payment at termination tied to the change in value of the underlying) are accrued over the life of the swap based on an estimate of the amount of the payment.[960] The amount of a taxpayer's accrual is redetermined periodically as more information becomes available.[961]

Final Treasury regulations do not address the character of notional principal contract payments. However, the 2004 proposed regulations provide that any periodic or nonperiodic payment generally constitutes ordinary income or expense.[962] The preamble to the 2004 proposed regulations explains that ordinary income treatment is warranted because neither periodic nor nonperiodic payments involve the sale or exchange of a capital asset. The 2004 proposed regulations provide that gain or loss attributable to the termination of a notional principal contract is capital if the contract is a capital asset of the taxpayer but do not specify whether a taxpayer who holds a notional principal contract for more than one year should recognize capital gain or loss on account of a termination payment as short term or long term. Those regulations do provide that final settlement payments with respect to a notional principal contract are not termination payments under section 1234A.[963]

Section 1256 contracts

Section 1256 provides timing and character rules for defined types of derivatives. Any section 1256 contract held by a taxpayer at the close of a taxable year is marked to market, that is, the contract is treated as having been sold by the taxpayer for its fair market value on the last business day of the taxable year.[964] The character of gain or loss on the mark to market, or if the contract is terminated or transferred,[965] is 60 percent long term capital gain or loss, and 40 percent short term capital gain or loss, regardless of the taxpayer's holding period.[966] Different character rules apply to foreign currency contracts that come within both sections 1256 and 988.[967]

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[960] Notional Principal Contracts; Contingent Nonperiodic Payments: Notice of Proposed Rulemaking, Fed. Reg. vol. 69, 38, February 26, 2004, p. 8886 (the "2004 proposed regulations").

[961] *Ibid.*

[962] Prop. Treas. Reg. sec. 1.1234A-1.

[963] Prop. Treas. Reg. sec. 1.1234A-1(b).

[964] Sec. 1256(a)(1).

[965] Sec. 1256(c)(1).

[966] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that, but for the rule in section 1256(a)(3), would be ordinary income property.

[967] The interaction between section 988 governing foreign currency transactions and section 1256 is extremely complex, *see* Viva Hammer, "U.S. Taxation of Foreign Currency Derivatives: 30 Years of Uncertainty,"

A section 1256 contract is defined as: (1) a regulated futures contract,[968] (2) a foreign currency contract, (3) a nonequity option traded on or subject to the rules of a qualified board or exchange,[969] (4) an equity option purchased or granted by an options dealer that is listed on a qualified board or exchange on which the dealer is registered,[970] and (5) a securities futures contract entered into by a dealer that is traded on a qualified board or exchange. Excluded from the definition of section 1256 contracts are (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract and (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.[971]

Mark to market accounting for dealers and traders

Section 475 requires that securities dealers – taxpayers that regularly purchase securities from or sell securities to customers in the ordinary course of business – recognize gain and loss on a mark to market basis. The term "security" is defined to include stocks, interests in widely held or publicly traded partnerships and trusts, debt instruments, interest rate swaps, currency swaps, and equity swaps, as well as options, forwards, and short positions on any of the above-mentioned financial instruments, and other positions identified as hedges with respect to any of the above-mentioned instruments.[972] The statute also allows traders in securities to elect into mark to market, and it allows traders in commodities to opt into the mark to market regime and to have their commodity holdings treated analogously to securities under section 475.[973]

For taxpayers required to follow the mark to market rules or who elect into those rules, securities or commodities in the hands of the taxpayer at the close of a tax year must be treated as if they were sold for their fair market value on the last business day of the year. All resulting mark to market gains or losses with respect to such securities or commodities are treated as ordinary.[974] However, mark to market accounting is neither required nor permitted for: (1)securities held for investment; (2) debt instruments acquired in the ordinary course of a trade or business (unless those debt instruments are held for sale, in which case they must be marked

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Bulletin of International Taxation, vol. 64, no. 3, March 2010, expanded and updated in Practising Law Institute, *Taxation of Financial Products and Transactions,* Matthew A. Stevens (ed.), 2013.

[968] A contract is a "regulated futures contract" if the parties are required to post margin on a mark to market basis and the contract is traded on or subject to the rules of a qualified board or exchange. Sec. 1256(g)(1).

[969] An option on a narrow-based security index is treated as an equity option and therefore not a section 1256 contract.

[970] Sec. 1256(g)(4).

[971] Sec. 1256(b)(2).

[972] Sec. 475(c)(2).

[973] Sec. 475(f).

[974] Sec. 475(d)(3).

to market); and (3) for securities that are held as hedges (unless the security is a hedge for another security that is inventory in the hands of the dealer, in which case the hedge must be marked to market as well).[975]

Straddles

Section 1092 defines a "straddle" as offsetting positions with respect to actively traded property.[976] Positions are offsetting if there is a substantial diminution of risk of loss from holding any position in actively traded property by holding one or more other positions with respect to actively traded property.[977] Section 1092(a) provides that a taxpayer's loss with respect to one position that is part of a straddle may only be taken into account to the extent that the loss exceeds the taxpayer's unrecognized gain with respect to any offsetting position that is part of the straddle. The taxpayer may carry forward any disallowed loss into succeeding taxable years and may take such loss into account once the taxpayer disposes of the offsetting position.[978]

Exceptions from the straddle rules are provided for hedging transactions,[979] straddles composed entirely of section 1256 contracts,[980] and qualified covered calls.[981] Special rules apply for mixed straddles (generally, straddles comprised of both section 1256 contracts and non-section 1256 contracts)[982] and for identified straddles.[983]

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[975] Sec. 475(b)(1).

[976] Sec. 1092(c)(1) and (d)(1).

[977] Sec. 1092(c)(2)(A). "Substantial diminution of risk of loss" is an undefined term and its meaning is the subject of controversy among practitioners.

[978] Sec. 1092(a)(1).

[979] Sec. 1092(e). A hedging transaction is a transaction entered into in the normal course of the taxpayer's trade or business primarily to manage the risk of price changes or currency fluctuations with respect to ordinary property held by the taxpayer or to manage the risk of interest rate changes, price changes, or currency fluctuations with respect to borrowings made or ordinary obligations incurred by the taxpayer. Sec. 1221(b)(2)(A). To qualify as a hedging transaction for purposes of the straddle rule exception, the transaction must be clearly identified as such before the close of the day on which the transaction was entered into. Sec. 1256(e)(2).

[980] Sec. 1256(a)(4).

[981] Sec. 1092(c)(4); Treas. Reg. sec. 1.1092(c)-1(b).

[982] Sec. 1092(b)(2). If a straddle consists of positions that are section 1256 contracts and non-section 1256 contracts, the taxpayer may designate the positions as a mixed straddle. Positions in a mixed straddle are not subject to the mark to market rule of section 1256, but instead are subject to regulatious designed to prevent the deferral of tax or the conversion of short term capital gain into long term capital gain or the conversion of long term capital loss into short term capital loss.

[983] Sec. 1092(a)(2). If a taxpayer clearly identifies a straddle as such before the close of the day on which the straddle is acquired, then the loss deferral rules of section 1092(a) do not apply. Instead, any loss incurred with respect to a position that is part of an identified straddle will be added to the tax basis of the offsetting positions in

Identification of hedges

Several provisions governing the taxation of derivatives grant special treatment to "identified" hedges. The mark to market requirement under section 475 does not apply to any security which is identified as a hedge with respect to a position, right, or liability that is not itself subject to the mark to market rule.[984] Likewise, the mark to market requirement under section 1256 does not apply to a transaction that the taxpayer identifies as a hedging transaction.[985]

Hedges must be identified by the close of the day on which a taxpayer enters into the hedging transaction.[986] The identification must be made on, and retained as part of, the taxpayer's books and records.[987] The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the nontax identification is also being made for tax purposes.[988]

Treatment of convertible debt instruments

Treasury Regulations provide for the treatment of debt instruments with contingent payments.[989] In the case of debt instruments issued for money or publicly traded property, the noncontingent bond method applies for accruing original issue discount ("OID").[990] Under this method, interest accrues assuming a comparable yield to maturity "at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument..., including the level of subordination, term, timing of payments, and general market conditions."[991] This method does not apply to a debt instrument merely because it provides for an option to convert the debt instrument into stock of the issuer (or of stock or debt of a related party), or into cash or other property equal to the approximate value of the stock

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the straddle. Sec. 1092(a)(2)(A); William R. Pomierski, "Identified Straddles: Uncertainties Resolved and Created by 2007 Technical Corrections," *Journal of Taxation of Financial Products*, vol. 7, no. 2, 2008, pp. 5-10, 55-57.

[984] Sec. 475(b)(1)(C), (2).

[985] Sec. 1256(e).

[986] Treas. Reg. sec. 1.1221-2(f)(1).

[987] Treas. Reg. sec. 1.1221-2(f)(4)(i).

[988] Treas. Reg. sec. 1.1221-2(f)(4)(ii).

[989] Treas. Reg. sec. 1.1275-4.

[990] For a discussion of OID, see section 3413 of this discussion draft, "Coordination with rules for inclusion not later than for financial accounting purposes."

[991] Treas. Reg. sec. 1.1275-4(b)(4)(i).

or debt.[992] It does apply to a debt instrument that is convertible into the corporation's stock and provides for one or more cash contingent payments.[993]

In the case of a convertible debt instrument which is not treated as a contingent debt instrument, no allocation of value is made to the conversion feature. When a convertible debt instrument is repurchased by a corporation, no deduction is allowed for amounts paid in excess of the sum of the adjusted issue price plus a normal call premium for a nonconvertible bond.[994]

Description of Proposal

In general

The proposal requires all taxpayers to mark their derivatives to market, recognizing gain or loss as if the derivatives were sold for fair market value on the last business day of the taxpayers' taxable year. Gain and loss from the mark to market is treated as ordinary income or loss attributable to a trade or business of the taxpayer for purposes of determining the amount of nonbusiness deductions which are allowed in computing a net operating loss. The proposal does not require stocks or bonds to be marked to market. However, if a taxpayer has a straddle of derivative and a non-derivative offsetting positions, then both the derivative and the non-derivative positions are required to be marked to market. Upon entering into such a straddle, the taxpayer must recognize any built-in gain (and defer any built-in loss) on the non-derivative.

Definition of derivative

In general

A derivative is any contract the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following: (1) any share of stock in a corporation, (2) any partnership or beneficial ownership interest in a partnership or trust, (3) any note, bond, debenture, or other evidence of indebtedness, (4) any real property (other than real property for which an exclusion is available), (5) any commodity that is actively traded within the meaning of section 1092(d)(1), (6) any currency, (7) any rate, price, amount, index, formula, or algorithm, and (8) any other item prescribed by the Secretary. The term derivative does not include an item described in (1) through (8).

The term "derivative" includes an embedded derivative component. If a contract has derivative and non-derivative components, then each derivative component is treated as a derivative. If an embedded derivative component cannot be separately valued, the entire contract that includes the embedded derivative component is treated as a derivative. A debt instrument is not treated as having an embedded derivative component merely because the debt instrument is

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992 Treas. Reg. sec. 1.1275-4(a)(4).

993 Rev. Rul. 2002-31, 2002-1 C. B. 1023.

994 Sec. 249.

denominated in, or specifies payments by reference to, a nonfunctional currency or is a convertible debt instrument, a contingent payment debt instrument, a variable rate debt instrument, an integrated debt instrument, an investment unit, a debt instrument with alternative payment schedules, or another debt instrument with respect to which the regulations under section 1275(d) apply.

Exclusions

The proposal has a number of exclusions.

If a derivative is with respect to a tract of real property as defined in section 1237(c), or real property which would be inventory if held directly by the taxpayer, then the proposal's timing and character rules do not apply to such derivatives. The Secretary is directed to prescribe regulations or other guidance under which multiple tracts of real property may be treated as a single tract of real property if the contract is of a type designed to facilitate the acquisition or disposition of such real property.[995]

The proposal excludes from the definition of a derivative any contract that is part of a hedging transaction within the meaning of section 1221(b) as amended or section 988(d)(1).

To the extent provided by the Secretary, the proposal excludes financing transactions such as securities lending, sale-repurchase and similar financing transactions from the definition of a derivative. The types of transactions that are intended to be excluded from the definition of a derivative are financing transactions, not those transactions that provide payments or other transfers determined by reference to: (1) any share of stock in a corporation, (2) any partnership or beneficial ownership interest in a partnership or trust, (3) any note, bond, debenture, or other evidence of indebtedness, (4) any real property (other than real property for which an exclusion is available), (5) any commodity that is actively traded within the meaning of section 1092(d)(1), (6) any currency, (7) any rate, price, amount, index, formula, or algorithm, and (8) any other item prescribed by the Secretary.

It is intended that the types of securities lending, sale-repurchase and similar financing transactions excluded from the definition of derivative by the Secretary reflect current market practice and be flexible enough to accommodate future developments in the market but not be so broad as to undermine the general rule.

The proposal excludes from the definition of a derivative an option described in section 83(e)(3) received in connection with the performance of services. It also excludes an insurance, annuity, or endowment contract issued by an insurance company to which subchapter L applies (or, in the case of a foreign corporation, would apply if the foreign corporation were domestic). A contract that is otherwise within the definition of a derivative is not treated as a derivative if it is with respect to stock issued by any member of the same worldwide affiliated group (within the meaning of section 864(f)) of which the taxpayer is a member. A contract with respect to a

[995] The proposal is intended to allow a narrow exclusion from the mark-to-market rule for contracts related to single pieces of real estate and for contracts related to real estate held for sale by real estate developers.

commodity that is otherwise within the definition of derivative is not treated as a derivative if the contract requires physical delivery, the contract contains the option of cash settlement only in unusual and exceptional circumstances, the commodity is used in the normal course of the taxpayer's trade or business, and the derivative relates to quantities normally used in the normal course of that business.

American depositary receipts and similar instruments with respect to shares of stock in foreign corporations are treated as shares of stock of foreign corporations and not as derivatives.

Mark-to-market of certain offsetting positions

If a taxpayer has a straddle of derivative and a non-derivative offsetting positions, the non-derivative position is treated as a derivative for both timing and character purposes. A straddle is defined in section 1092(c), applied by treating all offsetting positions as being with respect to personal property. Upon establishing such a straddle, a taxpayer must treat any built-in gain position as if it were sold for its fair market value, but the proposal's character and net operating loss rules do not apply to any gain taken into account as a result of the deemed sale. A built-in gain position is any position (other than a derivative) with respect to which gain would be realized if the position were sold for its fair market value at the time that the straddle is established with respect to the position.

Built-in gain need not be recognized for any position with respect to debt if the interest payments or similar amounts with respect to the position meet the rate calculation requirements of section 860G(a)(1)(B)(i) and the position is not directly or indirectly convertible into stock of the issuer or a related person. Built-in gain need not be recognized for any position that is part of a straddle if: (1) all the offsetting positions which are part of the straddle consist of one or more qualified covered call options and the stock to be purchased from the taxpayer under such options, and (2) the straddle is not part of a larger straddle. A qualified covered call option means any option granted by the taxpayer to purchase stock held by the taxpayer (or acquired in connection with granting of the option) but only if the option is traded on a national securities exchange registered with the Securities and Exchange Commission ("SEC") or other market which the Secretary designates, the option is granted more than 30 days and not more than 90 days before the day the option expires, and the option is not granted by an options dealer in connection with its activity of dealing in options.

Upon establishing a straddle, a taxpayer may not treat any built-in loss position as if it were sold, and the amount of the built-in loss is not taken into account in determining the amount that is marked-to-market while the straddle is in place. Rather, the built-in loss position is deferred until such position is sold or otherwise terminated. A built-in loss position is any position (other than a derivative) with respect to which a loss would be realized if the position were sold for its fair market value at the time that the straddle is established with respect to the position.

The holding period for any position to which the proposal's mark to market provision applies does not include the period during which the position is part of a straddle, or, in the case of a built-in gain position, the period before the position was deemed sold.

The timing and character rules in the proposal also apply to the termination or transfer during the taxable year of a taxpayer's rights or obligations with respect to a derivative. At the time the derivative is terminated, all positions that are part of a straddle with the derivative are treated as the derivative is treated. Fair market value for such terminations or transfers is determined at the time of the termination or transfer.

Fair market value

It is expected that taxpayers and the Internal Revenue Service will use general tax principles in determining the fair market value of a derivative (including an embedded derivative component) and non-derivatives in a straddle that includes a derivative. In determining fair market value, it is intended that taxpayers use sources of information and valuation methods consistently from period to period, incorporating developments in financial markets and advances in financial engineering in a reasonable and fair manner. It is expected that non-tax reports and statements will provide evidence of a mark to market value for purposes of the proposal. Non-tax reports and statements will be preferred in the following order: (1) statements required to be filed with the SEC prepared in accordance with U.S. generally accepted accounting principles ("GAAP"); (2) statements filed with a Federal agency other than the Internal Revenue Service prepared in accordance with U.S. GAAP; (3) certified audited financial statements prepared in accordance with U.S. GAAP given to creditors to make lending decisions; (4) statements prepared in accordance with International Financial Reporting Standards required to be filed with agencies equivalent to the SEC in jurisdictions that have equivalent stringent reporting standards as those in the U.S.; (5) statements provided to other regulatory and governmental bodies as provided by the Secretary.

Treatment of convertible debt instruments

The proposal provides that the Treasury regulations shall be modified to provide that convertible debt instruments are treated in a manner similar to contingent payment debt instruments.

Coordination rules; repeal of certain existing rules

The proposal provides a number of rules for coordinating the new mark-to-market regime with present law rules related to financial instruments taxation.

The proposal repeals sections 1233, 1234, 1234A, 1234B, 1236, 1256, 1258, 1259, and 1260.

Effective Date

The proposal applies to taxable years ending after December 31, 2014 with respect to property acquired and positions established after December 31, 2014, and taxable years ending after December 31, 2019 in case of any other property or position.

2. Modification of certain rules related to hedges (sec. 3402 of the discussion draft and sec. 1221 of the Code)

Present Law

In general

Capital gain treatment applies to gain on the sale or exchange of a capital asset. The term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include property that is part of a hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe).[996] Gain or loss on property that is part of an identified hedging transaction generally is treated as ordinary, rather than capital.[997]

A hedging transaction is defined as any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer, to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or to manage other risks as prescribed under Treasury regulations.[998]

Hedge identification requirement

The regulations issued under section 1221 require that, in order to qualify as a hedge, a taxpayer that enters into the hedge must clearly identify the transaction as a hedging transaction before the close of the day on which the taxpayer acquired, originated, or entered into the transaction and must also[999] identify the item, items, or aggregate risk being hedged.[1000] Identification of an item being hedged generally involves indentifying a transaction that creates risk and the type of risk that the transaction creates.[1001] Additional information is required for certain types of hedging transactions.[1002] The regulations also specify that the identification of a

[996] Sec. 1221(a)(7).

[997] Certain other Code sections also treat gains or losses as ordinary. For example, the gains or losses of securities dealers or certain electing commodities dealers or electing traders in securities or commodities that are subject to "mark-to-market" accounting are treated as ordinary (sec. 475).

[998] Sec. 1221(b)(2)(A).

[999] Treas. Reg. sec. 1.1221-2(f)(1).

[1000] Treas. Reg. sec. 1.1221-2(f)(2).

[1001] *Ibid.*

[1002] Treas. Reg. sec. 1.1221-2(f)(3) details additional requirements for anticipatory asset hedges, inventory hedges, hedges of debt of the taxpayer, hedges of aggregate risk, and transactions that counteract hedging transactions.

hedging transaction for financial accounting or regulatory purposes does not satisfy the identification requirement unless the taxpayer's books and records indicate that the identification also is being made for tax purposes. However, the taxpayer may indicate that individual hedging transactions or a class or classes of hedging transactions that are identified for financial accounting or regulatory purposes also are being identified as hedging transactions for tax purposes.[1003]

Financial accounting hedge identification requirement

Under U.S. Generally Accepted Accounting Principles ("GAAP"), there are rules applicable to accounting for hedging transactions, which have the effect of matching the timing of the income recognition of an instrument used as a hedge with that of the hedged item.[1004] These financial accounting rules have a hedge identification requirement similar, though not identical, to the Federal income tax requirement contained in the section 1221 regulations. To qualify for hedge accounting for financial accounting purposes, a formal identification must be made at the inception of a hedge,[1005] including documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. The documentation must include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged, and information for assessing the hedging instrument's effectiveness.

Commodity hedging

Under the subpart F anti-deferral regime applicable to controlled foreign corporations and their United States shareholders, the excess of gains over losses from transactions in commodities generally is foreign personal holding company income, one category of income of a controlled foreign corporation that is included in the income of United States shareholders on a current basis.[1006] This treatment of commodities gains as foreign personal holding company income does not, however, apply to income that arises out of commodity hedging transactions.[1007] For these purposes, a commodity hedging transaction is any transaction with respect to a commodity if the transaction is a hedging transaction under section 1221(b)(2) that is entered into by a controlled foreign corporation in the normal course of its trade or business

[1003] Treas. Reg. sec. 1.1221-2(f)(4)(ii).

[1004] Financial Accountiug Standards Board Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, now codified into Accounting Standards Codification ("ASC") 815. For financial accounting purposes, the income recognition of the hedging instrument and the hedged item are generally matched by marking both the hedging instrument and the hedged item to market.

[1005] The purpose of the requirement to identify and document the hedge at inception is to prevent a company from using hindsight in applying hedge accounting. ASC 815-20-25-3 states, "[c]oncurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result."

[1006] Sec. 954(c)(1)(C).

[1007] Sec. 954(c)(1)(C)(i).

primarily to manage risk of price changes or currency fluctuations with respect to ordinary property or section 1231(b) property that is held or is to be held by the controlled foreign corporation, or to manage such other risks as the Secretary may prescribe.[1008]

Description of Proposal

Under the proposal, a hedging transaction is treated as meeting the hedge identification requirement under section 1221 if the transaction is identified as a hedging transaction for tax purposes (as required under existing law), or if the transaction is treated as a hedging transaction within the meaning of GAAP for purposes of the taxpayer's audited financial statement. The audited financial statement must be certified as being prepared in accordance with GAAP by an independent auditor and must be used for the purposes of a statement or report to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes.[1009]

A transaction treated as a hedging transaction for purposes of an audited financial statement is treated as a hedging transaction for tax purposes, as long as the transaction also meets the substantive definition of a tax hedging transaction, which is unchanged by the proposal. If a transaction identified as a hedging transaction for purposes of an audited financial statement does not meet the definition of a hedging transaction for tax purposes, the taxpayer is not permitted to use hedge accounting for the transaction in its tax return. The rules under Treasury regulations for improper identification of a hedging transaction are not applicable to a hedge which is identified as a hedging transaction for financial statement purposes, but does not qualify as a hedging transaction for tax purposes, unless the taxpayer improperly treats the transaction as a tax hedging transaction in its tax return for the taxable year which includes such transaction.

The proposal treats a bond, debenture, note, certificate, or other evidence of indebtedness held by an insurance company as ordinary property solely for purposes of the determination of whether a transaction is to manage risk of price changes or currency fluctuations with respect to ordinary property held or to be held by the taxpayer. Thus, such a transaction involving such an instrument can be accorded hedging transaction tax treatment if identified in accordance with section 1221, as amended by this proposal. The proposal does not treat a bond, debenture, note, certificate, or other evidence of indebtedness held by an insurance company as ordinary property for any other purpose, such as for purposes of determining the character of gain, loss, or income.

The proposal broadens the exception from foreign personal holding company income for income arising out of commodity hedging transactions. It does so by providing that a commodity hedging transaction the income from which is excluded from foreign personal holding company income may be used to manage risk of price changes or currency fluctuations with respect to ordinary property or section 1231(b) property that is held or is to be held by the

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[1008] Sec. 954(c)(5)(A).

[1009] Taxpayers who do not prepare audited financial statements under GAAP may not identify hedging transactions based on financial statement identification.

controlled foreign corporation engaging in the transaction (as under present law), or by another controlled foreign corporation that is a related person (within the meaning of section 954(d)(3)).

Effective Date

The proposal applies to transactions entered into after December 31, 2014.

3. Current inclusion in income of market discount (sec. 3411 of the discussion draft and new sec. 1278 of the Code)

Present Law

If a bond declines in value after it is originally issued, the purchaser of the bond will acquire it with market discount. The decline in value may occur because general interest rates have risen, because the creditworthiness of the issuer has declined, or both. A taxpayer who purchases a bond after original issue at a price less than its principal amount (or adjusted issue price in the case of a bond originally issued at a discount) does not, absent an election, include in income any portion of the market discount prior to the disposition of the bond.

Market discount that accrues while the taxpayer holds a bond is treated as ordinary income, rather than capital gain, upon the disposition of the bond.[1010] The amount treated as ordinary income does not exceed the amount of gain recognized on the disposition of the bond. Market discount accrues on a ratable basis unless the taxpayer elects to accrue on the basis of a constant interest rate. A *de minimis* rule treats the amount of market discount as zero if the market discount is less than one quarter of one percent of the stated redemption price times the number of complete remaining years to maturity after the bond is acquired by the taxpayer.[1011]

Interest expense on indebtedness incurred or continued to purchase or carry a bond with market discount is allowed as a deduction for a taxable year only to the extent the interest expense exceeds the market discount accruing on the bond in that year.[1012] The taxpayer may elect to treat any interest expense disallowed in a prior taxable year as interest expense accruing in the current taxable year to the extent of the net interest income with respect to the bond.[1013] To the extent any interest expense has been previously disallowed, it is allowed at the time the market discount is recognized.[1014]

[1010] Sec. 1276.

[1011] Sec. 1278(a)(2)(C).

[1012] Sec. 1277.

[1013] Sec. 1277(b)(1).

[1014] Sec. 1277(b)(2).

A taxpayer may elect to include market discount in income as it accrues.[1015] If an election is made, the amount included in income is generally treated as interest. However, market discount on a State or local bond is not treated as interest and therefore not exempt from taxation. Similarly market discount realized by a foreign person is not treated as interest for purposes of determining the foreign person's U. S. tax liability under sections 871(a), 881, 1441 and 1442. Consequently, market discount not effectively connected with a U. S. trade or business is treated as gain from the sale of personal property and sourced in accordance with the rules of section 865. Thus, foreign persons generally are not subject to U. S. tax on market discount not effectively connected with a U. S. trade or business.

Original issue discount ("OID"), unlike market discount, is includible in income of the holder currently using a constant interest rate.[1016] OID is discount arising on the issuance of a bond for less than its principal amount. For example, if a publicly traded bond with a principal amount of $1,000 is issued for $800, the bond has $200 OID. OID is deductible by the issuer of the debt instrument over the term of the instrument, whereas the issuer is not impacted by market discount.

Amounts of OID includible in gross income in excess of $10 for one year on bonds for a term of more than one year must be reported to the bond holder by the issuer or broker from whom the bond was acquired.[1017] In addition, brokers are required to report gross proceeds from sale or disposition of bonds, as well as the adjusted basis in covered securities, and furnish copies of these reports or statements to their customers.[1018] Also, a person who transfers a bond to a broker is required to provide a statement to the transferee reflecting information necessary for the broker to comply with his information reporting obligations.[1019]

Description of Proposal

In general

Current inclusion of market discount accruals

Under the proposal, the holder of a market discount bond acquired after December 31, 2014, includes in gross income currently the sum of the daily portions of the market discount for

[1015] Sec. 1278(b).

[1016] Sec. 1272(a).

[1017] Sec. 6049(a), (d)(6); Treas. Reg. sec. 1.6049-4(a) *et seq.* See generally Internal Revenue Service, *Guide to Original Issue Discount (OID) Instruments*, Pub. 1212, (12/2011); Internal Revenue Service, *Investment Income and Expenses*, Pub. 550, chapter 1, "Market Discount Bonds."

[1018] A covered security is any debt instrument that has OID or market discount that was acquired after 2013 through a broker or transferred from a broker with a statement prescribed by the Code with respect to the transfer, if the recipient of the interest or proceeds is not an exempt recipient. Sec. 6045(g)(3); Treas. Reg. sec. 1.6045-1(c)(3), defining exempt recipient.

[1019] Sec. 6045A.

each day during the taxable year that the taxpayer holds the bond. The amount of the inclusion for any taxable year is computed on the basis of a constant interest rate. The amount included in gross income is generally treated as interest, with the same exceptions that apply under present law where an election to accrue market discount has been made.

The daily portion of market discount on any market discount bond is the amount that would be the daily portion of original issue discount which would be determined for a bond at original issuance if the bond had been issued for a price equal to the adjusted basis of the bond immediately after its acquisition. The daily portion of market discount is adjusted to exclude the daily portion of any OID on the bond so as to prevent a double inclusion of OID.[1020]

Limitation of market discount accruals

The amount of market discount includible in gross income by reason of this provision with respect to any bond for any accrual period may not exceed the excess (if any) of (i) the product of the maximum accrual rate which is the greater of (a) the bond's yield to maturity (determined as of the date of the issuance of the original bond) plus five percentage points or (b) the applicable Federal rate for the bond (determined at the time of acquisition using a term equal to the remaining term of the bond) plus ten percentage points, multiplied by the adjusted basis of the bond at the beginning of the accrual period, over (ii) the sum of the amounts of qualified stated interest and original issue discount allocable to the accrual period.

Other rules

The adjusted basis of the bond is increased by amounts included in gross income of the holder of a bond under this provision.

In the case of a bond held by a partnership with respect to which a transfer of a partnership interest occurs by sale or exchange or by reason of death, the market discount rules apply to the transferee partner as if any bond held by the partnership was acquired at the time of the transfer (and the basis of the bond for purposes of determining market discount shall be determined after any adjustment under section 743). If a partnership distributes a bond to a partner and the partner's basis in the bond is determined by reference to the basis in its partnership interest (sec. 732(a)(2) and (b)), for purposes of determining the amount of market discount, the adjusted basis of the bond immediately after its acquisition by the partner is not less than its fair market value.

The market discount provisions of present law (secs. 1276 (treatment of gain), 1277 (deferral of interest deduction), and 1278(b) (election for inclusion)) do not apply to any bond to which this provision applies.

[1020] In the case of a tax-exempt bond, market discount is includible in income although original issue discount is not so includible.

Under the provision, gain or loss on the sale or exchange of a market discount bond (assuming the bond is a capital asset) is capital gain or capital loss, except that the amount of any loss is treated as an ordinary loss to the extent market discount was included in gross income.

The proposal repeals the special rules for short-term non-governmental obligations held by taxpayers subject to current inclusion, which require the accrual of original issue discount but not market discount.[1021] Likewise the proposal repeals the special rules for short-term non-governmental obligations held by taxpayers not subject to current inclusion, which requires gain attributable to original issue discount, but not market discount, to be treated as ordinary income.[1022]

Brokers who hold a "covered bond" are required to report includible OID and market discount with respect to such bonds to the IRS and the customer. A covered bond is any debt instrument that has OID or market discount that was acquired after 2014 through a broker or transferred from a broker with a statement prescribed by the Code with respect to the transfer. In addition, persons who transfer a covered bond are required to provide the transferee with a statement in sufficient detail to permit the transferee to comply with its obligation to report market discount. Finally, to the extent that there may be duplicative reporting obligations with respect to OID, this provision takes precedence except to the extent provided in guidance from the Secretary.

Modernization of certain terms

The proposal makes changes to certain terms to conform the terms to definitions set forth in Treasury regulations or to eliminate obsolete material. The definitions of market discount bond, the revised issue price of a market discount bond, redemption price, adjusted issue price, the determination of daily portions, yield to maturity, and accrual period are updated by the proposal.

Example

On January 1, 2014, XYZ Corporation issues a $1,000 ten-year publicly-traded bond with a five-percent coupon, with $50 of interest paid annually on December 31 of each calendar year. The bond is issued for $960, with original issue discount of $40. Bondholders accrue original issue discount based on the bond's yield to maturity at issuance.[1023] XYZ Corporation deducts

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[1021] Sec. 1283(c).

[1022] Sec. 1271(a)(4).

[1023] Assume that a bond is issued at a price P_0, pays an annual coupon i, and is redeemable in N years for a price of one dollar. The yield to maturity (r) is the solution to the following equation: $P_0 = \frac{i}{r}\left[1 - \frac{1}{(1+r)^N}\right] + \frac{1}{(1+r)^N}$.

this amount of original issue discount over the life of the bond. The annual yield to maturity at the time the bond is issued is 5.53 percent.[1024]

On January 1, 2016, Taxpayer buys the bond in the secondary market for $950. In addition to original issue discount, Taxpayer accrues market discount under the proposal based on the calculated annual yield to maturity for the bond based on Taxpayer's adjusted basis of $950, which is 5.80 percent. On December 31, 2016, Taxpayer has income of $55.09 ($950 multiplied by .0580), of which $50 represents stated interest, $3.45 represents accrued original issue discount, and $1.64 represents accrued market discount. The accrued original issue discount and accrued market discount are added to the basis of the bond. For 2016, Taxpayer has total ordinary income of $55.09 and adjusted basis of $955.09.

Taxpayer holds the bond to maturity and receives $1,000 on December 31, 2024. Over the time it holds the bond, Taxpayer accrues $50 total in discount ($1,000-$950), including $33.63 of original issue discount[1025] and $16.37 of market discount.

The table below summarizes the annual income inclusions for Taxpayer.

Table 7.–Annual Income Inclusions for Taxpayer

Year	Adjusted Basis as of January 1	Stated Interest	Original Issue Discount	Market Discount	Total Ordinary Income
2016	$950.00	$50.00	$3.45	$1.64	$55.09
2017	$955.09	$50.00	$3.65	$1.73	$55.38
2018	$960.47	$50.00	$3.85	$1.85	$55.70
2019	$966.17	$50.00	$4.06	$1.97	$56.03
2020	$972.20	$50.00	$4.28	$2.10	$56.38
2021	$978.58	$50.00	$4.52	$2.23	$56.75
2022	$985.33	$50.00	$4.77	$2.37	$57.14
2023	$992.47	$50.00	$5.05	$2.48	$57.53
TOTAL	$1,000.00	$400.00	$33.63	$16.37	$450.00

Effective Date

The proposal applies to debt obligations acquired after December 31, 2014.

1024 Regulations permit rounding to two decimal places. The numbers appearing in the text and the table were rounded to two decimal places at the final stage. Calculations may vary if a different rounding convention is used.

1025 At the time Taxpayer acquired the bond, the bond had accrued, and XYZ Corporation had deducted, $6.37 in original issue discount. Thus, over the life of the bond, all bondholders accrue, and XYZ Corporation deducts, the full $40 in original issue discount.

4. Treatment of certain exchanges of debt instruments (sec. 3412 of the discussion draft and secs. 1037 and 1274B of the Code)

Present Law

Treatment of issuer

Gross income includes income from the cancellation of debt ("COD").[1026] The amount of COD income is generally the difference between the adjusted issue price[1027] of the debt being cancelled and the amount used to satisfy the debt.[1028] The COD rules generally apply to the exchange of an old debt obligation for a new debt obligation, including a modification of the old debt that is treated as an exchange.[1029] In the case of an old obligation that is exchanged for a new obligation, for purposes of determining the amount of COD, the amount used to satisfy the old obligation is the issue price of the new obligation.[1030]

If the issue price of the new debt obligation exceeds the adjusted issue price of the old debt obligation, the issuer has retirement premium that is immediately deductible if the debt obligation is publicly traded and, if not, the issuer reduces the issue price of the new debt and the premium is amortized over the term of the new debt.[1031]

Treatment of holder

The holder of an existing debt instrument exchanged for a new debt instrument generally recognizes gain or loss to the extent the adjusted basis of the existing debt differs from the sum of money and fair market value of any property received (including the new debt).[1032] The issue price of the new debt obligation generally determines the amount realized by the holder of the old debt.[1033] In the case of a corporate reorganization and certain corporate distributions, gain on

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[1026] Sec. 61. Section 108 provides that in the case of an insolvent debtor or debtor in bankruptcy, instead of including the amount in gross income, certain tax attributes are reduced. Present law (for amounts discharged before 2014) provides an exclusion relating to qualified principal residence indebtedness which is not affected by the proposal.

[1027] Treas. Reg. sec. 1.1275-1(b) provides that the adjusted issue price is the issue price increased by the amount of OID previously includible in gross income of any holder and decreased by payments other than payments of stated interest.

[1028] Treas. Reg. sec. 1.61-12(c)(2).

[1029] See Treas. Reg. sec. 1.1001-3(a).

[1030] Sec. 108(e)(10).

[1031] Treas. Reg. sec. 1.163-7(c).

[1032] Sec. 1001 and Treas. Reg. sec. 1.1001-1.

[1033] Treas. Reg. sec. 1.1001-1(g)(1).

the exchange of securities is recognized only to the extent of the fair market value of the excess of the principal amount of the securities received over the principal amount of the securities surrendered[1034] and loss on the exchange is not recognized.[1035]

Issue price of new obligation

The issue price of the new obligation is determined under the general rules applicable to a debt instrument issued for property.[1036] If the new debt is publicly traded, the issue price is the fair market value of the debt. If the new debt is not publicly traded, but the old debt is publicly traded, the issue price is the fair market value of the old debt. If neither debt is publicly traded, the issue price of the new debt is its stated redemption price at maturity if the debt has adequate stated interest, generally based on the applicable Federal rate ("AFR"). If the new debt does not have adequate stated interest, the issue price is an imputed principal amount using the applicable AFR as the discount rate.

Prior to the Omnibus Budget Reconciliation Act of 1990 ("the 1990 Act"),[1037] the Code provided a special rule for the determination of issue price in the case of exchange of debt instruments in a corporate reorganization. The special rule generally provided that in a corporate reorganization the issue price of the new debt instrument would not be less that the adjusted issue price of the old debt instrument. The 1990 Act repealed the special rule.[1038]

Certain exchange of government obligations

Present law provides that United States obligations may be exchanged without recognition of gain or loss.[1039] At one time, this provision allowed an individual to exchange Series E or EE savings bonds for Series H or HH savings bonds without recognition of income. The Treasury Department no longer issues Series H or HH savings bonds.[1040]

[1034] Sec. 356(d)(2)(B) and (C).

[1035] Sec. 356(b).

[1036] Secs. 1273(b) and 1274.

[1037] Pub.L. No. 101-508.

[1038] Sec. 1275(a)(4) was repealed by section 11325(a)(2) of the Omnibus Budget Reconciliation Act of 1990.

[1039] Sec. 1037.

[1040] The last series HH savings bonds were issued in August 2004.

Description of Proposal

Issue price of new obligation

The proposal provides that in the case of an exchange (including by significant modification)[1041] of a new debt instrument for an existing debt instrument of the same issuer, the issue price of the new debt instrument is the least of (1) the adjusted issue price of the existing debt instrument, (2) the stated principal amount of the new debt instrument, or (3) the imputed principal amount of the new debt instrument. The discount rate used to determine the imputed principal amount of the new debt instrument is the lesser of the AFR determined with respect to the new debt instrument or the AFR determined with respect to the old debt instrument (or, if greater, the stated interest rate of the old debt instrument). Thus, if the principal amount of the debt does not change and there is adequate stated interest, the exchange does not cause the issuer to recognize COD income.

Treatment of holder

In the case of an exchange of an existing debt obligation solely for a new debt obligation of the same issuer no gain or loss is recognized. If the holder receives money or property other than the new debt instrument ("boot"), the holder recognizes gain to the extent of the lesser of the amount of boot received or the amount of gain that would be recognized if the issue price of the new debt was determined without regard to the new issue price rule of section 1274B.

Conforming amendments are made to the reorganization provisions providing that the measure of recognized gain is determined by reference to the issue price of the securities received and the adjusted issue price of the securities surrendered.

Examples

The following examples illustrate the operation of the proposal.

Example 1.–If a debt instrument (whether or not publicly traded) with a redemption price and an adjusted issue price of $10,000 is exchanged for a new debt instrument of the issuer with a redemption price of $10,000 (and adequate stated interest) with an extended maturity, the issue price of the new debt is $10,000 regardless of the fair market value of the old debt. Thus, the issuer does not have any COD income. Likewise, the holder has no gain or loss, regardless whether the holder acquired the debt in the secondary market for more or less than $10,000.

Example 2.–The facts are the same as in example 1, except the debt instrument was originally issued for $9,000 and $500 OID had been accrued. The exchange is treated in the same manner as in example 1, and the OID and market discount (if any) carry over to the new obligation.

[1041] See Treas. Reg. sec. 1.1001-3 for the test when a significant modification occurs.

Example 3.–The facts are the same as in example 1, except the principal amount is reduced to $9,000. Under the proposal, the issuer has $1,000 COD income. The holder has no gain or loss.

Example 4.–X issues a publicly traded debt instrument with an issue price and redemption price of $100,000. Y purchases the debt for $40,000. Immediately after the purchase when fair market value of the debt is still $40,000, Y exchanges the old debt instrument with X for a new debt instrument with a redemption price of $50,000 (and adequate stated interest) and $10,000 cash. X has $40,000 income from the discharge of indebtedness (a $100,000 debt is satisfied with $10,000 cash and a $50,000 debt). Y recognizes no gain or loss, since in the absence of section 1274B, the new debt would have an issue price of $40,000 (its fair market value at issuance), and thus the amount realized by Y equals its basis in the old debt.

Certain exchange of government obligations

The proposal repeals as obsolete the present-law provision allowing the tax-free exchange of certain United States obligations.

Effective Date

The proposal applies to transactions after December 31, 2014.

5. Coordination with rules for inclusion not later than for financial accounting purposes (sec. 3413 of the discussion draft and sec. 451 of the Code)

Present Law

In general

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting.[1042] If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount whether or not the taxpayer makes the demand and actually receives the payment.[1043]

In general, for a cash basis taxpayer, an amount is included in income when actually or constructively received.[1044] For an accrual basis taxpayer, an amount generally is recognized (and included in income) the earlier of when such amount is earned by, due to, or received by the taxpayer, unless an exception permits deferral or exclusion.[1045]

[1042] Sec. 451(a).

[1043] See Treas. Reg. sec. 1.451-2.

[1044] *Ibid.*

[1045] See sec. 451 and Treas. Reg. sec. 1.451-1.

Interest income

A taxpayer generally must include in gross income the amount of interest received or accrued within the taxable year on indebtedness held by the taxpayer.[1046]

Original issue discount

The holder of a debt instrument with original issue discount ("OID") generally accrues and includes in gross income, as interest, the OID over the life of the obligation, even though the amount of the interest may not be received until the maturity of the instrument.[1047]

The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument.[1048] The stated redemption price at maturity includes all amounts payable at maturity.[1049] The amount of OID in a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period.[1050] The adjustment to the issue price is determined by multiplying the adjusted issue price (*i.e.*, the issue price increased by adjustments prior to the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period. Thus, in order to compute the amount of OID and the portion of OID allocable to a period, the stated redemption price at maturity and the time of maturity must be known. Issuers of OID instruments accrue and deduct the amount of OID as interest expense in the same manner as the holder.[1051]

Debt instruments subject to acceleration

Special rules for determining the amount of OID allocated to a period apply to certain instruments that may be subject to prepayment. First, if a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt. In addition, in the case of (1) any regular interest in a real estate mortgage investment conduit ("REMIC"), (2) qualified mortgages held by a REMIC, or (3) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, the daily portions of the OID on such debt instruments are

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[1046] Secs. 61(a)(4) and 451.

[1047] Sec. 1272.

[1048] Sec. 1273(a)(1).

[1049] Sec. 1273(a)(2).

[1050] See sec. 1272.

[1051] Sec. 163(e).

determined by taking into account an assumption regarding the prepayment of principal for such instruments.[1052]

The Taxpayer Relief Act of 1997[1053] extended these rules to any pool of debt instruments the payments on which may be accelerated by reason of prepayments.[1054] Thus, if a taxpayer holds a pool of credit card receivables that require interest to be paid only if the borrowers do not pay their accounts by a specified date ("grace-period interest"), the taxpayer is required to accrue interest or OID on such pool based upon a reasonable assumption regarding the timing of the payments of the accounts in the pool. Under these rules, certain amounts (other than grace-period interest) related to credit card transactions, such as late-payment fees,[1055] cash-advance fees,[1056] and interchange fees,[1057] have been determined to create OID or increase the amount of OID on the pool of credit card receivables to which the amounts relate.[1058]

Description of Proposal

The proposal modifies the proposed rules under section 451.[1059] Specifically, the proposal directs taxpayers to apply the revenue recognition rules under section 451 before applying the OID rules under section 1272. Thus, for example, to the extent amounts are included in income for financial statement purposes when received (*e.g.*, late-payment fees, cash-advance fees, interchange fees, *etc.*), such amounts generally are includable income at such time in accordance with the general recognition principles under section 451.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

[1052] Sec. 1272(a)(6).

[1053] Pub. L. No. 105-34, sec. 1004(a).

[1054] Sec. 1272(a)(6)(C)(iii).

[1055] Revenue Procedure 2004-33, 2004-1 C.B. 989.

[1056] Revenue Procedure 2005-47, 2005-2 C.B. 269.

[1057] *Capital One Financial Corp. v. Commissioner*, 133 T.C. 8, September 31, 2009; IRS Chief Counsel Notice CC-2010-018, September 27, 2010.

[1058] See also Rev. Proc. 2013-26, 2013-22 I.R.B. 1160, May 28, 2013, for a safe harbor method of accountiug for OID on a pool of credit card receivables for purposes of section 1272(a)(6).

[1059] For a discussion of the proposed changes to section 451, see section 3303 of the discussion draft, "Certain special rules for taxable year of inclusion."

6. Rules regarding certain government debt (sec. 3414 of the discussion draft and secs. 454 and 1272A of the Code)

Present Law

A cash-basis taxpayer holding a non-interest bearing obligation issued at a discount may elect to include in income the increase in the value of the obligation.[1060]

Discount on certain short-term government obligations, such as Treasury bills, is not considered to accrue until the obligation is paid at maturity or otherwise disposed of.[1061] However, in the case of a taxpayer using an accrual method of accounting and certain other taxpayers, discount on short-term obligations is required to be included currently in income.[1062]

Any increase in the redemption value of a United States savings bond (to the extent not previously included in income) is includible in gross income in the taxable year the bond is redeemed or the taxable year of final maturity, whichever is earlier.[1063]

Description of Proposal

The proposal moves the rules relating to the tax treatment of United States savings bonds to the portion of the Internal Revenue Code of 1986 relating generally to the treatment of bonds and other debt instruments. The proposal does not change the present-law tax treatment of United States savings bonds.

The proposal repeals the provision of present law relating to the accrual of interest on short-term government obligations as obsolete.

Effective Date

The proposal is generally effective on the date of enactment.

[1060] Sec. 454(a).

[1061] Sec. 454(b).

[1062] Sec. 1281(a).

[1063] Sec. 454(c).

7. Cost basis of specified securities determined without regard to identification (sec. 3421 of the discussion draft and sec. 1012 of the Code)

Present Law

In general

Gain or loss generally is recognized for Federal income tax purposes on realization of that gain or loss (for example, through the sale of property giving rise to the gain or loss). The taxpayer's gain or loss on a disposition of property is the difference between the amount realized and the adjusted basis.[1064]

To compute adjusted basis, a taxpayer must first determine the property's unadjusted or original basis and then make adjustments prescribed by the Code.[1065] The original basis of property is its cost, except as otherwise prescribed by the Code (for example, in the case of property acquired by gift or bequest or in a tax-free exchange). Once determined, the taxpayer's original basis generally is adjusted downward to take account of depreciation or amortization, and generally is adjusted upward to reflect income and gain inclusions or capital outlays with respect to the property.

Basis computation rules

If a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares deemed sold are the earliest acquired shares (the "first-in-first-out rule").[1066] If a taxpayer makes an adequate identification ("specific identification") of shares of stock that it sells, the shares of stock treated as sold are the shares that have been identified.[1067] A taxpayer who owns shares in a regulated investment company ("RIC") generally is permitted to elect, in lieu of the specific identification or first-in-first-out methods, to determine the basis of RIC shares sold under one of two average-cost-basis methods described in Treasury regulations (together, the "average basis method").[1068]

In the case of the sale, exchange, or other disposition of a specified security (defined below) to which the basis reporting requirement described below applies, the first-in-first-out rule, specific identification, and average basis method conventions are applied on an account by account basis.[1069] To facilitate the determination of the cost of RIC stock under the average basis

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[1064] Sec. 1001.

[1065] Sec. 1016.

[1066] Treas. Reg. sec. 1.1012-1(c)(1).

[1067] Treas. Reg. sec. 1.1012-1(c).

[1068] Treas. Reg. sec. 1.1012-1(e).

[1069] Sec. 1012(c)(1).

method, RIC stock acquired before January 1, 2012, generally is treated as a separate account from RIC stock acquired on or after that date unless the RIC (or a broker holding the stock as a nominee) elects otherwise with respect to one or more of its stockholders, in which case all the RIC stock with respect to which the election is made is treated as a single account and the basis reporting requirement described below applies to all that stock.[1070]

The basis of stock acquired after December 31, 2010, in connection with a dividend reinvestment plan ("DRP") is determined under the average basis method for as long as the stock is held as part of that plan.[1071]

Basis reporting

A broker is required to report to the IRS a customer's adjusted basis in a covered security that the customer has sold and whether any gain or loss from the sale is long-term or short-term.[1072]

A covered security is, in general, any specified security acquired after an applicable date specified in the basis reporting rules. A specified security is any share of stock of a corporation (including stock of a RIC); any note, bond, debenture, or other evidence of indebtedness; any commodity, or contract or derivative with respect to such commodity, if the Treasury Secretary determines that adjusted basis reporting is appropriate; and any other financial instrument with respect to which the Treasury Secretary determines that adjusted basis reporting is appropriate.

For purposes of satisfying the basis reporting requirements, a broker must determine a customer's adjusted basis in accordance with rules intended to ensure that the broker's reported adjusted basis numbers are the same numbers that customers must use in filing their tax returns.[1073]

Description of Proposal

The proposal requires that the cost of any specified security sold, exchanged, or otherwise disposed of on or after January 1, 2015, be determined on a first-in first-out basis except to the extent the average basis method is otherwise allowed (as in the case of stock of a RIC).

The proposal includes several conforming amendments, including a rule restricting a broker's basis reporting method to the first-in first-out method in the case of the sale of any stock for which the average basis method is not permitted.

[1070] Sec. 1012(c)(2).

[1071] Sec. 1012(d)(1). Other special rules apply to DRP stock. See sec. 1012(d)(2) and (3).

[1072] Sec. 6045(g); Treas. Reg. sec. 1.6045-1(d).

[1073] See sec. 6045(g)(2).

Effective Date

The proposal applies to sales, exchanges, and other dispositions after December 31, 2014.

8. Wash sales by related parties (sec. 3422 of the discussion draft and sec. 1091 of the Code)

Present Law

A taxpayer may not deduct losses from the disposition of stock or securities if substantially identical stock or securities (or an option to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date of sale (a "wash sale").[1074] Commodity futures are not treated as stock or securities for purposes of this rule. A deduction is allowed if the taxpayer incurred the loss in the ordinary course of business as a dealer in stock or securities.

If a loss is disallowed because of the wash sale rules, the basis of the substantially identical stock or securities is adjusted to include the disallowed loss. The holding period for substantially identical stock or securities acquired in a wash sale includes the holding period of the stock or securities sold.

Similar rules apply to disallow any loss realized on the closing of a short sale of stock or securities if substantially identical stock or securities are sold (or a short sale, option or contract to sell is entered into) during the applicable period before and after the closing of the short sale.

Under IRS guidance, transactions with certain related parties may also constitute wash sales. If a taxpayer sells stock and the taxpayer's spouse or a corporation controlled by the taxpayer buys substantially identical stock, the transaction constitutes a wash sale.[1075] If an individual sells stock or securities for a loss and acquires substantially identical stock or securities within an individual retirement account or a Roth IRA within the specified period of time, the loss on the sale of the stock or securities is disallowed under the wash sale rules, and the individual's basis in the IRA or Roth IRA is not increased.[1076]

Description of Proposal

The proposal expands application of the wash sale rules to acquisition of substantially identical stock or securities by the taxpayer or a related party. In the case of any acquisition of substantially identical stock or securities by a related party (other than the taxpayer's spouse), the basis of the substantially identical stock or securities is not adjusted to include the disallowed loss. If the substantially identical stock or securities is acquired by the taxpayer (or the

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[1074] Sec. 1091.

[1075] Internal Revenue Service, *Investment Income and Expenses (Including Capital Gains and Losses)*, Publication 550, October 16, 2012, p. 59.

[1076] Rev. Rul. 2008-5.

taxpayer's spouse), the basis of the acquired stock or securities is increased by the amount of the disallowed loss.

For purposes of the wash sale rules, a related party means: (1) the taxpayer's spouse; (2) any dependent of the taxpayer and any other taxpayer with respect to whom the taxpayer is a dependent; (3) any individual, corporation, partnership, trust, or estate that controls, or is controlled by the taxpayer or any individual described in (1) or (2); (4) any individual retirement plan, Archer MSA, or health savings account of the taxpayer or of any individual described in (1) or (2); (5) any account under a qualified tuition program or a Coverdell education savings account if the taxpayer or any individual described in (1) or (2) is the designated beneficiary of such account or has the right to make any decision with respect to the investment of any amount in such account; and (6) any account under a plan described in section 401(a), an annuity plan described in section 403(a), an annuity contract described in section 403(b), or an eligible deferred compensation plan described in section 457(b) and maintained by an employer described in section 457(e)(1)(A), if the taxpayer or any individual described in (1) or (2) with respect to the taxpayer has the right to make any decision with respect to the investment of any amount in such account.

Most relationships are determined as of the time of the acquisition of substantially identical stock or securities. Spousal and dependency relationships are determined for the taxable year that includes such acquisition. Marital status is determined under section 7703, except that a husband and wife who file separate returns for any taxable year and live apart at all times during such taxable year shall not be treated as married individuals for purposes of the wash sale rules.

Regulatory authority is provided to prevent the avoidance of the purposes of the subsection dealing with related parties, including regulations that treat persons as related parties if such persons are formed or availed of to avoid the purposes of such subsection.

Effective Date

The proposal applies to sales and other dispositions after December 31, 2014.

9. Nonrecognition for derivative transactions by a corporation with respect to its stock (sec. 3423 of the discussion draft and sec. 1032 of the Code)

Present Law

A corporation does not recognize gain or loss on the receipt of money or other property in exchange for its own stock.[1077] Likewise, a corporation does not recognize gain or loss when it redeems its stock with cash for less or more than it received when the stock was issued.

In addition, a corporation does not recognize gain or loss on any lapse or acquisition of an option, or with respect to a securities futures contract, to buy or sell its stock.[1078]

[1077] The first sentence of sec. 1032(a).

Description of Proposal

In general

The proposal provides generally that section 1032 derivative items of a corporation are not taken into account in determining the corporation's liability for income tax. A corporation generally does not recognize gain or loss on the receipt of money or other property in exchange for its stock,[1079] except as otherwise provided under the proposal with respect to certain forward contracts giving rise to income in the nature of interest income or under regulatory authority to carry out the purposes of the proposals.

A section 1032 derivative item of a corporation is an item of income, gain, loss, or deduction to the extent it arises from any rights or obligations under a derivative with respect to the corporation's stock or is attributable to transfer or extinguishment of any such right or obligation. A section 1032 derivative item of a corporation also is an item of income, gain, loss, or deduction that arises under any other contract or position to the extent the item reflects or is determined by reference to changes in the value of the corporation's stock or distributions on the stock. The term does not include any deduction with respect to which section 83 applies (relating to a deduction by an employer in connection with services performed), nor a deduction for any item in the nature of compensation for services rendered. Regulatory authority is provided to treat portions of an instrument separately and to treat section 1032 derivative items as contributions to capital that are includable in gross income of a corporation to the extent that not doing so is inconsistent with the purposes of new section 76 as added by the discussion draft.[1080]

Income recognition on certain forward contracts with respect to a corporation's stock

The proposal provides for income recognition on certain forward contracts as if the includible amounts were original issue discount. This rule applies if a corporation acquires its stock as part of a plan or series of related transactions pursuant to which the corporation enters into a forward contract with respect to its stock. In this case, the corporation includes in income the excess of the amount to be received under the forward contract over the fair market value of the stock as of the date the corporation entered into the forward contract. The income is included as if the excess were original issue discount on a debt instrument acquired on that date. This rule of inclusion applies only to the extent that the amount of the stock involved in the forward contract does not exceed the amount of stock acquired by the corporation pursuant to the plan or series of related transactions. Under the proposal, a plan is presumed to exist if a corporation enters into a forward contract with respect to its stock with the 60-day period beginning on the date 30 days before the date it acquires its stock.

[1078] The second sentence of sec. 1032(a).

[1079] See section 3101 of the discussion draft, relating to revision of treatment of contributions to capital.

[1080] See section 3101 of the discussion draft, relating to revision of treatment of contributions to capital.

Effective Date

The proposal applies to transactions entered into after the date of enactment.

10. Termination of private activity bonds (sec. 3431 of the discussion draft and sec. 103 of the Code)

Present Law

In general

Under present law, gross income generally does not include interest paid on State or local bonds.[1081] State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or that are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals). The exclusion from income for State and local bonds only applies to private activity bonds if the bonds are issued for certain permitted purposes ("qualified private activity bonds").

Private activity bonds

Present law provides three main tests for determining whether a State or local bond is in substance a private activity bond, the two-part private business test, the five-percent unrelated or disproportionate use test, and the private loan test.

Private business test

Private business use and private payments result in State and local bonds being private activity bonds if both parts of the two-part private business test are satisfied–

1. More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the "private business use test"); and

2. More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to be derived from payments in respect of such property (the "private payment test").

Private business use generally includes any use by a business entity (including the Federal government), which occurs pursuant to terms not generally available to the general public. For example, if bond-financed property is leased to a private business (other than pursuant to certain short-term leases for which safe harbors are provided under Treasury regulations), bond proceeds used to finance the property are treated as used in a private business use, and rental payments are treated as securing the payment of the bonds. Private business use

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[1081] Sec. 103.

also can arise when a governmental entity contracts for the operation of a governmental facility by a private business under a management contract that does not satisfy Treasury regulatory safe harbors regarding the types of payments made to the private operator and the length of the contract.

Five-percent unrelated or disproportionate business use test

A second standard to determine whether a bond is to be treated as a private activity bond is the five percent unrelated or disproportionate business use test. Under this test the private business use and private payment test (described above) are separately applied substituting five percent for 10 percent and generally only taking into account private business use and private payments that are not related or not proportionate to the government use of the bond proceeds. For example, while a bond issue that finances a new State or local government office building may include a cafeteria the issue may become a private activity bond if the size of the cafeteria is excessive (as determined under this rule).

Private loan test

The third standard for determining whether a State or local bond is a private activity bond is whether an amount exceeding the lesser of (1) five percent of the bond proceeds or (2) $5 million is used (directly or indirectly) to finance loans to private persons. Private loans include both business and other (*e.g.*, personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test. Present law provides that the substance of a transaction governs in determining whether the transaction gives rise to a private loan. In general, any transaction which transfers tax ownership of property to a private person is treated as a private loan.

Special limit on certain output facilities

A special rule for output facilities treats bonds as private activity bonds if more than $15 million of the proceeds of the bond issue are used to finance an output facility (an output facility includes electric and gas generation, transmission and related facilities but not a facility for the furnishing of water).[1082]

Special volume cap requirement for larger transactions

A special volume cap requirement for larger transactions treats bonds as private activity bonds if the nonqualified amount of private business use or private payments exceeds $15 million (even if that amount is within the general 10-percent private business limitation for governmental bonds) unless the issuer obtains a private activity bond volume allocation.[1083]

[1082] Sec. 141(b)(4).

[1083] Sec. 141(b)(5).

Qualified private activity bonds

As stated, interest on private activity bonds is taxable unless the bonds meet the requirements for qualified private activity bonds. Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[1084] The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities.[1085]

In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For 2014, the State volume limit is the greater of $100 multiplied by the State population, or $296,825,000.[1086]

Description of Proposal

The proposal repeals the exception from the exclusion from gross income for interest paid on qualified private activity bonds. Thus, interest on any private activity bond is includible in the gross income of the taxpayer.

Effective Date

The proposal applies to bonds issued after December 31, 2014.

11. Termination of credit for interest on certain home mortgages (sec. 3432 of the discussion draft and sec. 25 of the Code)

Present Law

Qualified governmental units can elect to exchange all or a portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates ("MCCs").[1087] MCCs entitle homebuyers to a nonrefundable income tax credit for a specified percentage of interest paid on mortgage loans on their principal residences. The tax credit provided by the MCC may

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[1084] Sec. 141(e).

[1085] Sec. 142(a).

[1086] Rev. Proc. 2013-35, 2013-47 I.R.B. 537 (November 18, 2013).

[1087] Sec. 25.

be carried forward for three years. Once issued, an MCC generally remains in effect as long as the residence being financed is the certificate-recipient's principal residence. MCCs generally are subject to the same eligibility and targeted area requirements as qualified mortgage bonds.[1088]

Description of Proposal

No credit is allowed with respect to any MCC issued after December 31, 2014.

Effective Date

The proposal applies to taxable years ending after December 31, 2014. Credits continue for interest paid on mortgage loans on principal residences for which MCCs have been issued on or before December 31, 2014.

12. Repeal advance refunding bonds (sec. 3433 of the discussion draft and sec. 149(d) of the Code)

Present Law

Section 103 generally provides that gross income does not include interest received on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals).[1089] Bonds issued to finance the activities of charitable organizations described in section 501(c)(3) ("qualified 501(c)(3) bonds") are one type of private activity bond. The exclusion from income for interest on State and local bonds only applies if certain Code requirements are met.

A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). The Code contains different rules for current as opposed to advance refunding bonds. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bond.[1090] Proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed.

Although there is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded, the Code limits advance refundings. Generally, governmental bonds

[1088] Sec. 143.

[1089] Sec. 141.

[1090] Sec. 149(d)(5).

and qualified 501(c)(3) bonds may be advance refunded one time.[1091] Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all.[1092] Furthermore, in the case of an advance refunding bond that results in interest savings (*e.g.*, a high interest rate to low interest rate refunding), the refunded bond must be redeemed on the first call date 90 days after the issuance of the refunding bond that results in debt service savings (the "first call requirement").[1093]

Description of Proposal

The proposal repeals the exclusion from gross income for interest on any bond issued to advance refund a bond.

Effective Date

The proposal applies to bonds issued after December 31, 2014.

13. Repeal tax credit bond rules (sec. 3434 of the discussion draft and secs. 54A, 54B, 54C, 54D, 54E, 54F and 6431 of the Code)

Present Law

In general

Tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost. The borrowing subsidy generally is measured by reference to the credit rate set by the Treasury Department. Current tax-credit bonds include qualified tax credit bonds, which have certain common general requirements, and include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy ("QZABs"), and qualified school construction bonds. The authority to issue two other types of tax-credit bonds, recovery zone economic development bonds and Build America Bonds expired on January 1, 2011.

Qualified tax-credit bonds

General rules applicable to qualified tax-credit bonds[1094]

Unlike tax-exempt bonds, qualified tax-credit bonds generally are not interest-bearing obligations. Rather, the taxpayer holding a qualified tax-credit bond on a credit allowance date

[1091] Sec. 149(d)(3). Bonds issued before 1986 and pursuant to certain transition rules contained in the Tax Reform Act of 1986 may be advance refunded more than one time in certain cases.

[1092] Sec. 149(d)(2).

[1093] Sec. 149(d)(3)(A)(iii) and (B); Treas. Reg. sec. 1.149(d)-1(f)(3). A "call" provision provides the issuer of a bond with the right to redeem the bond prior to the stated maturity.

[1094] Separate rules apply in the case of tax-credit bonds which are not qualified tax-credit bonds (*e.g.*, "recovery zone economic development bonds," and "Build America Bonds").

is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit rate for an issue of qualified tax credit bonds is determined by the Secretary and is estimated to be a rate that permits issuance of the qualified tax-credit bonds without discount and interest cost to the qualified issuer.[1095] The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

Qualified tax-credit bonds are subject to a maximum maturity limitation. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on a qualified tax-credit bond being equal to 50 percent of the face amount of such bond. The discount rate used to determine the present value amount is the average annual interest rate of tax-exempt obligations having a term of 10 years or more which are issued during the month the qualified tax-credit bonds are issued.

For qualified tax-credit bonds, 100 percent of the available project proceeds must be used within the three-year period that begins on the date of issuance. Available project proceeds are proceeds from the sale of the bond issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified projects during the three-year spending period, bonds will continue to qualify as qualified tax-credit bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Qualified tax-credit bonds also are subject to the arbitrage requirements of section 148 that apply to traditional tax-exempt bonds. Principles under section 148 and the regulations thereunder apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to qualified tax-credit bonds. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified tax-credit bonds are issued.

[1095] However, for new clean renewable energy bonds and qualified energy conservation bonds, the applicable credit rate is 70 percent of the otherwise applicable rate.

Issuers of qualified tax-credit bonds are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds. In addition, issuers of qualified tax-credit bonds are required to certify that applicable State and local law requirements governing conflicts of interest are satisfied with respect to such issue, and if the Secretary prescribes additional conflicts of interest rules governing the appropriate Members of Congress, Federal, State, and local officials, and their spouses, such additional rules are satisfied with respect to such issue.

New clean renewable energy bonds

New clean renewable energy bonds ("New CREBs") may be issued by qualified issuers to finance qualified renewable energy facilities.[1096] Qualified renewable energy facilities are facilities that: (1) qualify for the tax credit under section 45 (other than Indian coal and refined coal production facilities), without regard to the placed-in-service date requirements of that section; and (2) are owned by a public power provider, governmental body, or cooperative electric company.

The term "qualified issuers" includes: (1) public power providers; (2) a governmental body; (3) cooperative electric companies; (4) a not-for-profit electric utility that has received a loan or guarantee under the Rural Electrification Act; and (5) clean renewable energy bond lenders. There was originally a national limitation for New CREBs of $800 million. The national limitation was then increased by an additional $1.6 billion in 2009. As with other tax credit bonds, a taxpayer holding New CREBs on a credit allowance date is entitled to a tax credit. However, the credit rate on New CREBs is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.[1097]

Qualified energy conservation bonds

Qualified energy conservation bonds may be used to finance qualified conservation purposes.

The term "qualified conservation purpose" means:

1. Capital expenditures incurred for purposes of reducing energy consumption in publicly owned buildings by at least 20 percent; implementing green community programs;[1098] rural development involving the production of electricity from

[1096] Sec. 54C.

[1097] Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

[1098] Capital expenditures to implement green community programs include grants, loans and other repayment mechanisms to implement such programs. For example, States may issue these tax credit bonds to finance retrofits of existing private buildings through loans and/or grants to individual homeowners or businesses, or through other repayment mechanisms. Other repayment mechanisms can include periodic fees assessed on a renewable energy resources; or any facility eligible for the production tax credit under section 45 (other than Indian coal and refined coal production facilities);

2. Expenditures with respect to facilities or grants that support research in: (a) development of cellulosic ethanol or other nonfossil fuels; (b) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; (c) increasing the efficiency of existing technologies for producing nonfossil fuels; (d) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; and (e) technologies to reduce energy use in buildings;

3. Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;

4. Demonstration projects designed to promote the commercialization of: (a) green building technology; (b) conversion of agricultural waste for use in the production of fuel or otherwise; (c) advanced battery manufacturing technologies; (d) technologies to reduce peak-use of electricity; and (e) technologies for the capture and sequestration of carbon dioxide emitted from combusting fossil fuels in order to produce electricity; and

5. Public education campaigns to promote energy efficiency (other than movies, concerts, and other events held primarily for entertainment purposes).

There was originally a national limitation on qualified energy conservation bonds of $800 million. The national limitation was then increased by an additional $2.4 billion in 2009. As with other qualified tax credit bonds, the taxpayer holding qualified energy conservation bonds on a credit allowance date is entitled to a tax credit. The credit rate on the bonds is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.[1099]

Qualified zone academy bonds

QZABs are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy," and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

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government bill or utility bill that approximates the energy savings of energy efficiency or conservation retrofits. Retrofits can include heating, cooling, lighting, water-saving, storm water-reducing, or other efficiency measures.

[1099] Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

A total of $400 million of QZABs has been authorized to be issued annually in calendar years 1998 through 2008. The authorization was increased to $1.4 billion in 2009 and 2010, respectively. The authorization for calendar years 2011, 2012 and 2013 was set at $400 million.

Qualified school construction bonds

Qualified school construction bonds must meet three requirements: (1) 100 percent of the available project proceeds of the bond issue is used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a bond-financed facility is to be constructed; (2) the bond is issued by a State or local government within which such school is located; and (3) the issuer designates such bonds as a qualified school construction bond.

There is a national limitation on qualified school construction bonds of $11 billion for calendar years 2009 and 2010, and zero after 2010. If an amount allocated is unused for a calendar year, it may be carried forward to the following and subsequent calendar years. Under a separate special rule, the Secretary of Interior may allocate $200 million of school construction bond authority for Indian schools.

Direct-pay bonds and expired tax-credit bond provisions

The Code provides that an issuer may elect to issue certain tax credit bonds as "direct-pay bonds." Instead of a credit to the holder, with a "direct-pay bond" the Federal government pays the issuer a percentage of the interest on the bonds. The following tax credit bonds may be issued as direct-pay bonds: new clean renewable energy bonds, qualified energy conservation bonds, and qualified school construction bonds. Qualified zone academy bonds may be issued as direct-pay but such an election is not available regarding any allocation of the national zone academy bond allocation after 2011 or any carryforward of such allocation. The ability to issue Build America Bonds and Recovery Zone bonds, which have direct-pay features, has expired.

Description of Proposal

The proposal prospectively repeals all existing authority for issuing tax-credit bonds and direct-pay bonds.

Effective Date

The proposal is effective for bonds issued after the date of enactment. Current law remains in place for bonds outstanding on the date of enactment.

F. Insurance Reforms

1. Exception to pro rata interest expense disallowance for corporate-owned life insurance restricted to 20-percent owners (sec. 3501 of the discussion draft and sec. 264 of the Code)

Present Law

Inside buildup and death benefits under life insurance contracts generally tax-free

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract[1100] ("inside buildup").[1101] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[1102]

Premium and interest deduction limitations with respect to life insurance contracts

Premiums

Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.[1103]

[1100] By contrast to the treatment of life insurance contracts, if an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

[1101] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (*i.e.*, income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, *i.e.*, generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[1102] Sec. 101(a).

[1103] Sec. 264(a)(1).

Interest paid or accrued with respect to the contract[1104]

No deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual,[1105] with a key person insurance exception.[1106] This reflects a broadening of the interest deduction disallowance rule that was enacted in 1996.

Pro rata interest deduction limitation

A pro rata interest deduction disallowance rule also applies. This rule applies to interest, a deduction for which is not disallowed under the other interest deduction disallowance rules relating to life insurance, for example, interest on third-party debt that is not with respect to a life insurance, endowment or annuity contract. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.[1107] Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values of life insurance, annuity, and endowment contracts, plus the average adjusted bases of other assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who

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[1104] Earlier-enacted interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts, known as the "single premium" and "4-out-of-7" limitations. The single premium limitation provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract (sec. 264(a)(2)). Under the general rule to which the 4-out-of-7 limitation is a safe harbor, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise) (sec. 264(a)(3)). Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven -year period is paid by means of snch debt.

[1105] Sec. 264(a)(4).

[1106] This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. Under the key person exception (sec. 264(e)), otherwise nondeductible interest may be deductible, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed $50,000. The deductible interest may not exceed the amount determined by applying a rate based on Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of five percent of the total number of officers and employees of the taxpayer, or 20 individuals.

[1107] Sec. 264(f). This applies to any life insnrance, annuity or endowment contract issued after Jnne 8, 1997.

is an employee or is an officer, director, or 20-percent owner of the entity of the trade or business. The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

The pro rata interest deduction limitation was added in 1997.

Excludability of death benefits

In 2006, additional rules for excludability of death benefits under a life insurance contract were added in the case of employer-owned life insurance contracts[1108] (generally, those contracts insuring employees that are excepted from the pro rata interest deduction limitation). These rules permit an employer to exclude the death benefit under a contract insuring the life of an employee if the insured was an employee at any time during the 12-month period before his or her death, or if the insured is among the highest paid 35 percent of all employees. Notice and consent requirements must be satisfied.

Description of Proposal

The proposal eliminates the exception under the pro rata interest deduction disallowance rule for employees, officers, and directors. The exception for 20-percent owners is retained, however.

Effective Date

The proposal is effective for contracts issued after December 31, 2014. A material change in the death benefit or other material change in the contract causes the contract to be treated as a new contract for this purpose.

2. Net operating losses of life insurance companies (sec. 3502 of the discussion draft and sec. 805 of the Code)

Present Law

A net operating loss ("NOL") generally means the amount by which a taxpayer's business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years. NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.[1109]

For purposes of computing the alternative minimum tax ("AMT"), a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI.[1110]

[1108] Sec. 101(j).

[1109] Sec. 172(b)(2).

[1110] Sec. 56(d).

In the case of a life insurance company, present law allows a deduction for the operations loss carryovers and carrybacks to the taxable year, in lieu of the deduction for net operation losses allowed to other corporations.[1111] A life insurance company is permitted to treat a loss from operations (as defined under section 810(c)) for any taxable year as an operations loss carryback to each of the three taxable years preceding the loss year and an operations loss carryover to each of the 15 taxable years following the loss year.[1112]

Description of Proposal

The provision repeals the operations loss deduction for life insurance companies and allows the NOL deduction under section 172. This provides the same treatment for losses of life insurance companies as for losses of property and casualty insurance companies and of other corporations. The provision thus limits the NOL carryback period for life insurance companies to two years and extends the NOL carryover period to 20 years. The NOL deduction is determined by treating the NOL for any taxable year generally as the excess of the life insurance deductions for such taxable year, over the life insurance gross income for such taxable year.

Effective Date

The provision applies to losses arising in taxable years beginning after December 31, 2014.

3. Repeal small life insurance company deduction (sec. 3503 of the discussion draft and sec. 806 of the Code)

Present Law

The small life insurance company deduction for any taxable year is 60 percent of so much of the tentative life insurance company taxable income ("LICTI") for such taxable year as does not exceed $3 million, reduced by 15 percent of the excess of tentative LICTI over $3 million. The maximum deduction that can be claimed by a small company is $1.8 million, and a company with a tentative LICTI of $15 million or more is not entitled to any small company deduction. A small life insurance company for this purpose is one with less than $500 million of assets.

Description of Proposal

The provision repeals the small life insurance company deduction.

Effective Date

The provision applies to taxable years beginning after December 31, 2014.

[1111] Secs. 810, 805(a)(5).

[1112] Sec. 810(b)(1).

4. Computation of life insurance tax reserves (sec. 3504 of the discussion draft and sec. 807 of the Code)

Present Law

Reserves

In determining life insurance company taxable income, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[1113] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

In computing the net increase or net decrease in reserves, six items are taken into account. These are (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations under insurance and annuity contracts that do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (5) premiums received in advance and liabilities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance that are held for retired lives, premium stabilization, or a combination of both.

Life insurance reserves for any contract are the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules, but in no event to exceed the statutory reserve with respect to the contract (for regulatory reporting). In computing the Federally prescribed reserve for any type of contract, the taxpayer must use the tax reserve method applicable to the contract, an interest rate for discounting of reserves to take account of the time value of money, and the prevailing commissioners' standard tables for mortality or morbidity.

Interest rate

The assumed interest rate to be used in computing the Federally prescribed reserve is the greater of the applicable Federal interest rate or the prevailing State assumed interest rate. The applicable Federal interest rate is the annual rate determined by the Secretary under the discounting rules for property and casualty reserves for the calendar year in which the contract is issued. The prevailing State assumed interest rate is generally the highest assumed interest rate permitted to be sued in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning the calendar year in which the contract is issued. In determining the highest assumed rates permitted in at least 26 States, each State is treated as permitting the use of every rate below its highest rate.

[1113] Sec. 807.

A one-time election is permitted (revocable only with the consent of the Secretary) to apply an updated applicable Federal interest rate every five years in calculating life insurance reserves. The election is provided to take account of the fluctuations in market rates of return that companies experience with respect to life insurance contracts of long duration. The use of the updated applicable Federal interest rate under the election does not cause the recalculation of life insurance reserves for any prior year. Under the election no change is made to the interest rate used in determining life insurance reserves if the updated applicable Federal interest rate is less than one-half of one percentage point different from the rate utilized by the company in calculating life insurance reserves during the preceding five years.

Description of Proposal

Under the provision, the interest rate used in determining reserves is the applicable Federal interest rate plus 3.5 percentage points. Any income or loss resulting from a change in reserves as a result of the change in interest rate under the provision is taken into account ratably over an eight-year period.

Effective Date

The provision applies to taxable years beginning after December 31, 2014. For the first taxable year beginning after December 31, 2014, the reserve with respect to any contract at the end of the preceding taxable year is determined as if the provision had applied to such reserve in such preceding taxable year and by using the interest rate applicable to such reserves for calendar year 2015.

5. Adjustment for change in computing reserves (sec. 3505 of the discussion draft and sec. 807 of the Code)

Present Law

Change in method of accounting

In general, a taxpayer may change its method of accounting under section 446 with the consent of the Secretary of the Treasury (or may be required to change its method of accounting by the Secretary). In such instances, a taxpayer generally is required to make an adjustment (a "section 481(a) adjustment") to prevent amounts from being duplicated in, or omitted from, the calculation of the taxpayer's income. Pursuant to IRS procedures, negative section 481(a) adjustments generally are deducted from income in the year of the change whereas positive section 481(a) adjustments generally are required to be included in income ratably over four taxable years.[1114]

However, section 807(f) explicitly provides that changes in the basis for determining life insurance company reserves are to be taken into account ratably over 10 years.

[1114] See, *e.g.*, Rev. Proc. 97-27, 1997-21 I.R.B. 10, and Rev. Proc. 2011-14, 2011-4 I.R.B. 330.

10-year spread for change in computing life insurance company reserves

For Federal income tax purposes, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[1115] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

Income or loss resulting from a change in the method of computing reserves is taken into account ratably over a 10-year period.[1116] The rule for a change in basis in computing reserves applies only if there is a change in basis in computing the Federally prescribed reserve (as distinguished from the net surrender value). Although life insurance tax reserves require the use of a Federally prescribed method, interest rate, and mortality or morbidity table, changes in other assumptions for computing statutory reserves (e.g., when premiums are collected and claims are paid) may cause increases or decreases in a company's life insurance reserves that must be spread over a 10-year period. Changes in the net surrender value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve but a current liability.

If for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments to reserves is taken into account for the preceding taxable year.

Description of Proposal

Income or loss resulting from a change in method of computing life insurance company reserves is taken into account consistent with IRS procedures, generally ratably over a four-year period, instead of over a 10-year period.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

6. Modification of rules for life insurance company proration (sec. 3506 of the discussion draft and sec. 812 of the Code)

Present Law

Reduction of reserve deduction and dividends received deduction to reflect untaxed income

A life insurance company is subject to proration rules in calculating life insurance company taxable income.

The proration rules reduce the company's deductions, including reserve deductions and dividends received deductions, if the life insurance company has tax-exempt income, deductible

[1115] Sec. 807.

[1116] Sec. 807(f).

dividends received, or other similar untaxed income items, because deductible reserve increases can be viewed as being funded proportionately out of taxable and tax-exempt income.

Under the proration rules, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest.[1117]

Similarly, under the proration rules, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends,[1118] but not for the policyholders' share. Fully deductible dividends from affiliates are excluded from the application of this proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer. In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts.

Company's share and policyholder's share

The life insurance company proration rules provide that the company's share, for this purpose, means the percentage obtained by dividing the company's share of the net investment income for the taxable year by the net investment income for the taxable year.[1119] Net investment income means 95 percent of gross investment income, in the case of assets held in segregated asset accounts under variable contracts, and 90 percent of gross investment income in other cases.[1120]

Gross investment income includes specified items.[1121] The specified items include interest (including tax-exempt interest), dividends, rents, royalties and other related specified items, short term capital gains, and trade or business income. Gross investment income does not include gain (other than short term capital gain to the extent it exceeds net long-term capital loss) that is, or is considered as, from the sale or exchange of a capital asset. Gross investment income also does not include the appreciation in the value of assets that is taken into account in computing the company's tax reserve deduction under section 817.

The company's share of net investment income, for purposes of this calculation, is the net investment income for the taxable year, reduced by the sum of (a) the policy interest for the taxable year and (b) a portion of policyholder dividends.[1122] Policy interest is defined to include

[1117] Secs. 807(a)(2)(B) and (b)(1)(B).

[1118] Secs. 805(a)(4), 812.

[1119] Sec. 812(a).

[1120] Sec. 812(c).

[1121] Sec. 812(d).

[1122] Sec. 812(b)(1). This portion is defined as gross investment income's share of policyholder dividends.

required interest at the greater of the prevailing State assumed rate or the applicable Federal rate (plus some other interest items). Present law provides that in any case where neither the prevailing State assumed interest rate nor the applicable Federal rate is used, "another appropriate rate" is used for this calculation. No statutory definition of "another appropriate rate" is provided; the law is unclear as to what rate or rates are appropriate for this purpose.[1123]

In 2007, the IRS issued Rev. Rul. 2007-54,[1124] interpreting required interest under section 812(b) to be calculated by multiplying the mean of a contract's beginning-of-year and end-of-year reserves by the greater of the applicable Federal interest rate or the prevailing State assumed interest rate, for purposes of determining separate account reserves for variable contracts. However, Rev. Rul. 2007-54 was suspended by Rev. Rul. 2007-61, in which the IRS and the Treasury Department stated that the issues would more appropriately be addressed by regulation.[1125] No regulations have been issued to date.

General account and separate accounts

A variable contract is generally a life insurance (or annuity) contract whose death benefit (or annuity payout) depends explicitly on the investment return and market value of underlying assets.[1126] The investment risk is generally that of the policyholder, not the insurer. The assets underlying variable contracts are maintained in separate accounts held by life insurers. These separate accounts are distinct from the insurer's general account in which it maintains assets supporting products other than variable contracts.

Reserves

For Federal income tax purposes, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[1127] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

[1123] Legislative history of section 812 mentions that the general concept that items of investment yield should be allocated between policyholders and the company was retained from prior law. H. Rep. 98-861, Conference Report to accompany H.R. 4170, the Deficit Reduction Act of 1984, 98th Cong., 2d Sess., 1065 (June 23, 1984). This concept is referred to in Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84, December 31, 1984, p. 622, stating, "[u]nder the Act, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under prior law in computing gain or loss from operations (*i.e.*, by reference to 'required interest')." This may imply that a reference to pre-1984-law regulations may be appropriate. See Rev. Rul. 2003-120, 2003-2 C.B. 1154, and Technical Advice Memoranda 20038008 and 200339049.

[1124] 2007-38 I.R.B. 604.

[1125] 2007-42 I.R.B.799.

[1126] Section 817(d) provides a more detailed definition of a variable contract.

[1127] Sec. 807.

For purposes of determining the amount of the tax reserves for variable contracts, however, a special rule eliminates gains and losses. Under this rule,[1128] in determining reserves for variable contracts, realized and unrealized gains are subtracted, and realized and unrealized losses are added, whether or not the assets have been disposed of. The basis of assets in the separate account is increased to reflect appreciation, and reduced to reflect depreciation in value, that are taken into account in computing reserves for such contracts.

Dividends received deduction

A corporate taxpayer may partially or fully deduct dividends received.[1129] The percentage of the allowable dividends received deduction depends on the percentage of the stock of the distributing corporation that the recipient corporation owns.

Limitation on dividends received deduction under section 246(c)(4)

The dividends received deduction is not allowed with respect to stock either (1) held for 45 days or less during a 91-day period beginning 45 days before the ex-dividend date, or (2) to the extent the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property.[1130] The taxpayer's holding period is reduced for periods during which its risk of loss is reduced.[1131]

Description of Proposal

The proposal modifies the life insurance company proration rule for reducing dividends received deductions and reserve deductions with respect to untaxed income.

Under the proposal, the company's share of untaxed income, for purposes of reducing deductions, is determined on an account by account basis. That is, a company determines its company's share separately for the general account and for each separate account.

The company's share is the excess of the mean assets of such account over the mean reserves with respect to such account divided by the mean assets of such account for such taxable year. The policyholder's share is the excess of 100 percent over the company share.

Mean assets for any taxable year are 50 percent of the sum of the fair market value of the assets of an account as of the beginning of the taxable year and the fair market value of the assets

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[1128] Sec. 817.

[1129] Sec. 243 *et seq*. Conceptually, dividends received by a corporation are retained in corporate solution; these amounts are taxed when distributed to noncorporate shareholders.

[1130] Sec. 246(c).

[1131] Sec. 246(c)(4). For this purpose, the holding period is reduced for periods in which (1) the taxpayer has an obligation to sell or has shorted substantially similar stock; (2) the taxpayer has granted an option to buy substantially similar stock; or (3) under Treasury regulations, the taxpayer has diminished its risk of loss by holding other positions with respect to substantially similar or related property.

as of the close of the taxable year. Mean reserves are 50 percent of the sum of the reserves with respect to such account determined under section 807 as of the beginning of the year and the reserves with respect to such account determined under section 807 as of the close of the taxable year.

For purposes of determining mean assets or mean reserves, dividends described in section 246(c) (relating to the holding period limitation on the dividends received deduction), fees, and expenses, are not taken into account.

Effective Date

The provision applies to taxable years beginning after December 31, 2014.

7. Repeal treatment of distributions to shareholders from pre-1984 policyholders surplus account (sec. 3507 of the discussion draft and sec. 815 of the Code)

Present and Prior Law

Under the law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system, a company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations was deferred, and was accounted for as part of a policyholder's surplus account and, subject to certain limitations, taxed only when distributed to stockholders or upon corporate dissolution (Phase III). To determine whether amounts had been distributed, a company maintained a shareholders surplus account, which generally included the company's previously taxed income that would be available for distribution to shareholders. Distributions to shareholders were treated as being first out of the shareholders surplus account, then out of the policyholders surplus account, and finally out of other accounts.

The Deficit Reduction Act of 1984[1132] included provisions that, for 1984 and later years, eliminated further deferral of tax on amounts (described above) that previously would have been deferred under the three-phase system. Although for taxable years after 1983, life insurance companies may not enlarge their policyholders surplus account, the companies are not taxed on previously deferred amounts unless the amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account (sec. 815).

Any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company is subject to tax at the corporate rate in the taxable year of the distribution. Present law (like prior law) provides that any distribution to shareholders is treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.

[1132] Pub. L. No. 98-369.

For taxable years beginning after December 31, 2004, and before January 1, 2007, the application of the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a life insurance company were suspended. Distributions in those years were treated as first made out of the policyholders surplus account, to the extent thereof, and then out of the shareholders surplus account, and lastly out of other accounts.

Description of Proposal

The provision repeals section 815, the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a stock life insurance company.

In the case of any stock life insurance company with an existing policyholders surplus account (as defined in section 815 before its repeal), tax is imposed on the balance of the account as of December 31, 2014. A life insurance company is required to pay tax on the balance of the account ratably over the first eight taxable years beginning after December 31, 2014. Specifically, the tax imposed on a life insurance company is the tax on the sum of life insurance company taxable income for the taxable year (but not less than zero) plus 1/8 of the balance of the existing policyholders surplus account as of December 31, 2014. Thus, life insurance company losses are not allowed to offset the amount of the policyholders surplus account balance subject to tax.

Effective Date

The provision applies to taxable years beginning after December 31, 2014.

8. Modification of proration rules for property and casualty insurance companies (sec. 3508 of the discussion draft and sec. 832 of the Code)

Present Law

The taxable income of a property and casualty insurance company is determined as the sum of its gross income from underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions.

A proration rule applies to property and casualty insurance companies. In calculating the deductible amount of its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment or annuity contracts the company owns.[1133] This proration rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from deductible dividends, and from other untaxed amounts.

[1133] Sec. 832(b)(5).

Description of Proposal

The proposal modifies the percentage applicable under the proration rule for property and casualty insurers. The deduction for losses incurred is reduced by the ratio (expressed as a percentage) of the average adjusted basis of tax-exempt assets to the average adjusted basis of all assets of the company. This percentage replaces the 15-percent reduction under present law.

Adjustments to basis are made in accordance with section 1016. For purposes of the proposal, tax-exempt assets are assets of the type which give rise to income subject to proration (*i.e.*, tax-exempt interest, deductible dividends received, or the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts).

Effective Date

The proposal applies to taxable years beginning after December 31, 2014. A transition rule provides that for the first taxable year beginning after December 31, 2014, adjustments are taken into account ratably for that taxable year and the seven succeeding taxable years.

9. Treatment of Blue Cross and Blue Shield organizations (sec. 3509 of the discussion draft and sec. 833 of the Code)

Present Law

A property and casualty insurance company is subject to tax on its taxable income, generally defined as its gross income less allowable deductions.[1134] For this purpose, gross income includes underwriting income and investment income, as well as other items. Underwriting income is the premiums earned on insurance contracts during the year, less losses incurred and expenses incurred. The amount of losses incurred is determined by taking into account the discounted unpaid losses. Premiums earned during the year is determined taking into account a 20-percent reduction in the otherwise allowable deduction, intended to represent the allocable portion of expenses incurred in generating the unearned premiums.[1135]

Present law provides that an organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance.[1136] When this rule was enacted in 1986,[1137] special rules were

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[1134] Sec. 832.

[1135] Sec. 832(b)(4)(B).

[1136] Sec. 501(m).

[1137] See H. Rep. 99-426, Tax Reform Act of 1985, December 7, 1985, p. 664. The Committee on Ways and Means stated, "[T]he availability of tax-exempt status under [then-]present law has allowed some large insurance entities to compete directly with commercial insurance companies. For example, the Blue Cross/Blue Shield organizations historically have been treated as tax-exempt organizations described in sections 501(c)(3) or (4). This group of organizations is now among the largest health care insurers in the United States." See also Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87 (May 4, 1987), pp. 583-592.

provided under section 833 for Blue Cross and Blue Shield organizations providing health insurance that (1) were in existence on August 16, 1986; (2) were determined at any time to be tax-exempt under a determination that had not been revoked; and (3) were tax-exempt for the last taxable year beginning before January 1, 1987 (when the present-law rule became effective), provided that no material change occurred in the structure or operations of the organizations after August 16, 1986, and before the close of 1986 or any subsequent taxable year. Any other organization is eligible for section 833 treatment if it meets six requirements set forth in section 833(c).[1138]

Section 833 provides a deduction with respect to health business of such organizations. The deduction is equal to 25 percent of the sum of (1) claims incurred, and liabilities incurred under cost-plus contracts, for the taxable year, and (2) expenses incurred in connection with administration, adjustment, or settlement of claims or in connection with administration of cost-plus contracts during the taxable year, to the extent this sum exceeds the adjusted surplus at the beginning of the taxable year. Only health-related items are taken into account.

Section 833 provides an exception for such an organization from the application of the 20-percent reduction in the deduction for increases in unearned premiums that applies generally to property and casualty companies.

Section 833 provides that such an organization is taxable as a stock property and casualty insurer under the Federal income tax rules applicable to property and casualty insurers.

The rules of section 833 are limited to those organizations meeting a medical loss ratio standard of 85 percent for the taxable year. Thus, an organization that does not meet the 85-percent standard is not allowed the 25-percent deduction and the exception from the 20-percent reduction in the unearned premium reserve deduction under section 833.

For this purpose, an organization's medical loss ratio is determined as the percentage of total premium revenue expended on reimbursement for clinical services that are provided to enrollees under the organization's policies during the taxable year, as reported under section 2718 of the PHSA.[1139]

[1138] The six requirements are: (1) substantially all of its activities involve providing health insurance; (2) at least 10 percent of its health insurance is provided to individuals and small groups (not taking into account Medicare supplemental coverage); (3) it provides continuous full-year open enrollment for individuals and small groups; (4) for individuals, it provides full coverage of pre-existing conditions of high-risk individuals and coverage without regard to age, income, or employment of individuals under age 65; (5) at least 35 percent of its premiums are community rated; and (6) no part of its net earnings inures to the benefit of any private shareholder or individual.

[1139] See Wednesday, March 24, 2010, Senate Floor statement of Senator Baucus relating to this provision, 156 Cong. Rec. S1989, stating in part, "First, it was our intention that, in calculating the medical loss ratios, these entities could include both the cost of reimbursement for clinical services provided to the individuals they insure and the cost of activities that improve health care quality. Determining the medical loss ratio under this provision using those two types of costs is consistent with the calculation of medical loss ratios elsewhere in the legislation. This determination would be made on an annual basis and would only affect the application of the special deductions for that year. Second, it was our intention that the only consequence for not meeting the medical loss ratio threshold would be that the 25 percent deduction for claims and expenses and the exception from the 20 percent reduction in

Description of Proposal

The provision repeals section 833 in two stages. In stage one, the special deduction for 25 percent of claims and expenses incurred during the taxable year less the adjusted surplus at the beginning of the year, and the exception from the application of the 20-percent reduction in the deduction for increases in unearned premium reserves, are repealed. The limitation based on medical loss ratio is also repealed.

In stage two, section 833 is repealed in its entirety. Thus, an organization described therein is no longer treated automatically as a stock property and casualty insurance company.

Effective Date

The first stage of repeal applies to taxable years beginning after December 31, 2014.

Repeal of section 833 in its entirety applies to taxable years beginning after December 31, 2016.

10. Modification of discounting rules for property and casualty insurance companies (sec. 3510 of the discussion draft and sec. 846 of the Code)

Present Law

A property and casualty insurance company generally is subject to tax on its taxable income (sec. 831(a)). The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions (sec. 832). Among the items that are deductible in calculating underwriting income are additions to reserves for losses incurred and expenses incurred.

To take account of the time value of money, discounting of unpaid losses is required. All property and casualty loss reserves (unpaid losses and unpaid loss adjustment expenses) for each line of business (as shown on the annual statement) are required to be discounted for Federal income tax purposes.

The discounted reserves are calculated using a prescribed interest rate which is based on the applicable Federal mid-term rate ("mid-term AFR"). The discount rate is the average of the mid-term AFRs effective at the beginning of each month over the 60-month period preceding the calendar year for which the determination is made.

To determine the period over which the reserves are discounted, a prescribed loss payment pattern applies. The prescribed length of time is either the accident year and the following three calendar years, or the accident year and the following 10 calendar years,

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the deduction for unearned premium reserves would not be allowed. The entity would still be treated as a stock property and casualty insurance company." A technical correction may be necessary so that the statute reflects this intent.

depending on the line of business. In the case of certain "long-tail" lines of business, the 10-year period is extended, but not by more than five additional years. Thus, present law limits the maximum duration of any loss payment pattern to the accident year and the following 15 years. The Treasury Department is directed to determine a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years, starting with 1987.

Under the discounting rules, an election is provided permitting a taxpayer to use its own (rather than an industry-wide) historical loss payment pattern with respect to all lines of business, provided that applicable requirements are met.

The Treasury Department publishes discount factors for each line of business to be applied by taxpayers for discounting reserves.[1140] The discount factors are published annually, based on (1) the interest rate applicable to the calendar year, and (2) the loss payment pattern for each line of business as determined every five years.

Description of Proposal

The provision modifies the reserve discounting rules applicable to property and casualty insurance companies. In general, the provision modifies the prescribed interest rate, extends the periods applicable under the loss payment pattern, and repeals the election to use a taxpayer's historical loss payment pattern.

Interest rate

The provision provides that the interest rate is an annual rate for any calendar year to be determined by the Treasury Department based on the corporate bond yield curve (rather than the mid-term AFR as under present law). For this purpose, the corporate bond yield curve means, with respect to any month, a yield curve that reflects the average, for the preceding 24-month period, of monthly yields on investment grade corporate bonds with varying maturities and that are in the top 3 quality levels available.[1141] Because the corporate bond yield curve provides for 24-month averaging, the present-law rule providing for 60-month averaging to determine the interest rate is repealed under the provision. It is expected that the Treasury Department will determine a 24-month average for the 24 months preceding the first month of the calendar year for which the determination is made.

[1140] The most recent property and casualty reserve discount factors published by the Treasury Department are in Rev. Proc. 2007-9, 2007-3 I.R.B. 1.

[1141] This rule adopts the definition found in section 430(h)(2)(D)(i) of the term "corporate bond yield curve." Section 430, which relates to minimum funding standards for single-employer defined benefit pension plans, includes other rules for determining an "effective interest rate," such as segment rate rules. The term "effective interest rate" along with these other rules, including the segment rate rules, do not apply for purposes of property and casualty insurance reserve discounting.

Loss payment patterns

The provision extends the periods applicable for determining loss payment patterns. Under the provision, the maximum duration of the loss payment pattern is determined by the amount of losses remaining unpaid using aggregate industry experience for each line of business, rather than by a set number of years as under present law.

Like present law, the provision provides that the Treasury Department determines a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years. Under the provision, the first determination is to be made for calendar year 2013.

Under the provision, the present-law three-year and 10-year periods following the accident year are extended for the lines of business to which each period applies. For lines of business to which the three-year period applies, the amount of losses that would have been treated as paid in the third year after the accident year is treated as paid in that year and each subsequent year in an amount equal to the amount treated as paid in the second year (or, if less, the remaining amount). Similarly, for lines of business to which the 10-year period applies, the amount of losses that would have been treated as paid in the 10th year following the accident year is treated as paid in that year and each subsequent year in an amount equal to the amount treated as paid in the ninth year (or if less, the remaining amount).

The provision repeals the present-law rule providing that in the case of certain "long-tail" lines of business, the 10-year period is extended, but not by more than 5 additional years. The provision does not change the lines of business to which the three-year, and 10-year, periods, respectively, apply.

The provision retains the present-law rule providing that, for lines of business to which the 10-year period applies, if the amount of losses treated as paid in the ninth year is zero or negative, then the rule extending the payment period is applied by using the average of losses treated as paid in the seventh, eighth and ninth years. The provision adds a similar rule for lines of business to which the three-year period applies, providing that if the amount of losses treated as paid in the third year is zero or negative, then the rule extending the payment period is applied by using the average of losses treated as paid in the first and second years. The provision retains the present-law rule that, except as otherwise provided in regulations, any determination by the Treasury Department with respect to unpaid losses relating to the international and reinsurance lines of business is made using a pattern based on the combined losses for the auto liability, other liability, medical malpractice, workers' compensation and multiple peril lines of business.

Election to use own historical loss payment pattern

The provision repeals the present-law election permitting a taxpayer to use its own (rather than an industry-wide) historical loss payment pattern with respect to all lines of business.

Effective Date

The provision is effective generally for taxable years beginning after December 31, 2014. Under a transitional rule for the first taxable year beginning in 2015, the amount of unpaid losses and expenses unpaid (under section 832(b)(5)(B) and (6)) and the unpaid losses (under sections 805(c)(2) and 805(a)(1)) at the end of the preceding taxable year are determined as if the provision had applied to these items in such preceding taxable year, using the interest rate and loss payment patterns for accident years ending with calendar year 2015. Any adjustment is spread over eight taxable years, *i.e.*, is included in the taxpayer's gross income ratably in the first taxable year beginning in 2015 and the seven succeeding taxable years. For taxable years subsequent to the first taxable year beginning in 2015, the provision applies to such unpaid losses and expenses unpaid (*i.e.*, unpaid losses and expenses unpaid at the end of the taxable year preceding the first taxable year beginning in 2015) by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 2015.

11. Repeal of special estimated tax payments (sec. 3511 of the discussion draft and sec. 847 of the Code)

Present Law

Allowance of additional deduction and establishment of special loss discount account

Present law allows an insurance company required to discount its reserves an additional deduction that is not to exceed the excess of (1) the amount of the undiscounted unpaid losses over (2) the amount of the related discounted unpaid losses, to the extent the amount was not deducted in a preceding taxable year. This provision imposes the requirement that a special loss discount account be established and maintained, and that special estimated tax payments be made. Unused amounts of special estimated tax payments are treated as a section 6655 estimated tax payment for the 16th year after the year for which the special estimated tax payment was made.[1142]

The total payments by a taxpayer, including section 6655 estimated tax payments and other tax payments, together with special estimated tax payments made under this provision, are generally the same as the total tax payments that the taxpayer would make if the taxpayer did not elect to have this provision apply, except to the extent amounts can be refunded under the provision in the 16th year.

Calculation of special estimated tax payments based on tax benefit attributable to deduction

More specifically, present law imposes a requirement that the taxpayer make special estimated tax payments in an amount equal to the tax benefit attributable to the additional deduction allowed under the provision. If amounts are included in gross income due to a reduction in the taxpayer's special loss discount account or due to the liquidation or termination

[1142] Sec. 847.

of the taxpayer's insurance business, and an additional tax is due for any year as a result of the inclusion, then an amount of the special estimated tax payments equal to such additional tax is applied against such additional tax. If there is an adjustment reducing the amount of additional tax against which the special estimated tax payment was applied, then in lieu of any credit or refund for the reduction, a special estimated tax payment is treated as made in an amount equal to the amount that would otherwise be allowable as a credit or refund.

The amount of the tax benefit attributable to the deduction is to be determined (under Treasury regulations (which have not been promulgated)) by taking into account tax benefits that would arise from the carryback of any net operating loss for the year as well as current year benefits. In addition, tax benefits for the current and carryback years are to take into account the benefit of filing a consolidated return with another insurance company without regard to the consolidation limitations imposed by section 1503(c).

The taxpayer's estimated tax payments under section 6655 are to be determined without regard to the additional deduction allowed under this provision and the special estimated tax payments. Legislative history[1143] indicates that it is intended that the taxpayer may apply the amount of an overpayment of his section 6655 estimated tax payments for the taxable year against the amount of the special estimated tax payment required under this provision. The special estimated tax payments under this provision are not treated as estimated tax payments for purposes of section 6655 (*e.g.*, for purposes of calculating penalties or interest on underpayments of estimated tax) when such special estimated tax payments are made.

Refundable amount

To the extent that a special estimated tax payment is not used to offset additional tax due for any of the first 15 taxable years beginning after the year for which the payment was made, such special estimated tax payment is treated as an estimated tax payment made under section 6655 for the 16th year after the year for which the special estimated tax payment was made. If the amount of such deemed section 6655 payment, together with the taxpayer's other payments credited against tax liability for such 16th year, exceeds the tax liability for such year, then the excess (up to the amount of the deemed section 6655 payment) may be refunded to the taxpayer to the same extent provided under present law with respect to overpayments of tax.

Regulatory authority

In addition to the regulatory authority to adjust the amount of special estimated tax payments in the event of a change in the corporate tax rate, authority is provided to the Treasury Department to prescribe regulations necessary or appropriate to carry out the purposes of the provision.

Such regulations include those providing for the separate application of the provision with respect to each accident year. Separate application of the provision with respect to each

[1143] See H.R. Rep. No. 100-1104, Conference Report to accompany H.R. 4333, the Technical and Miscellaneous Revenue Act of 1988, October 21, 1988, p. 174.

accident year (*i.e.*, applying a vintaging methodology) may be appropriate under regulations to determine the amount of tax liability for any taxable year against which special estimated tax payments are applied, and to determine the amount (if any) of special estimated tax payments remaining after the 15th year which may be available to be refunded to the taxpayer.

Regulatory authority is also provided to make such adjustments in the application of the provision as may be necessary to take into account the corporate alternative minimum tax. Under this regulatory authority, rules similar to those applicable in the case of a change in the corporate tax rate are intended to apply to determine the amount of special estimated tax payments that may be applied against tax calculated at the corporate alternative minimum tax rate. The special estimated tax payments are not treated as payments of regular tax for purposes of determining the taxpayer's alternative minimum tax liability.

Regulations have not been promulgated under section 847.

Explanation of Provision

The provision repeals section 847, effective for taxable years beginning after December 31, 2013. Thus, the election to apply the provision, the additional deduction, special loss discount account, special estimated tax payment, and refundable amount rules of present law are eliminated under the proposal.

The entire balance of an existing account is included in income of the taxpayer for the first taxable year beginning after 2012, 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 section 6655.

Effective Date

The provision applies to taxable years beginning after December 31, 2014.

12. Capitalization of certain policy acquisition expenses (sec. 3512 of the discussion draft and sec. 848 of the Code)

Present Law

In the case of an insurance company, specified policy acquisition expenses for any taxable year are required to be capitalized, and are amortized generally over the 120-month period beginning with the first month in the second half of the taxable year.[1144]

Specified policy acquisition expenses are determined as that portion of the insurance company's general deductions for the taxable year that does not exceed a specific percentage of the net premiums for the taxable year on each of three categories of insurance contracts. For

[1144] Sec. 848.

annuity contracts, the percentage is 1.75; for group life insurance contracts, the percentage is 2.05; and for all other specified insurance contracts, the percentage is 7.7.

With certain exceptions, a specified insurance contract is any life insurance, annuity, or noncancellable accident and health insurance contract or combination thereof. A group life insurance contract is any life insurance contract that covers a group of individuals defined by reference to employment relationship, membership in an organization, or similar factor, the premiums for which are determined on a group basis, and the proceeds of which are payable to (or for the benefit of) persons other than the employer of the insured, an organization to which the insured belongs, or other similar person.

Description of Proposal

The three categories of insurance contracts are replaced with two categories: (1) group contracts and (2) all other specified insurance contracts. The percentage of net premiums that may be treated as specified policy acquisition expenses is 5 percent for group insurance contracts and 12 percent for all other specified insurance contracts.

A group insurance contract is any specified insurance contract that covers a group of individuals defined by reference to employment relationship, membership in an organization, or similar factor, the premiums for which are determined on a group basis, and the proceeds of which are payable to (or for the benefit of) persons other than the employer of the insured, an organization to which the insured belongs, or other similar person.

Effective Date

The provision applies to taxable years beginning after December 31, 2014.

13. Tax reporting for life settlement transactions, clarification of tax basis of life insurance contracts, and exception to transfer for valuable consideration rules (secs. 3513, 3514, and 3515 of the discussion draft, new sec. 6050X of the Code, and secs. 1016 and 101 of the Code)

Present Law

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[1145]

[1145] Sec. 101(a)(1). In the case of certain accelerated death benefits and viatical settlements, special rules treat certain amounts as amounts paid by reason of the death of an insured (that is, generally, excludable from income). Sec. 101(g). The rules relating to accelerated death benefits provide that amounts treated as paid by reason of the death of the insured include any amount received under a life insurance contract on the life of an insured who is a terminally ill individual, or who is a chronically ill individual (provided certain requirements are met). For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification. A chronically ill individual is one who has been certified by a licensed health care practitioner within the preceding 12-month period as meeting certain ability-related requirements. In the case of a viatical settlement, if

Under rules known as the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable generally is limited.[1146] Under the limitation, the excludable amount may not exceed the sum of (1) the actual value of the consideration, and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the consideration he pays combined with his subsequent premium payments on the contract are less than the amount of the death benefit he later receives under the contract, then the difference is includable in the buyer's income.

Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract,[1147] or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.[1148]

IRS guidance sets forth more details of the tax treatment of a life insurance policyholder who sells or surrenders the life insurance contract and the tax treatment of other sellers and of buyers of life insurance contracts. The guidance relates to the character of taxable amounts (ordinary or capital) and to the taxpayer's basis in the life insurance contract.

In Revenue Ruling 2009-13,[1149] the IRS ruled that income recognized under section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of sale of a cash value life insurance contract, the IRS ruled that the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the "inside buildup"), and any excess is long-term capital gain. Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain under the ruling.

In Revenue Ruling 2009-14,[1150] the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the

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any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill is sold to a viatical settlement provider, the amount paid for the sale or assignment of that portion is treated as an amount paid under the life insurance contract by reason of the death of the insured (that is, generally, excludable from income). For this purpose, a viatical settlement provider is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of terminally ill or chronically ill individuals (provided certain requirements are met).

[1146] Sec. 101(a)(2).

[1147] Sec. 101(a)(2)(A).

[1148] Sec. 101(a)(2)(B).

[1149] 2009-21 I.R.B. 1029.

[1150] 2009-21 I.R.B. 1031.

insured is includable as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (*e.g.*, premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain, and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

Description of Proposal

In general

The provision imposes reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the payor in the case of the payment of reportable death benefits. The provision sets forth rules for determining the basis of a life insurance or annuity contract. Lastly, the provision modifies the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale.

Reporting requirements for acquisitions of life insurance contracts

Reporting upon acquisition of life insurance contract

The reporting requirement applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year. 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 the life insurance contract). An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is (1) the buyer's name, address, and taxpayer identification number ("TIN"), (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, and (4) the amount of each payment. The statement the buyer provides to any issuer of a life insurance contract is not required to include the amount of the payment or payments for the purchase of the contract.

Reporting of seller's basis in the life insurance contract

On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller (1) the basis of the contract (i.e., the investment in the contract within the meaning of section 72(e)(6)), (2) the name, address, and TIN of the seller or the transferor to a foreign person, and (3) the policy number of the contract. Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.

Reporting with respect to reportable death benefits

When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports (1) the gross amount of the payment; (2) the taxpayer identification number of the payee; and (3) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

For purposes of these reporting requirements, a payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale.

Determination of basis

The provision provides that 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 (known as "cost of insurance"). This reverses the position of the IRS in Revenue Ruling 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.

Scope of transfer for value rules

The provision provides that the exceptions to the transfer for value rules do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

Effective Date

Under the provision, the reporting requirement is effective for reportable policy sales occurring after December 31, 2014, and reportable death benefits paid after December 31, 2014. The clarification of the basis rules for life insurance and annuity contracts is effective for transactions entered into after August 25, 2009. The modification of exception to the transfer for value rules is effective for transfers occurring after December 31, 2014.

G. Pass-Thru and Certain Other Entities

Overview of S Corporations

In general, an S corporation is not subject to corporate-level income tax. Instead, an S corporation passes through its items of income, gain, and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns. To prevent double taxation of these items when the stock is later disposed of, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses). A shareholder's loss may be deducted only to the extent of his or her basis in the stock or in debt of the S corporation to the shareholder. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

1. Reduced recognition period for built-in gains made permanent (sec. 3601 of the discussion draft and sec. 1374 of the Code)

Present Law

In general

A small business corporation may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level income tax. Instead, items of income, gain, and loss of an S corporation pass through to its shareholders. Each shareholder takes into account separately its share of these items on its own income tax return.[1151]

Under section 1374, a corporate level built-in gains tax, at the highest corporate income tax rate (currently 35 percent), is imposed on an S corporation's net recognized built-in gain.[1152] This rule applies to gain that arose prior to the conversion of the corporation from a C corporation to an S corporation, and that is recognized by the S corporation during the recognition period, *i.e.*, the 10-year period beginning with the first day of the first taxable year for which the S election is in effect.[1153] If the taxable income of the S corporation is less than the amount of net recognized built-in gain in the year such built-in gain is recognized (for example, because of post-conversion losses), no tax under section 1374 is imposed on the excess of such built-in gain over taxable income for that year. However, the untaxed excess of net recognized built-in gain over taxable income for that year is treated as recognized built-in gain in the

[1151] Sec. 1366.

[1152] Certain built-in income items are treated as recognized built-in gain for this purpose. Sec. 1374(d)(5).

[1153] Sec. 1374(d)(7)(A). The 10-year period refers to ten calendar years from the first day of the first taxable year for which the corporation was an S corporation. Treas. Reg. sec. 1.1374-1(d).

succeeding taxable year (subject to the taxable income limitation in the succeeding taxable year).[1154]

Treasury regulations provide that if a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under section 453 during or after the recognition period, that income is subject to tax under section 1374.[1155] The treatment of all payments received under the installment method is governed by the proposals of section 1374(d)(7) applicable to the taxable year in which the sale was made.

The built-in gain tax also applies to net recognized built-in gain attributable to any asset received by an S corporation from a C corporation in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to the basis of such asset (or other property) in the hands of the C corporation.[1156] In the case of such a transaction, the recognition period for any asset transferred by the C corporation starts on the date the asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.[1157]

The built-in-gain tax imposed on the corporation is in addition to the tax imposed on each shareholder on his or her share of the gain taken into account in computing the shareholder's taxable income. The amount of the built-in gain tax under section 1374 is treated as a loss by each of the S corporation shareholders in computing its own income tax.[1158]

Reduced period for taxable years beginning in 2009 thru 2013

The10-year period during which the built-in gains tax applies has been shortened on a temporary basis.[1159] For any taxable year beginning in 2009 or 2010, a seven-year period applies, and for any taxable year beginning in 2011, 2012, or 2013, a five-year period applies.

Application to RICs and REITs

A regulated investment company ("RIC") or a real estate investment trust ("REIT") that was formerly a C corporation (or that acquired assets from a C corporation) generally is subject to the rules of section 1374 as if the RIC or REIT were an S corporation, unless the relevant C corporation elects "deemed sale" treatment.[1160]

[1154] Sec. 1374(d)(2).

[1155] Treas. Reg. sec. 1.1374-4(h).

[1156] Sec. 1374(d)(8).

[1157] Sec. 1374(d)(8)(B).

[1158] Sec. 1366(f)(2).

[1159] Sec. 1374(d)(7)(B) and (C).

[1160] Treas. Reg. secs. 1.337(d)-7(b)(1) and (c)(1).

Description of Proposal

The five-year recognition period in effect for taxable years beginning in 2012 and 2013 is made permanent for S corporations. The reduced period does not apply to RICs and REITs, which are subject to a different rule under the proposal.[1161]

Effective Date

The proposal applies to taxable years beginning after December 31, 2013.

2. Modifications to S corporation passive investment income rules (sec. 3602 of the discussion draft and secs. 1362 and 1375 of the Code)

Present Law

Passive investment income

An S corporation is subject to corporate-level tax at the highest corporate tax rate (currently 35 percent) on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.[1162]

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year.[1163] Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income.[1164] Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, and annuities.[1165] Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, or certain interest and dividend income of banks and depository institution holding companies.

In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and has

[1161] See section 3647 of the bill for provisions relating to RICs and REITs.

[1162] Sec. 1375(a).

[1163] Sec. 1375(b)(1).

[1164] Sec. 1375(b)(2).

[1165] Sec. 1375(b)(3).

gross receipts for each of those years more than 25 percent of which are passive investment income.[1166]

Description of Proposal

The provision terminating the election of an S corporation having excess passive investment income for three consecutive taxable years is repealed. Instead, the corporation continues to be subject to tax on any excess net passive income.

The 25-percent threshold above which an S corporation's excess net passive income is subject to a corporate-level tax is increased to 60 percent.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

3. Expansion of qualifying beneficiaries of an electing small business trust (sec. 3603 of the discussion draft and sec. 1361 of the Code)

Present Law

An electing small business trust ("ESBT") may be a shareholder of an S corporation.[1167] Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT.[1168]

The portion of an ESBT which consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers (currently 39.6 percent). This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

Description of Proposal

The proposal allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

Effective Date

The proposal is effective on January 1, 2015.

[1166] Sec. 1362(d)(3).

[1167] Sec. 1361(c)(2)(A)(v).

[1168] Sec. 1361(b)(1)(C) and (c)(2)(B)(v).

4. Charitable contribution deduction for electing small business trusts (sec. 3604 of the discussion draft and sec. 641(c) of the Code)

Present Law

An electing small business trust ("ESBT") may be a shareholder of an S corporation.[1169] The portion of an ESBT that consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers (currently 39.6 percent). This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

Because an ESBT is a trust, the deduction for charitable contributions applicable to trusts,[1170] rather than the deduction applicable to individuals,[1171] applies to the trust. Generally, a trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which pursuant to the terms of the governing instrument are paid for a charitable purpose. No carryover of excess contributions is allowed. An individual is allowed a charitable contribution deduction limited to certain percentages of adjusted gross income generally with a five-year carryforward of amounts in excess of this limitation.

Description of Proposal

The proposal provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather to the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

5. Permanent rule regarding basis adjustment to stock of S corporations making charitable contributions of property (sec. 3605 of the discussion draft and sec. 1367 of the Code)

Present Law

If an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[1172] A shareholder of an S corporation reduces the basis in the stock of the S

[1169] Sec. 1361(c)(2)(A)(v).

[1170] Sec. 642(c).

[1171] Sec. 170.

[1172] Sec. 1366(a)(1)(A).

corporation by the amount of the charitable contribution that flows through to the shareholder.[1173]

In the case of contributions made in taxable years beginning before January 1, 2014, the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. For contributions made in taxable years beginning after December 31, 2013, the amount of the reduction is the shareholder's pro rata share of the fair market value of the contributed property.

Description of Proposal

The proposal makes permanent the basis reduction rule in effect for contributions made in taxable years beginning before January 1, 2014.

Effective Date

The proposal applies to contributions made in taxable years beginning after December 31, 2013.

6. Extension of time for making S corporation elections (sec. 3606 of the discussion draft and sec. 1362 of the Code)

Present Law

An election by a small business corporation to be treated as an S corporation may be made for any taxable year at any time during the preceding taxable year or at any time on or before the 15th day of the third month of the taxable year.[1174] An election continues in effect for subsequent taxable years until it is terminated.[1175]

An election is valid only if all persons who are shareholders in the corporation on the day on which the election is made consent to the election.[1176]

An election to be an S corporation made on or before the 15th day of the third month of a corporation's taxable year is effective beginning with the taxable year when made if (i) the corporation meets all eligibility requirements for the pre-election portion of the taxable year, and (ii) all persons who held stock in the corporation any time during the portion of the year before the election is made consent to the election.

[1173] Sec. 1367(a)(2)(B).

[1174] Sec. 1362(b)(1).

[1175] Sec. 1362(c).

[1176] Sec. 1362(a)(2).

If the eligibility requirements are not met for the entire pre-election portion of the year for which the election is made, if consents of all shareholders who had disposed of their stock prior to the making of the election are not obtained, or if the election is made after the 15th day of the third month of the taxable year, the election becomes effective for the following taxable year.

An election may be revoked by the action of shareholders holding more than one-half of the corporation's voting stock.[1177]

The due date for filing a return on or before the 15th day of the third month following the close of the taxable year.[1178]

Qualified subchapter S trusts and electing small business trusts may be shareholders in an S corporation. The Code provides that an election to be a qualified subchapter S trust is effective for up to 15 days and two months before the date the election is made. The Code does not provide a specific time period to make the election to be an electing small business trust.

Description of Proposal

An election to be treated as an S corporation for a taxable year may be made not later than the due date (with extensions) for filing the corporation's return for the taxable year. The election may be made on a timely filed return for the taxable year.

The Secretary of the Treasury may treat a revocation as timely made for a taxable year if the Secretary determines that there was reasonable cause for the failure to timely make the revocation.

The proposal also repeals the provision that an election to be a qualified subchapter S trust is effective up to 15 days and 2 months before the date of the election. The repeal of this provision allows the Internal Revenue Service to better coordinate the time for making an election to be a qualified small business trust or an electing small business trust with the time for making an election to be an S corporation.

Effective Date

The proposal relating to the time for electing to be treated as an S corporation applies to elections for taxable years beginning after December 31, 2014.

The proposal relating to revocations applies to revocations after December 31, 2014.

[1177] Sec. 1361(d)(1).

[1178] Sec. 6072(b).

7. Relocation of C corporation definition (sec. 3607 of the discussion draft and sec. 7701 of the Code)

Present Law

The term "corporation" is defined in section 7701(a)(3). The term "C corporation" is defined in section 1361(a)(2) (relating to S corporations) to mean any corporation other than an S corporation.

Description of Proposal

The proposal moves the present law C corporation definition from section 1361 to section 7701. There is no substantive change to the definition.

Effective Date

The proposal is effective on the date of enactment.

Overview of Partnerships

Partnerships are not subject to Federal income tax.[1179] Instead, partners take into account items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership regardless of whether the income is distributed to the partners.[1180] A partner's basis of a partnership interest is adjusted to prevent double taxation when the partner later disposes of the partnership interest. A partner's basis includes the partner's capital contribution and the partner's share of partnership liabilities, is increased by the partner's distributive share of partnership income and gain, and is reduced by its distributive share of the partnership's deductible losses and nondeductible expenditures not properly chargeable to capital account as well as by partnership distributions.[1181] A partner's deduction for partnership losses is limited to the adjusted basis of the partnership interest.[1182] To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.

Partners have flexibility to vary their respective shares of partnership income and other tax items. Unlike corporations, partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect and meet regulatory requirements.

8. Repeal of rules relating to guaranteed payments (sec. 3611(a) of the discussion draft and sec. 707(c) of the Code)

Present Law

Guaranteed payments made by a partnership generally refer to payments to a partner that are determined without regard to the income of the partnership and are for services or for the use of capital.[1183] Guaranteed payments are distinct from a partnership distribution of income or capital,[1184] and from payments by the partnership to a partner not acting in its capacity as a partner.[1185]

[1179] Sec. 701.

[1180] Sec. 702(a). The recognition of income under this rule does not necessarily correspond with distributions from the partnership, such as to cover the tax liabilities of individual partners.

[1181] Sec. 705.

[1182] Sec. 704(d). In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by partnership losses and deductions (sections 469 and 465) for partners that are individuals or closely held corporations.

[1183] Sec. 707(c).

[1184] Secs. 731 and 733.

[1185] Sec. 707(a).

A distribution of income or capital reduces a partner's basis in the partnership and, to the extent an amount of money in excess of basis is distributed, gain is recognized. Payments by a partnership to a partner not acting in its capacity as a partner, such as making a loan to the partnership, are treated for tax purposes as if the partner was a third party.

Guaranteed payments are treated as payments made to one who is not a member of the partnership, but only for purposes of determining gross income and (subject to any capitalization requirement) the deduction for trade or business expenses. Thus, guaranteed payments generally are deductible by the partnership and includible in the income of the partner in the partner's taxable year in which, or with which, the partnership year ends.

According to the legislative history, the provision relating to guaranteed payments was enacted to address the treatment of payments to a partner during a taxable year when the payments for the year exceeded the partnership income for the year.[1186] The provision has created a great deal of uncertainty, confusion, and controversy since its enactment.[1187]

Description of Proposal

The proposal repeals section 707(c), the special rule for inclusion in income by a partner, and deduction or capitalization by a partnership, of a guaranteed payment that is determined without regard to the income of the partnership and is made by a partnership to a partner for services, or for the use of capital.[1188] Thus, payments by a partnership to a partner are treated either as a payment to a partner not acting in its capacity as a partner under section 707(a), or as a distribution of partnership income or capital under section 731.

Effective Date

The proposal applies to partnership taxable years beginning after December 31, 2014.

[1186] See H. R. Rep. No 1337, 83d Cong., 2d Sess., 67-8 (1954), and S. Rep. No. 1622, 83d Cong., 2d Sess., 92 and 94 (1954).

[1187] See, for example, L. Steinberg, "Fun and Games with Guaranteed Payments," *Tax Lawyer*, Vol. 57, Winter 2004, p. 533.

[1188] Several commentators have recommended the repeal of section 707(c). See, for example, W. Brannan, *The Tax Club*, Feb. 19, 1997, "Congressional Committee Report on the Subchapter K Reform Act of 1997," reprinted at *Tax Notes*, vol. 76, April 7, 1997, p. 121, and P. Postlewaite and J. Pennell, "JCT's Partnership Tax Proposals--Houston, We Have a Problem," *Tax Notes*, vol.76, July 19, 1997, p. 527.

9. Repeal of rules relating to liquidating distributions (sec. 3611(b) of the discussion draft and secs. 736 and 753 of the Code)

Present Law

In general

Section 736 provides rules for the treatment of payments made in the liquidation of a retiring or deceased partner's partnership interest. Payments are treated either as (1) a distributive share or guaranteed payment[1189] or (2) payments in exchange for the partner's interest in partnership property.[1190]

Payments for goodwill generally are amortized over a period of 15 years.[1191] However, under section 736(a), if a retiring general partner of a service partnership[1192] agrees to treat payments for his share of partnership goodwill and unrealized receivables as ordinary income, the payments are deductible by the partnership (if the amount is determined without regard to the income of the partnership) or treated as a distributive share of partnership income (if determined with regard to the income of the partnership) thereby reducing the distributive share of the other partners (which is the equivalent to a deduction).

In the case of payments made in liquidation of a retiring or deceased partner's partnership interest to which section 736(a) does not apply, then under section 736(b), the payments are treated as made in exchange for the partnership interest. If the partner is a general partner in a service partnership, this treatment does not apply to unrealized accounts receivables and, except to the extent the partnership agreement provides otherwise, goodwill.[1193]

Income in respect of a decedent

Under present law, the receipt of income in respect of a decedent is includible in gross income,[1194] and the general rule providing for a fair market value basis for property acquired from a decedent does not apply to property which consists of an item of income in respect of a decedent.[1195] Section 753 provides that amounts includible in gross income of a successor in interest of a deceased partner under section 736(a) are considered income in respect of a

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[1189] Sec. 736(a).

[1190] Sec. 736(b).

[1191] Sec. 197.

[1192] A service partnership refers to a partnership in which capital is not a material income-producing factor.

[1193] Sec. 736(b)(2).

[1194] Sec. 691.

[1195] Sec. 1014(c).

decedent.[1196] Courts have ruled that upon the death of a partner, the transferee's basis in its partnership interest is not adjusted for the portion of the partnership interest attributable to items representing income in respect of a decedent.[1197]

Description of Proposal

The proposal repeals section 736 and correspondingly repeals section 753 as obsolete.[1198] Thus, payments made to retiring partners and successors-in-interest to deceased partners are subject to the Federal tax rules generally applicable to the transaction, such as section 197 (relating to the treatment of goodwill), the provisions of subchapter D (relating to payments under deferred compensation plans), and the generally applicable rules[1199] governing income in respect of a decedent.[1200]

Effective Date

The proposal applies to partners retiring or dying after December 31, 2014.

10. Mandatory adjustments to basis of partnership property in case of transfer of partnership interests (sec. 3612 of the discussion draft and sec. 743 of the Code)

Present Law

In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election under section 754 to make basis adjustments, or the partnership has a substantial built-in loss immediately after the transfer.[1201]

If an election is in effect, or if the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner to the basis of partnership property.[1202] These adjustments are to account for the difference between the

[1196] For a discussion of the interaction of this section with other provisions of subchapter K, see G. McBride, "Alice's Estate in the Wonderland of Subchapter K," *Tax Notes*, vol. 122, Feb. 23, 2009, p. 971.

[1197] *Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), aff'd per curiam, 444 F.2nd 90 (8th Cir. 1971).

[1198] The proposal codifies the rule in Treas. Reg. sec. 1.736-1(a)(ii) that a retired partner or a deceased partner's successor will be treated as a partner until its interest in the partnership has been completely liquidated.

[1199] Secs. 691 and 1014(c).

[1200] See P. Postlewaite and Roseuzweig, "Anachronisms in Subchapter K of the Internal Revenue Code: Is It Time to Part With Section 736?," *Northwestern University Law Review*, vol. 100, 2006, p.1, for a proposal to repeal section 736.

[1201] Sec. 743(a).

[1202] Sec. 743(b).

transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest. The adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner.

A substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.[1203] Certain securitization partnerships and electing investment partnerships are not treated as having a substantial built-in loss in certain instances, and thus are not required to make basis adjustments to partnership property.[1204] For electing investment partnerships, in lieu of the partnership basis adjustments, a partner-level loss limitation rule applies. The provision does not apply to a securitization partnership.

Description of Proposal

The proposal provides that the adjustments to the basis of partnership property in the case of a transfer of an interest in a partnership are required in all cases. The special rules for electing investment partnerships and securitization partnerships are repealed.

Effective Date

The proposal applies to transfers after December 31, 2014.

11. Mandatory adjustments to basis of undistributed partnership property (sec. 3613 of the discussion draft and sec. 734 of the Code)

Present Law

Treatment of distributee partners

Partners generally may receive distributions of partnership property without recognition of gain or loss.[1205] In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).[1206] In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is

[1203] Sec. 743(d).

[1204] See sec. 743(e) (alternative rules for electing investment partnerships) and sec. 743(f) (exception for securitization partnerships).

[1205] Sec. 731(a) and (b). Exceptions to this nonrecognition rule apply: (1) when money (and the fair market value of marketable securities) received exceed a partner's adjusted basis in the partnership (sec. 731(a)(1)); (2) when only money, inventory and unrealized receivables are received in liquidation of a partner's interest and a loss is sustained (sec. 731(a)(2)); (3) to certain disproportionate distributions involving inventory and unrealized receivables (sec. 751(b)); and (4) to certain distributions relating to contributed property (secs. 704(c) and 737).

[1206] Sec. 732(b).

equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).[1207]

In the event that multiple properties are distributed by a partnership, allocation rules are provided for determining their bases in the distributee partner's hands. Under these rules, basis is first allocated to unrealized receivables and inventory items so that the properties bases equal their adjusted bases to the partnership before the distribution (or, if the total basis to be allocated is less than the partnership's bases, then the decrease is allocated in proportion to the respective amounts of unrealized depreciation to the extent thereof, and then to the extent the decrease has not been allocated, in proportion to their adjusted bases). No allocation may increase the basis of unrealized receivables or inventory items over their adjusted basis to the partnership before the distribution. To the extent basis is not allocated to unrealized receivables or inventory items, basis is allocated to other distributed property, first by allocating to each property the partnership's adjusted basis and then by increasing or decreasing that amount in order to have the adjusted bases of the properties equal the basis remaining after the allocation to unrealized receivables or inventory items. Basis decreases are allocated among properties in the manner described above; basis increases are allocated among properties first in proportion to their unrealized appreciation (to the extent of each property's unrealized appreciation) and then, to the extent of the increase that has not been allocated, in proportion to their fair market values.[1208]

Treatment of partnership

Adjustments to the basis of the partnership's undistributed properties generally are required if (and only if) there is a distribution with respect to which there is a substantial basis reduction or if an election under section 754 is in effect.[1209] A substantial basis reduction means a downward adjustment of more than $250,000 that would be made to the basis of partnership assets if a section 754 election were in effect.

Adjustments are made by a partnership to increase or decrease the basis of remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by the distributee partner).[1210]

1207 Sec. 732(a).

1208 If a partnership interest is transferred to a partner and the partnership has not elected to adjust the basis of partnership property, a special basis rule provides for the determination of the transferee partner's basis of properties that are later distributed by the partnership as if an election had been in effect (sec. 732(d)).

1209 Sec. 734(a).

1210 Section 734(b) provides for adjustments to the basis of partnership property in the case of distributions of property. Unlike section 743(b) (relating to transfers of partnership interests), there is no provision in section 734(b) that adjustments may be made only with respect to the transferee partner. This may result in the improper allocation of adjustments in the case of distributions not in complete liqnidation of a partner's interest.

Basis allocations among properties generally are allocated to reduce the difference between the fair market values and adjusted basis or partnership properties and by making allocations to property of a like kind among properties which are (1) capital assets and property used in a trade or business and (2) other properties.[1211]

Present law provides an exception for securitization partnerships to the rules requiring partnership basis adjustments in the case of transfers of partnership interests and distributions of property to a partner.

Description of Proposal

The proposal requires a partnership to adjust the basis of partnership property in the case of a distribution to a partner. The adjustments are made so each remaining partner's net liquidation amount is unchanged. The net liquidation amount with respect to a partner is the net amount of gain or loss (if any) which would be taken into account by that partner under section 702 if all partnership property were sold at fair market value. Thus, under the proposal, each remaining partner's share of net gain or loss from the sale of all partnership properties immediately after the distribution is the same as its share of net gain or loss if all the properties (including the distributed properties) had been sold by the partnership immediately before the distribution.

In the case of a distribution not in liquidation of the partnership, the partnership's adjustments with respect to the distributee partner take into account any gain recognized by the distributee partner on the distribution and any unrealized gain or loss which would be recognized by the distributee partner if it sold the properties for fair market value immediately after the distribution.

Basis is allocated among the remaining partnership properties in a manner similar to the allocation of bases among properties received by a distributee partner. Thus, negative adjustments are made first to property other than unrealized receivables and inventory items to the extent thereof. Positive adjustments are made only to property other than unrealized receivables and inventory property. In the case of a basis decrease, if there is insufficient adjusted basis in partnership property, each partner recognizes gain in the amount of the prevented decrease. In the case of a basis increase, if there is no partnership property whose basis may be increased, a loss is allowed to each partner in the amount of the prevented increase. Any gain or loss is treated as from the sale of the partnership interest.[1212]

[1211] Sec. 755. Under section 755(c), however, no decrease in basis may be allocated to stock in a corporate partner (or related person), but must be allocated to other partnership property. Gain is recognized to the extent an amount required to be allocated to other partnership property exceeds the aggregate adjusted bases of the other property immediately before the distribution. This rule is intended to limit the ability of corporate partners to "duplicate tax deductions at no economic cost" through reducing the basis of stock in certain transactions. Senate Finance Committee Report to the "Jumpstart our Business Strength (JOBS) Act," S. Rep. 108-192, November 7, 2003, p. 127.

[1212] Section 751(b) continues to apply to partnership distributions.

The exception for securitization partnerships is repealed.

The following examples illustrate the operation of this proposal:

Example 1.—A, B, and C form partnership ABC by contributing $100 each. The partnership buys capital assets X, Y, and Z for $80, $100, and $120 respectively. At a time when the fair market value of each asset is $150, ABC distributes one of the assets to C in liquidation of its partnership interest. Immediately before the distribution, each partner would take into account $50 gain if all the assets were sold by the partnership for their fair market value.

a. If the partnership distributes property Y to C, no basis adjustment is required in order that A and B's share of the gain from the sale of X and Z remains at $50 each.

b. If the partnership distributes property X to C, the basis of the remaining properties is decreased by a total of $20 (from $220 to $200) in order that A and B's share of the gain from the sale of Y and Z remains at $50 each. The decrease in each of the assets is in proportion to their respective adjusted bases.[1213] Thus, the basis of Y is reduced by 100/220 times $20, or $9.09, and is now $91.91. The basis of Z is reduced by 120/220 times $20, or $10.91, and is now $109.09.

c. If the partnership distributes property Z to C, the basis of the remaining properties is increased by a total of $20 (from $180 to $200) in order that A and B's share of the gain from the sale of X and Y remains at $50 each. The increase in each of the assets is in proportion to their respective unrealized appreciation before the increase.[1214] Thus, the basis of X is increased by 50/80 times $20, or $12.50, and is now $112.50. The basis of Y is increased by 30/80 times $20, or $7.50, and is now $127.50.

Example 2.–A and B form partnership AB by each contributing $100. AB buys capital asset X for $60. At the time when X has increased in value to $340, the partnership distributes $120 cash to A. A's interest in the partnership is decreased by half and A's share of future profits and losses (but not accrued unrealized gain) likewise decreases. As under present law, A recognizes a $20 gain on the distribution ($120 cash less $100 basis in partnership interest)[1215] and the basis in A's partnership interest is reduced to zero.[1216]

Under the proposal, the partnership's basis in X is unchanged with respect to B since B's gain on the sale of X ($140 ($170 less $30)) immediately after the distribution is the same as its share of gain ($140) if the partnership had sold X immediately before the distribution. The partnership increases the basis of X with respect to A by the $20 gain recognized on the

[1213] Sec. 732(c)(3).

[1214] Sec. 732(c)(2).

[1215] Sec. 731(a)(1).

[1216] Sec. 733.

distribution to A so that A would recognize $120 ($170 less $50) on the sale of X for $340 by the partnership immediately after the distribution (in addition to the $20 gain recognized on the distribution).[1217] If, the partnership sells X for $340 and distributes $120 to A in liquidation of its interest, no gain or loss would be recognized on the distribution ($120 less adjusted basis of $120, after adjustment for the $120 taxable income taken into account by X from the sale).[1218] The total amount of gain recognized by A would be $140 ($20 on the first distribution and $120 on the sale of X by the partnership).

If, instead of the partnership selling X, A instead sells its partnership interest immediately after the distribution for $120 (the value of its 1/3 interest in the partnership) it recognizes $120 gain on the sale in addition to the $20 gain on the distribution for a total of $140.

Example 3.–A and B form partnership AB by each contributing $100. AB buys capital asset X for $80 and capital asset Y for $120. At a time when the value of X has increased to $360 and the value of Y is still $120, the partnership distributes Y to A. A's interest in the partnership is decreased by half and A's share of future profits and losses (but not accrued unrealized gain) likewise decreases. As under present law A's basis in Y is $100 immediately after the distribution[1219] so that if A immediately sells Y it will recognize gain of $20. A's basis in its partnership interest is reduced to zero.[1220]

Under the proposal, no partnership basis adjustment is required in X with respect to B since B's gain on the sale of X ($140) immediately after the distribution is the same as its share of gain ($140) if X were sold immediately before the distribution. The partnership increases the basis of X with respect to A by $20, so that A recognizes $120 on the sale of X immediately after the distribution (in addition to the $20 gain which would be recognized if A sold Y immediately after the distribution).[1221]

Example 4.–A and B form partnership AB by each contributing $100. AB buys asset X for $60 and asset Y for $100. At the time when X has increased in value to $320 and Y has increased in value to $120, the partnership distributes Y to A. A's interest in the partnership is decreased by half and A's share of future profits and losses (but not accrued unrealized gain) likewise decreases. As under present law, A's basis in Y is $100 so that if A immediately sold Y, A would recognize gain of $20. The basis in A's partnership interest is reduced to zero.

[1217] Under present law, if a section 754 election is in effect, the partnership increases the basis of X by $20, but the adjustment does not apply solely with respect to A (present law sec. 734(b)(1)(A)).

[1218] Sec. 705.

[1219] Sec. 732(a)(2).

[1220] Sec. 733.

[1221] Under present law, if a section 754 election is in effect, the partnership increases the basis of X by $20, but the adjustment does not apply solely with respect to A (present law sec. 734(b)(1)(B)).

Under the proposal, the partnership's basis in X is decreased by $10 with respect to B so that if X is sold immediately after the distribution, B recognizes the same amount of gain ($140) that B would have recognized if both assets had been sold immediately before the distribution. The basis of X is increased by $10 with respect to A, so that A recognizes $120 on the sale of X immediately after the distribution in addition to the $20 gain which would be recognized if A sold Y immediately after the distribution.[1222]

Example 5.–A and B form partnership AB by each contributing $200. AB buys capital asset X for $10, capital asset Y for $190, and two other capital assets for $100 each. At a time when the value of each of the four assets is $100, the partnership distributes X to A and Y to B. As under present law, no gain or loss is recognized on the distribution, A's basis in X is $10 and its basis in its partnership interest is $190, and B's basis in Y is $190 and its basis in its partnership interest is $10.[1223]

Under the proposal, the partnership adjusts its basis in partnership properties so that A and B's aggregate gain or loss if all the assets (including the distributed asset) were sold immediately after the distribution is the same as if all the assets were sold immediately before the distribution. If the partnership sold all its assets immediately before the distribution, neither A nor B would recognize any gain or loss (aggregate basis to the partnership of $400 and aggregate value of $400).

Thus, the partnership adjusts its basis in the two remaining assets with respect to A to $95 each so that if the partnership sells both its assets and A sells X, A will recognize no gain or loss ($90 gain with respect to X and a $45 loss with respect to each of the partnership assets). The same result occurs in A sells both X and its partnership interest.

The partnership adjusts its basis in the two remaining assets with respect to B to $5 each so that if the partnership sells both assets and B sells Y, B will recognize no gain or loss ($90 loss with respect to Y and a $45 gain with respect to each of the partnership assets). The same result occurs if B sells both Y and its partnership interest.

Effective Date

The proposal applies to distributions after December 31, 2014.

[1222] Under present law, if a section 754 election is in effect, the partnership makes no basis adjustment, since no gain or loss is recognized by A and the basis of property Y to A is the same as the basis to the partnership.

[1223] Secs. 731(a)(1), 732(a) and 733.

12. Corresponding adjustments to basis of properties held by partnership where partnership basis adjusted (sec. 3614 of the discussion draft and new sec. 736 of the Code)

Present Law

The basis of property held by a partnership may be adjusted as a result of a distribution of other property by the partnership[1224] or by the transfer of an interest in the partnership by sale, exchange, or upon the death of a partner.[1225] Under present law, certain of these adjustments are not mandatory.[1226]

The property whose basis is adjusted may be an interest in another partnership.

Description of Proposal

The proposal provides rules applicable to tiered partnerships in the event adjustments are required to the basis of partnership property.

If a distribution of partnership property requires a basis adjustment to an upper-tier partnership's interest in a lower tier partnership, then the lower-tier partnership is required to make a corresponding adjustment to the adjusted basis of its partnership property. Similarly, if a distribution of an interest in a lower-tier partnership to an upper-tier partnership (or a sale or exchange of an interest in an upper-tier partnership that holds an interest in a lower-tier partnership) results in an increase or a decrease in the basis of the partnership interest in the hands of the distributee partner, then a corresponding basis increase or decrease is required in the property of the lower-tier partnership. These corresponding adjustments are required through successive tiers of partnerships, and only with respect to the partnership's proportionate share of the adjusted basis of lower-tier partnership property.

An upper-tier partnership is required to furnish the lower-tier partnership (in such manner as the Secretary prescribes) the information necessary to enable the lower-tier partnership to make the basis adjustments.

Effective Date

The proposal applies to distributions and transfers after December 31, 2014.

[1224] Sec. 734.

[1225] Sec. 743. For purposes of section 743, any distribution of an interest in a partnership is treated as an exchange. Sec. 761(e)(2).

[1226] The adjustments are made mandatory by other provisions of the discussion draft.

13. Charitable contributions and foreign taxes taken into account in determining limitation on allowance of partner's share of loss (sec. 3615 of the discussion draft and sec. 704(d) of the Code)

Present Law

A partner's distributive share of partnership loss (including capital loss) is allowed only to the extent of the adjusted basis (before reduction by current year's losses) of the partner's interest in the partnership at the end of the partnership taxable year in which the loss occurred. Any disallowed loss is allowable as a deduction at the end of the first succeeding partnership taxable year, and subsequent taxable years, to the extent that the partner's adjusted basis for its partnership interest at the end of any such year exceeds zero (before reduction by the loss for the year).[1227]

A partner's basis in its partnership interest is increased by its distributive share of income (including tax exempt income) and is decreased (but not below zero) by distributions by the partnership and its distributive share of partnership losses and expenditures of the partnership not deductible in computing partnership taxable income and not properly chargeable to capital account.[1228] In the case of a charitable contribution, a partner's basis is reduced by the partner's distributive share of the adjusted basis of the contributed property.[1229]

A partnership computes its taxable income in the same manner as an individual with certain exceptions. The exceptions provide, in part, that the deductions for foreign taxes and charitable contributions are not allowed to the partnership.[1230] Instead, a partner takes into account its distributive share of the foreign taxes paid by the partnership and the charitable contributions made by the partnership for the taxable year.[1231]

Treasury regulations provide that "[i]f the partner's distributive share of the aggregate of items of loss specified in section 702(a)(1), (2), (3), (8) [now (7)], and (9) [now (8)] exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss."[1232] These regulations exclude from the 704(d) limitation the items specified in section 702(a)(4) (charitable contributions) and 702(a)(6) (foreign taxes paid or accrued).

[1227] Sec. 704(d) and Treas. Reg. sec. 1.704-1(d)(1).

[1228] Sec. 705(a).

[1229] Rev. Rul. 96-11, 1996-1 C. B. 140.

[1230] Sec. 703(a)(2)(B) and (C). In addition, section 703(a)(2) provides that other deductions are not allowed to the partnership, notwithstanding that the partnership's taxable income is computed in the same manner as an individual's taxable income, specifically: personal exemptions, net operating loss deductions, certain itemized deductions for individuals, or depletion.

[1231] Sec. 702.

[1232] Treas. Reg. sec. 1.704-1(d)(2).

The IRS has taken the position in a private letter ruling that the section 704(d) loss limitation on partner losses does not apply to limit the partner's deduction for its share of the partnership's charitable contributions.[1233]

While the regulations relating to the section 704(d) loss limitation do not mention the foreign tax credit, a taxpayer may choose the foreign tax credit in lieu of deducting foreign taxes.[1234]

Section 1366(d) limits the losses and deductions which may be taken into account by a shareholder of an S corporation to the shareholder's basis in stock and debt of the corporation. For purposes of this limitation, the shareholder's pro rata share of charitable contributions and foreign taxes are taken into account by reason of the last sentence of section 1366(a)(1).[1235]

Description of Proposal

The proposal modifies the section 704(d) loss limitation rule to provide that a partner's distributive share of items that are not deductible in computing the partnership's taxable income, and not properly chargeable to capital account, are allowed only to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership taxable year in which the expenditure occurs. Thus, the section 704(d) loss limitation applies to a partner's distributive share of charitable contributions and foreign taxes.

Effective Date

The proposal applies to partnership taxable years beginning after December 31, 2014.

[1233] Priv. Ltr. Rul. 8405084. And see William S. McKee, William F. Nelson and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, WG&L, 4th Edition (2011), paragraph 11.05[1][b], pp. 11-214 (noting that the "failure to include charitable contributions in the § 704(d) limitation is an apparent technical flaw in the statute. Because of it, a zero-basis partner may reap the benefits of a partnership charitable contribution without an offsetting decrease in the basis of his interest, whereas a fellow partner who happens to have a positive basis may do so only at the cost of a basis decrease.").

[1234] Sec. 901.

[1235] In connection with the application of the section 1366(d) limitation to charitable contributions, section 1366(d)(4) provides a special rule prorating the amount of appreciation not subject to the limitation in the case of charitable contributions of appreciated property by the S corporation. Under a related rule, the shareholder's basis in his interest is decreased by the basis (rather than the fair market value) of appreciated property by reason of a charitable contribution of the property by the S corporation (temporarily through 2013) (sec. 1367(a)(2)).

14. Revisions related to unrealized receivables and inventory items (sec. 3616 of the discussion draft and sec. 751 of the Code)

Present Law

Gain or loss from the sale or exchange of a partnership interest generally is treated as gain or loss from the sale or exchange of a capital asset.[1236] However, gain is treated as ordinary income on the sale or exchange of a partnership interest of a partnership holding unrealized receivables or inventory items to the extent thereof.[1237]

Certain distributions are treated as sales or exchanges where a partnership holds unrealized receivables or substantially appreciated inventory.[1238] To the extent a partner receives in a distribution any partnership property that is unrealized receivables or substantially appreciated inventory items in exchange for all or a part of his interest in other partnership property (including money), or vice versa, the transaction is treated under regulations as a sale or exchange of the property between the distributee partner and the partnership (as constituted after the distribution). This treatment is provided to prevent reallocation among the partners of ordinary income and capital gain.

Unrealized receivables generally includes amounts for the right to payment for goods sold (otherwise treated as ordinary income) and services, to the extent not previously included in income. In addition, for purposes of sections 731 (relating to gain or loss on distributions), 732 (relating to basis of distributed property other than money), and 741 (relating to recognition and character of gain or loss on sale or exchange of partnership interest), but not for purposes of section 735 (relating to character of gain or loss on disposition of distributed property), unrealized receivables includes numerous listed properties to the extent ordinary income would arise if the properties were sold at their fair market value.

Treasury regulations[1239] provide examples that analyze shifts in the partnership's and the distributee partner's shares of the value of partnership assets, but do not take account of shifts in the partnership's and the distributee partner's shares of ordinary income and gain.

Description of Proposal

The proposal eliminates the substantial appreciation limitation with respect to inventory items of a partnership in the case of distributions treated as sales or exchanges under section 751(b). Thus, section 751(b) applies to distributions by partnerships holding inventory items, whether or not substantially appreciated.

[1236] Sec. 741.

[1237] The last sentence of sec. 741 and sec. 751(a).

[1238] Sec. 751(b).

[1239] Treas. Reg. sec. 1.751-1. Examples are provided in Treas. Reg. sec. 1.751-1(g).

The Secretary of the Treasury is required to revise regulations issued under section 751(b) to take into account the partner's share of income and gain rather than the partner's share of partnership assets.[1240]

The proposal simplifies the definition of an unrealized receivable by providing that the term includes any property other than an inventory item but only to the extent of the amount that would be treated as ordinary income if the property were sold for its fair market value.

Effective Date

The proposal relating to the repeal of the substantial appreciation requirement applies to distributions after December 31, 2014.

The proposal relating to the simplification of the definition of unrealized receivables applies to partnership taxable years beginning after December 31, 2014.

15. Repeal of time limitation on taxing precontribution gain (sec. 3617 of the discussion draft and secs. 704(c) and 737 of the Code)

Present Law

If a partner contributes appreciated property to a partnership, no gain or loss is recognized to the contributing partner at the time of the contribution. The contributing partner's basis in its partnership interest is increased by the basis of the contributed property at the time of the contribution. The pre-contribution gain or loss is reflected in the difference between the partner's capital account and its basis in its partnership interest. Income, gain, loss, and deduction with respect to the contributed property must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.[1241]

If the property is subsequently distributed to another partner within seven years of the contribution, the contributing partner generally recognizes gain or loss from the sale of the property in an amount equal to the gain or loss which would have been allocated to the partner by reason of the variation between basis and value at the time of contribution as if the property had been sold for its fair market value at the time of the distribution.[1242]

Similarly, the contributing partner generally includes pre-contribution gain in income to the extent that the value of other property distributed by the partnership to that partner exceeds

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[1240] Notice 2006-14, 2006-1 CB 498, requested comments on alternative approaches to the current section 751(b) regulations to achieve the purposes of the provision that would provide greater simplicity.

[1241] Sec. 704(c)(1)(A).

[1242] Sec. 704(c)(1)(B).

its adjusted basis in its partnership interest, if the distribution by the partnership is made within seven years after the contribution of the appreciated property.[1243]

Description of Proposal

The proposal repeals the limitation on the time period in which a partner recognizes pre-contribution gain with respect to property contributed to a partnership. Thus, under the proposal, a partner that contributes appreciated property to a partnership generally recognizes pre-contribution gain in the event that the partnership distributes the contributed property to another partner, or distributes to the contributing partner other property whose value exceeds that partner's basis in its partnership interest, regardless of when the distribution occurs.

Effective Date

The proposal applies to property contributed to a partnership after December 31, 2014.

16. Partnership interests created by gift (sec. 3618 of the discussion draft and secs. 704(e) and 761 of the Code)

Present Law

Under present law, a partnership includes an unincorporated organization that carries on any business, financial operation, or venture which is not a type of entity such a corporation or a trust recognized for Federal tax purposes.[1244] The Supreme Court has stated that the test of a partnership is "whether considering all the facts...the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[1245] A partner means a member of a partnership.[1246]

Present law also provides that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any person.[1247] The predecessor of this provision was enacted in 1951 to prevent the IRS from denying partner status to a taxpayer who shared actual ownership of the partnership's income-producing capital on the basis that the interest was acquired from a family member. According to the legislative history, the present-law provision "...makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxed to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or

[1243] Sec. 737.

[1244] Sec. 761(a). See also sec. 7701(a)(2).

[1245] *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949).

[1246] Sec. 761(b).

[1247] Sec. 704(e)(1).

whether the business benefitted from the entrance of the new partner."[1248] In enacting this provision, Congress intended to override the intent test established by the Supreme Court.[1249]

The scope of section 704(e)(1) is not entirely clear. It might be read to do nothing more than state the general principle that income derived from capital is taxed to the owner of the capital.[1250] Also, it might be read as providing an alternative test as to what constitutes a "partner" by treating the holder of a capital interest as a partner without regard to how the term is defined in section 761.[1251]

Description of Proposal

The proposal provides that, in the case of a capital interest in a partnership in which capital is a material income-producing factor, the determination of whether a person is recognized as a partner is made without regard to whether the interest is derived by gift from any other person. The proposal is not intended to change the principle that the real owner of the capital interest is to be taxed on the income from the capital interest, regardless of the motivation of the transferor of the interest to the owner. However, the determination of whether the owner of a capital interest is a partner is to be made under the generally applicable rules defining a partnership and a partner.

The proposal retains the present-law rule that the donee partner's distributive share as determined under the partnership agreement is subject to adjustment to the extent that (1) the donee partner's distributive share is determined without allowance of reasonable compensation for services the donor provides to the partnership; or (2) the donee owner's distributive share attributable to donated capital is proportionately greater than the donor's distributive share attributable to the donor's capital. For purposes of the proposal, in the case of a partnership interest created by gift, the fair market value of the interest is considered to be the amount of donated capital. The donee partner's basis and capital account are adjusted as under present law.

Effective Date

The proposal is effective for partnership taxable years beginning after December 31, 2014.

[1248] See S. Rep. No. 781, 82d Cong, 1st Sess., 38, 39 (1951): H.R. Rep. No. 586, 82d Cong., 1st Sess., 32 (1951).

[1249] See McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners*, 4th ed., para. 3.02[3], pages 3-21 thru 3-25.

[1250] See 4 Bittker and Lokken, *Federal Taxation of Income, Estates, and Gifts,* para. 86.3.1, pages 86-29 (3rd ed. 2003): "The reference to 'ownership' of a capital interest is odd because it is a pervasive principle of tax law, seemingly needing no repetition for a limited class of assets, that income from property transferred by gift is thereafter taxed to the donee."

[1251] See *TIFD III-E v. United States*, 459 F3d 220 (2d Cir. 2006), reversing and remanding 342 F. Supp. 2d 94 (D. Conn. 2004).

17. Repeal of partnership technical terminations (sec. 3619 of the discussion draft and sec. 708(b)(1)(B) of the Code)

Present Law

Present law provides that a partnership is terminated under specified circumstances.[1252] Rules are also provided for the merger, consolidation, or division of a partnership.[1253]

A partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.[1254]

A partnership is treated as terminated if within any 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.[1255] This is sometimes referred to as a technical termination. Under regulations, the technical termination gives rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners.[1256]

The effect of a technical termination is not necessarily the end of the partnership's existence, but rather, the termination of some tax attributes. Upon a technical termination, the partnership's taxable year closes, potentially resulting in short taxable years.[1257] Partnership-level elections generally cease to apply following a technical termination.[1258] A technical termination generally results in the restart of partnership depreciation recovery periods.[1259]

[1252] Sec. 708(b)(1).

[1253] Sec. 708(b)(2). Mergers, consolidations, and divisions of partnerships take either an assets-over form or an assets-up form pursuant to Treas. Reg. sec. 1.708-1(c).

[1254] Sec. 708(b)(1)(A).

[1255] Sec. 708(b)(1)(B).

[1256] Treas. Reg. sec. 1.708-1(b)(4).

[1257] Sec. 706(c)(1); Treas. Reg. sec. 1.708-1(b)(3).

[1258] Partnership level elections include, for example, the section 754 election to adjust basis on a transfer or distribution, as well as other elections that determine the partnership's tax treatment of partnership items. A list of elections can be found at William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, 4th edition, para. 9.01[7], pp. 9-42 - 9-44.

[1259] Although section 168(i)(7) provides that for purposes of computing the depreciation deduction, generally the transferee partnership is treated as the transferor when property is contributed in a tax-free transaction governed by section 721, it further provides that this rule does not apply in the case of a technical termination. Thus, the deemed contribution under Treas. Reg. sec. 1.708-1(b)(4) has the result of restarting depreciation periods applying the current adjusted basis of the property deemed contributed. See also William S. McKee, William F.

Description of Proposal

The proposal repeals the section 708(b)(1)(B) rule providing for technical terminations of partnerships. The proposal does not change the present-law rule of section 708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Effective Date

The proposal applies to partnership taxable years beginning after December 31, 2014.

18. Publicly traded partnership exception restricted to mining and natural resources partnerships (sec. 3620 of the discussion draft and sec. 7704 of the Code)

Present Law

Partnerships in general

A partnership generally is not treated as a taxable entity (except for certain publicly traded partnerships), but rather, is treated as a passthrough entity. Income earned by a partnership, whether distributed or not, is taxed to the partners.[1260] The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[1261]

Publicly traded partnerships

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes.[1262] A corporation is subject to tax at the corporate level on its taxable income.[1263] For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).[1264] As of the first day that a partnership is treated as a corporation, the partnership is treated for Federal tax purposes as transferring all its assets (subject to liabilities) to a newly formed corporation in

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Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, 4th edition, para. 13.05[2][k], pp. 13-33 - 13-37.

[1260] Sec. 701.

[1261] Sec. 702.

[1262] Sec. 7704(a).

[1263] Sec. 11(a).

[1264] Sec. 7704(b).

exchange for the stock of the corporation, and distributing the stock to its partners in liquidation of their partnership interests.1265

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.[1266] Qualifying income includes interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of partnership, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts.

Description of Proposal

The proposal generally repeals exceptions from corporate treatment for publicly traded partnerships. However, the provision continues to permit partnership treatment for publicly traded partnerships, 90 percent of whose gross income consists of certain mining and natural resources income.

Thus, under the provision, an exception from corporate treatment is provided for those publicly traded partnerships, 90 percent or more of whose gross income is (1) income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including geothermal energy and excluding fertilizer and timber) or industrial source carbon dioxide, and (2) any gain from the sale or disposition of a capital asset (or property described in section 1231(b)) held for the production of income of described in (1).

Effective Date

The proposal applies to taxable years beginning after December 31, 2016.

[1265] Sec. 7704(f).

[1266] Sec. 7704(c)(2).

19. Ordinary income treatment in the case of partnership interests held in connection with performance of services (sec. 3621 of the discussion draft and new sec. 710 of the Code)

Present Law

Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxed upon the receipt of the partnership interest.[1267]

In 1993, the Internal Revenue Service, referring to the litigation of the tax treatment of receiving a partnership profits interest and the results in the cases, issued administrative guidance that the IRS generally would treat the receipt of a partnership profits interest for services as not a taxable event for the partnership or the partner.[1268] Under this guidance, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. More recent administrative guidance[1269] clarifies that this treatment applies provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.[1270]

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating to the receipt of property for the performance of services.[1271] A partnership capital interest for this purpose is an interest that

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[1267] Only a handful of cases have addressed this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner*, 56 T.C. 530 (1971), aff'd 492 F.2d 286 (7th Cir. 1974)), a more recent case concluded that partnership profits interests were not includable on receipt, because the profits interests were speculative and without fair market value (*Campbell v. Commissioner,* 943 F. 2d 815 (8th Cir. 1991)).

[1268] Rev. Proc. 93-27 (1993-2 C.B. 343), citing the *Diamond* and *Campbell* cases, *supra*.

[1269] Rev. Proc. 2001-43 (2001-2 C.B. 191). This result applies under the guidance even if the interest is substantially nonvested on the date of grant.

[1270] A similar result would occur under the "safe harbor" election under proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).

[1271] Secs. 61 and 83; Treas. Reg. sec. 1.721-1(b)(1); see *U.S. v. Frazell*, 335 F.2d 487 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965).

would entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.[1272]

Property received for services under section 83

In general

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the "service provider") generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture). The amount includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property. A deduction is allowed to the person for whom such services are performed (the "service recipient") equal to the amount included in gross income by the service provider.[1273] The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which the amount is included in the service provider's income.

Property that is subject to a substantial risk of forfeiture and that is not transferable is generally referred to as "substantially nonvested." Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance (or refraining from performance) of substantial services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.

Section 83(b) election

Under section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a "section 83(b) election." The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

Proposed regulations on compensatory transfer of a partnership interest

The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest.[1274] The proposed regulations

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[1272] Rev. Proc. 93-27, 1993-2 C.B. 343.

[1273] Sec. 83(h).

[1274] 70 Fed. Reg. 29675 (May 24, 2005).

provide that a partnership interest is "property" for purposes of section 83. Thus, a compensatory transfer of a partnership interest is includible in the service provider's gross income at the time that it first becomes substantially vested (or, in the case of a substantially nonvested partnership interest, at the time of grant if a section 83(b) election is made).

However, because the fair market value of a compensatory partnership interest is often difficult to determine, the proposed regulations also permit a partnership and a partner to elect a safe harbor under which the fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, in the case of a true profits interest in a partnership (one under which the partner would be entitled to nothing if the partnership were liquidated immediately following the grant), under the proposed regulations, the grant of a substantially vested profits interest (or, if a section 83(b) election is made, the grant of a substantially nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

Passthrough tax treatment of partnerships

The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[1275] Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower tax rates. A partner's basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership's tax status as a passthrough entity. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

Employment tax treatment of partners

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").[1276] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").[1277]

[1275] Sec. 702.

[1276] See Chapter 21 of the Code.

[1277] Sec. 1401.

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[1278] The amount of wages subject to this component is capped at $117,000 for 2014. Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. For remuneration received in taxable years beginning after December 31, 2012, the employee portion of the HI tax (as well as the self-employment tax HI component) is increased by an additional tax of 0.9 percent on wages and self-employment income received in excess of a specific threshold amount.[1279] The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.[1280]

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at $117,000 for 2014. Under the HI component, the rate is 2.9 percent,[1281] and the amount of self-employment income subject to the HI component is not capped.

For SECA tax purposes, net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules.[1282] Specified types of income or loss are excluded, such as rentals from real estate in

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[1278] Secs. 3101 and 3111.

[1279] Secs. 3101(b)(2) and 1401(b)(2). Unlike the general 1.45 percent HI tax on wages, the additional 0.9 percent tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case (unmarred individual or head of household).

[1280] S corporation shareholders who are employees of the S corporation are subject to FICA taxes. A considerable body of case law has addressed the issue of whether amounts paid to S corporation shareholder-employees are reasonable compensation for services and therefore are wages subject to FICA tax or whether some portion is properly characterized as another type of income (typically, the shareholder's distributive share) and therefore not subject to FICA tax. Case law addressing this issue includes *David E. Watson, P.C., v. U.S.*, 668 F.3d 1008 (8th Cir. 2012); *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, *Joseph M. Grey Public Accountant, P.C., v. Commissioner*, 119 T.C. 121 (2002), aff'd, 93 Fed. Appx. 473 (3d Cir. 2004), and *Nu-Look Design, Inc. v. Commisioner*, 356 F.3d 290 (3d Cir. 2004), in which an officer and sole shareholder of an S corporatiou argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loaus, rather than as wages subject to employment tax.

[1281] Sec. 1401; an additional 0.9 percent tax applies for remuneration received in taxable years beginning after December 31, 2012 (sec. 1401(b)(2)).

[1282] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), *i.e.*, 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.[1283]

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as capital gains and dividends, as described above). This rule applies to individuals who are general partners.

A special rule applies for limited partners of a partnership.[1284] In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.[1285]

For taxable years beginning after 2012, in the case of an individual, estate, or trust, an unearned income Medicare contribution tax is imposed.[1286] In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income[1287] over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

Description of Proposal

General rule

The proposal provides for ordinary income treatment of certain net capital gain with respect to any applicable partnership interest held by the taxpayer. The net capital gain in excess of the amount to which the proposal applies is not recharacterized as ordinary.

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intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes under section 164(f).

[1283] Secs. 1402(a)(1), (2), and (3).

[1284] Sec. 1402(a)(13).

[1285] In *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136. T. C. 137 (2012), the Tax Court held that the section 1402(a)(13) limited partner exception did not apply to the distributive shares of partners performing legal services in a law partnership.

[1286] Sec. 1411.

[1287] Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1), net of the deductions and exclusions disallowed with respect to foreign earned income.

The proposal applies if the taxpayer holds one or more applicable partnership interests at any time during the taxable year. The amount treated as ordinary income is the portion of the taxpayer's net capital gain with respect to such interests that does not exceed the taxpayer's recharacterization account balance (as defined in the proposal) for the taxable year.

Section 83 (relating to property transferred in connection with performance of services) does not apply to the transfer of a partnership interest to which the proposal applies. It is intended that Rev. Proc. 93-27[1288] not apply to the transfer of a partnership interest to which the proposal applies.

Net capital gain

In general

To determine the net capital gain that could be recharacterized as ordinary income, the items of gain or loss of the taxpayer that are taken into account are only (1) those taken into account under section 702 with respect to any applicable partnership interest, (2) those recognized on disposition of any applicable partnership interest, or (3) those recognized on a distribution of property with respect to an applicable partnership interest. For this purpose, any property that is taken into account in determining gains and losses to which section 1231 applies is treated as a capital asset held for more than one year, so long as the section 1231 gains exceed the section 1231 losses for the taxable year without regard to this proposal. Net capital gain is determined without regard to recharacterization of any item as ordinary income under the general rule of the proposal.

The amount treated as ordinary income under the proposal is allocated ratably among those items of long-term capital gain which are taken into account in the calculation of net capital gain. Thus, net capital gain that is treated as ordinary income under the proposal for the taxable year serves to reduce the amount of the taxpayer's overall capital gain (or to increase the amount of the taxpayer's overall capital loss) for the taxable year.

Dispositions and property distributions

The proposal requires that gain on the disposition of an applicable partnership interest be recognized notwithstanding any other provision of the Code. This rule applies to any disposition, such as a sale, exchange, or partial or complete liquidation (redemption) of the applicable partnership interest. For example, if a partnership redeems an applicable partnership interest for cash, gain is taken into account in determining net capital gain under the proposal. Similarly, the proposal provides rules for recognition of gain by a partner on a distribution with respect to an applicable partnership interest of partnership property. The partner recognizes gain to the extent the fair market value of the property exceeds the basis in the distributed property determined without regard to this proposal. The basis of the distributed property in the hands of

[1288] Rev. Proc. 93-27 (1993-2 C.B. 343) generally provides administrative guidance that the IRS will not treat the receipt of a partnership profits interest as a taxable event for the partner or the partnership in some circumstances.

the distributee partner is the fair market value of the property. For example, assume a partnership's adjusted basis in an item of partnership property is $20 and the property's fair market value is $50. The partnership distributes the property to a partner whose applicable partnership interest has an adjusted basis of $10. Under the proposal, the amount of gain that that the distributee partner is required to recognize on the distribution is $40 ($50 minus $10, the partner's adjusted basis in the distributed property determined under section 732(a)(2) without regard to this proposal). The distributee partner's basis in the distributed property under the proposal is $50 (its fair market value at the time of distribution). The distributee partner's basis in his partnership interest is reduced to zero (sec. 733). The $40 gain recognized on the distribution under this rule is taken into account in determining net capital gain under the proposal.

Recharacterization account balance

In general

The recharacterization account balance (defined below) depends, conceptually, on the highest percentage of partnership profits that might be allocated to an applicable partnership interest during the taxable year. The recharacterization account balance represents a running total of the amount that can be recharacterized as ordinary under the proposal.

The amount of the recharacterization account balance is calculated as follows with respect to any taxpayer for any taxable year. The amount is the excess of one sum over a second sum. The first is the sum of (1) the taxpayer's aggregate annual recharacterization amounts with respect to applicable partnership interests for the taxable year plus (2) the taxpayer's recharacterization account balance for the taxable year preceding such taxable year. The second is the sum of (1) the taxpayer's net ordinary income with respect to applicable partnership interests for the taxable year (determined without regard to this proposal), plus (2) the amount treated as ordinary income of the taxpayer under the proposal for the taxable year preceding such taxable year.

Net ordinary income

The net ordinary income with respect to applicable partnership interests for a taxable year (determined without regard to this proposal) generally can be described as income from applicable partnership interests that is already ordinary without application of the proposal. Thus, a partner's distributive share of ordinary income from such interests is acknowledged and taken into account first in determining whether any amount of net capital gain is to be recharacterized as ordinary under the proposal. Similarly, amounts recharacterized as ordinary under the proposal before the current taxable year are also acknowledged and taken into account. Specifically, net ordinary income with respect to applicable partnership interests is defined as the taxpayer's distributive share of ordinary items of income and gain under section 702 with respect to such interests (determined without regard to items of gain taken into account in determining net capital gain under the proposal), reduced by the taxpayer's distributive share of deduction and loss with respect to such interests (determined without regard to items of loss taken into account in determining net capital gain under the proposal).

The rule defining the recharacterization account balance in turn depends on the annual recharacterization amount.

Annual recharacterization amount

The annual recharacterization amount with respect to any applicable partnership interest for any partnership taxable year is determined by multiplying together two factors.

The first factor is the specified rate for the calendar year in which the partnership taxable year begins. For this purpose, the specified rate for any calendar year is the Federal long-term rate (determined under section 1274(d)(1) for the last month of the calendar year) plus 10 percentage points. For example, if the Federal long-term rate (so determined) is three percent, then the specified rate is 13 percent; if the Federal long-term rate (so determined) is 12 percent, then the specified rate is 22 percent.

The second factor is the excess of (1) an amount equal to the applicable percentage of the partnership's aggregate invested capital for the taxable year, over (2) the specified capital contribution of the partner with respect to the applicable partnership interest for the taxable year. These terms are explained below.

If the taxpayer holds an applicable partnership interest for less than the entire taxable year, then the annual recharacterization amount, so determined, is ratably reduced.

Applicable percentage

The applicable percentage with respect to any applicable partnership interest is the highest percentage of profits of the partnership that could be allocated with respect to the interest for the taxable year (consistent with the partnership agreement and assuming facts and circumstances with respect to the taxable year as would result in the highest percentage). Authority is provided to the Secretary to prescribe regulations or other guidance under this rule.

For example, if during the taxable year, a partner has a 20-percent profits interest in a partnership which applies after an 8-percent hurdle rate is met or after capital is returned to other partners, then it is assumed for this purpose that the 8-percent hurdle rate has been met or capital has been returned to other partners, and 20 percent is the highest percentage of profits that could be allocated with respect to the partner's interest for the taxable year (even if the 8-percent hurdle rate has not been met or capital has not been returned during the year). Similarly, it is not required that the partnership have profits for the year for 20 percent to be the applicable percentage under the proposal. As a further example, if the partnership agreement requires the holder of the applicable partnership interest to return prior distributions or to be allocated a loss or a reduced portion of profits in certain circumstances (but otherwise could have a 20-percent interest in profits), it is assumed for this purpose that the circumstances have not occurred during the year (regardless of whether the circumstances have occurred) so that the applicable percentage is 20 percent.

Aggregate invested capital

The aggregate invested capital with respect to any taxable is the average daily amount of invested capital of the partnership for the taxable year.

Invested capital

The invested capital with respect to any partnership as of any day includes the total cumulative value, determined at the time of contribution, of all money or other property contributed to the partnership on or before that day.

Invested capital includes the aggregate value (determined at the time of the loan) of money or other property loaned by a partner to the partnership. It is intended that any loan or other advance to the partnership made or guaranteed, directly or indirectly, by a partner is included in invested capital, and that Treasury regulations or guidance implement this intent. For example, if a loan or guarantee is included in basis with respect to any partner or the partnership, it is included in invested capital of the partnership. Invested capital also includes the face amount of any convertible debt of the partnership or any obligation providing equity participation in the partnership.

If the principal amount of a partner's loan to the partnership is repaid in full, then on the day of repayment, the invested capital is reduced by the principal amount of the fully repaid loan, to the extent the loan was included in invested capital.

For purposes of determining the value of property contributed or loaned to the partnership, it is not intended that property of uncertain or speculative worth at the time of its contribution or loan be treated as having no value. Such property is to be valued using a valuation method reasonably consistent with the purposes of the proposal, for example, the highest potential value for it that is presented to investors or potential investors, regulators, or lenders.

Amounts that are not contributed or loaned to the partnership are not included in invested capital. For example, invested capital includes a partner's earnings from the partnership that are contributed or loaned to the partnership. As another example, if a partner transfers a partnership interest, the transferee partner's payment to the transferor does not either increase or reduce invested capital of the partnership.

Invested capital is reduced only by the aggregate amount distributed in liquidation of interests in the partnership. Thus, invested capital is not reduced by other distributions, allocations, or payments, such as partner draws, preferred returns or profits, amounts loaned by the partnership, or by any distribution that is a nonliquidating distribution or that is not a distribution in liquidation of any interest. It is anticipated that Treasury guidance will narrowly limit the circumstances in which distributions taking place over a period longer than the taxable year can be treated as distributions in liquidation of interests in the partnership under this rule. Invested capital cannot be a negative number.

Authority for Treasury regulations or guidance is provided to prevent the abuse of the purposes of the proposal, including through reduction of the invested capital of the partnership and through attempts to undervalue property or property that is contributed or loaned to the partnership. It is not intended that aggregate invested capital be artificially reduced in relation to a partner's contributed capital with respect to an applicable partnership interest, nor that a partner's contributed capital with respect to an applicable partnership interest be artificially increased in relation to aggregate invested capital, in an attempt to reduce the amount recharacterized as ordinary under the proposal.

Specified capital contribution with respect to an applicable partnership interest

A specified capital contribution with respect to any applicable partnership interest for any taxable year is the average daily amount of contributed capital with respect to the interest for the taxable year.

Contributed capital

Contributed capital is not determined on the basis of the partner's capital account, nor on the basis of the partner's taxable income, gain, or loss from the partnership. The contributed capital of a partner generally reflects the excess of contributions over distributions with respect to the applicable partnership interest, determined as follows. The contributed capital with respect to an applicable partnership interest as of any day is the excess (if any) of (1) the total cumulative value of all money or other property contributed by the partner to the partnership with respect to the interest as of that day, over (2) the total cumulative value of all money or other property distributed by the partnership to the partner with respect to the interest as of that day. By contrast to the determination of invested capital, distributions taken into account in determining contributed capital under this rule are not limited to distributions in liquidation of interests in the partnership.

Any amount borrowed directly or indirectly from the partnership or any other partner of the partnership or any person related to the other partner or the partnership is not taken into account in determining the taxpayer's contributed capital (by contrast to the treatment of partner loans in determining invested capital). For this purpose a person is related if the relationship is described in section 267(b) or 707(b) substituting 10 percent for 50 percent. For example, any loan or other advance made or guaranteed, directly or indirectly, by any of these parties is not taken into account as contributed capital under this rule.

Multiple applicable partnership interests in the same partnership held directly or indirectly the by taxpayer during the taxable year are treated as one for this purpose.

Simplified example illustrating recharacterization account balance

For example, assume that a partner, M, has a 20-percent profits interest in a partnership[1289] subject to an initial hurdle rate of return to investor partners, except that partner

[1289] The possibility that the partnership in which investors hold interests may be a lower-tier partnership is ignored for purposes of this simplified example.

M is to be allocated up to 10 percent of the partnership's net fee income without regard to the hurdle rate requirement. Assume that M's interest is an applicable partnership interest.

A total of $5.5 million of capital is contributed to the partnership during the first year of the partnership's operation, $5.4 million by investor partners and $100,000 by partner M. The partnership spends the $5.5 million to acquire stock in several startup businesses.

Assume for purposes of this example that the Federal long-term rate for any calendar month is five percent. Assume further that the partnership and all partners have a calendar year taxable year.

For each of the first seven years of the partnership's operation, the partnership has $1 million of fees (ordinary income) and $500,000 of deductible expenses, resulting in net ordinary income each year of $500,000. Partner M is allocated 10 percent, resulting in net fee income of $50,000 each year.

For the first year, partner M has a recharacterization account balance of $100,000. This amount is determined as follows. First, partner M's annual recharacterization amount is determined as $150,000. This is the specified rate (five percent plus 10 percentage points or 15 percent), multiplied by $1 million, which is 20 percent of the $5.5 million aggregate invested capital of the partnership reduced by M's capital contribution (that is, $1.1 million reduced by $0.1 million). The recharacterization account balance for the year is the amount by which the $150,000 exceeds partner M's distributive share of net ordinary income, $50,000. Because the recharacterization account balance is calculated as an excess, if any, of one number over another, the recharacterization account balance cannot be a negative number. For the taxable year, no amount is recharacterized as ordinary income under the proposal, so there is no reduction in the recharacterization account balance for that.

For each subsequent taxable year, M's recharacterization account balance is calculated in this manner and is increased by the recharacterization account balance for the preceding taxable year. After performing this calculation for each of the first seven years, partner M's recharacterization account balance is $700,000 by the end of the seventh year.

In year eight of the partnership's operation, the partnership sells one of the startup businesses for $10.5 million, a $10 million net capital gain for the partnership. The hurdle rate requirement is met and the highest percentage of profits that could be allocated to partner M for the taxable year is 20 percent. Partner M's distributive share of net capital gain is 20 percent of $10 million, or $2 million. For the taxable year, the partnership also has fees (ordinary income) of $1 million and deductible expenses of $500,000, resulting in $500,000 of net ordinary income, but M's distributive share of net fee income is 0 for the year under the terms of the partnership agreement (no inference is intended as to the validity of partnership allocations in this simplified example). Partner M's recharacterization account balance increases to $850,000 for the taxable year, $50,000 higher than in prior years as M has no ordinary fee income for the year.

The amount treated as ordinary income under the proposal for the taxable year is $850,000, the amount of M's distributive share of net capital gain ($2 million) that does not exceed M's recharacterization account balance for the taxable year ($850,000). The remaining

$1.15 million of M's distributive share of partnership net capital gain is not treated as ordinary, but rather is treated as capital gain.

If, instead of being allocated a distributive share of partnership net capital gain, M had sold, redeemed, or transferred the applicable partnership interest shortly before the partnership sold the appreciated property and incurred the gain, the gain on sale, redemption, or transfer of the partnership interest is taken into account in determining net capital gain subject to recharacterization as ordinary income under the proposal, without regard to nonrecognition treatment that might otherwise apply. Similarly, if instead of allocating to M a distributive share of partnership net capital gain on sale of appreciated partnership property, the partnership had distributed 20 percent of the appreciated partnership property to M, gain on the partnership distribution must be taken into account in determining net capital gain subject to recharacterization as ordinary income under the proposal.

In year nine of the partnership's operation, the partnership does not sell any assets and has no capital gain or loss, but does have $1 million of fees (ordinary income) and $500,000 of deductible expenses, resulting in net ordinary income of $500,000. Partner M is allocated 10 percent of the net fee income or $50,000. Partner M's recharacterization account balance for the taxable year is calculated as the excess of one sum over another, as follows. First, partner M's annual recharacterization amount is determined as $150,000. This is the specified rate (five percent plus 10 percentage points or 15 percent), multiplied by $1 million, which is 20 percent of the $5.5 million aggregate invested capital of the partnership reduced by M's capital contribution (that is, $1.1 million reduced by $0.1 million). The first sum is $1 million, that is, this $150,000 plus the $850,000 recharacterization account balance for the preceding taxable year. The second sum is $900,000, which is (1) partner M's distributive share of net ordinary income for the current taxable year, $50,000, plus (2) the $850,000 that partner M treated as ordinary income under the proposal for the preceding taxable year. The year-nine recharacterization account balance -- the amount that can be recharacterized as ordinary income going forward -- is $100,000, which is the amount by which the first sum, $1 million, exceeds the second sum, $900,000.

Applicable partnership interest

An applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business. The services may be performed by the taxpayer or by any other person or persons. It is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership, and the Treasury Department is directed to provide guidance implementing this intent.

Applicable trade or business

An applicable trade or business means any trade or business (regardless of whether the activities of the trade or business are conducted in one or more entities) that consists in whole or in part of the following: (1) raising or returning capital, (2) investing in (or disposing of) trades or businesses (or identifying the trades or businesses for investing or disposition), and (3) developing the trades or businesses. An activity that does not rise to the level of a trade or business is not an applicable trade or business. For example, an investment, expenses for which are deductible under section 212 but are not deductible under section 162, is not an applicable trade or business.

Any activity involving research or experimentation (within the meaning of section 469(c)(4), as redesignated) is treated as a trade or business under the parts of the proposal referring to investing in (or disposing of) trades or businesses (or identifying trades or businesses for investing or disposition, and developing trades or businesses. Thus, if an activity involves any research or experimental expenditures that may be deductible or amortizable under section 174 (regardless of whether the method has been adopted or the election has been made to do so), it is treated as a trade or business referred to in those parts of the proposal.

In determining whether an applicable trade or business exists, developing trades or businesses is a criterion. Developing trades or businesses takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider. Services performed as an employee of an applicable trade or business are treated as performed in an applicable trade or business for purposes of this rule. Merely voting shares owned does not amount to development; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development.

For example, assume that X and Y are partners in XY partnership which is the managing partner of a private equity fund. In year one, XY partnership receives a 30-percent profits interest in the fund in connection with future performance of investment-related services for the fund. X and Y contact wealthy individuals and institutional investors to raise capital for the fund. These investors become limited partners in the fund and agree under the terms of the fund's partnership agreement to make capital contributions as the fund invests in portfolio businesses. X, Y, and the employees of XY identify portfolio businesses in which the private equity fund invests. The terms of the fund's investment permit the fund and its service providers to have management input in the portfolio businesses which is designed to develop the value of the portfolio companies over the period of the fund's investment. After several years, the fund's interests in the portfolio companies are sold. In this example, from year one, X and Y each hold an interest in a partnership (XY) in connection with the performance of services in an applicable trade or business, so the proposal applies.

Transfer of applicable partnership interest to related person

If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, then the taxpayer includes in gross income (as ordinary income) so much of the taxpayer's recharacterization account balance for the taxable year as is allocable to the applicable partnership interest. Treasury guidance may provide rules for making this allocation. The amount included as ordinary income on the transfer is reduced by the amount treated as ordinary income for the taxable year under the general rule of the proposal. A related person for this purpose is a family member (within the meaning of section 318(a)(1)) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

Reporting requirement

A partnership is required to report each partner's annual recharacterization amount for the taxable year to the partner and to the IRS. In the case of a partner that is a partnership or S corporation, a similar reporting requirement applies. The penalties otherwise applicable to a failure to report to partners under section 6031(b) apply to failure to report under this requirement.

Regulatory authority

The Treasury Department is directed to issue regulations or other guidance necessary to carry out the proposal, including specified guidance (some of which is described above). The guidance is to address prevention of the abuse of the purposes of the proposal, including through the allocation of income to tax-indifferent parties or reduction in the invested capital of the partnership (including attempts to undervalue property contributed to or loaned to the partnership). Guidance is also to provide for the application of the proposal in the case of tiered structures of entities.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

20. Reform audit and adjustment procedures for partnerships (sec. 3622 of the discussion draft and secs. 6221 through 6234 and 6240 through 6256 of the Code)

Present Law

General framework for partnership audit rules

Under present law, the manner in which the examination and redetermination of tax consequences of partnership activities depends upon the number of partners in a partnership and whether the partnership has elected to avail itself of certain special procedures. First, for partnerships with more than 10 partners, present law mandates application of the centralized audit rules enacted in 1982,[1290] unless the partnership is an electing large partnership. For an electing large partnership (a partnership with more than 100 partners that has elected to be subject to electing large partnership audit rules enacted in 1997), a different centralized audit process applies.[1291] Finally, for partnerships with 10 or fewer partners, that does not elect to be governed by TEFRA rules,[1292] adjustments to items of income, gain, loss, deduction, or credit of

[1290] Secs. 6221-6234, enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248), "TEFRA." Partnerships with fewer than 10 partners may elect to apply the TEFRA rules.

[1291] Secs. 6240-6256.

[1292] Prior to 1982, these rules applied regardless of the number of partners in the partnership.

a partnership are determined in separate proceedings, both administrative and judicial, for each partner, under procedures applicable generally to taxpayers subject to the Federal income tax.[1293]

TEFRA partnership audit rules

Unified audit rules

TEFRA established unified audit rules applicable, when enacted in 1982, to all but certain small (10 or fewer partners) partnerships. These rules require the tax treatment of all partnership items to be determined at the partnership, rather than the partner, level.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations. Those items that are related to the items required to be taken into account for the partnership's return but are more appropriately determined at the partner level are "affected items" and remain subject to determination at the partner level.

The rationale stated in 1982 for adding new audit rules for large partnerships was that "[d]etermination of the tax liability of partners resulted in administrative problems under prior law due to the fragmented nature of such determinations. These problems became excessively burdensome as partnership syndications have developed and grown in recent years. Large partnerships with partners in many audit jurisdictions result in the statute of limitations expiring with respect to some partners while other partners are required to pay additional taxes. Where there are tiered partnerships, identifying the taxpayer is difficult."[1294]

The TEFRA rules do not, however, change the process for collecting deficiencies at the partner (not the partnership) level, though a settlement agreement with respect to partnership items binds all parties to the settlement.[1295]

Tax Matters Partner

The TEFRA rules establish the "Tax Matters Partner" as the primary representative of a partnership in dealings with the IRS. The Tax Matters Partner is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no Tax Matters Partner is designated, and it is

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[1293] Secs. 6231 and 6201 *et seq.*

[1294] See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), December 31, 1982, p. 268. Additional reasons for the 1982 change mentioned include the problems of duplication of administrative and judicial effort, inconsistent results, difficulty of reaching settlement, and inadequacy of prior-law filing and recordkeeping requirements for foreign partnerships with U.S. partners.

[1295] Sec. 6224(c).

impractical to apply the largest profits interest rule, the IRS may select any partner as the Tax Matters Partner.

Notice requirements: notice required to partners separately

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than one percent.

Adjudication of disputes concerning partnership items

After the IRS makes an administrative adjustment, the Tax Matters Partner (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court.

Statute of limitations

Absent an agreement to extend the statute of limitations, the IRS generally cannot adjust a partnership item for a partnership taxable year if more than three years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return. The statute of limitations is extended in specified circumstances such as in the case of a false return, a substantial omission of income, or no return. If the administrative adjustment is timely made within the limitations period described above, the tax resulting from that adjustment, as well as tax attributable to affected items, including related penalties or additions to tax, must be assessed against the partners within one year after the conclusion of the period during which a final partnership administrative adjustment may be the subject of a petition to U.S. Tax Court.[1296]

Partners' limited ability to challenge partnership treatment

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.[1297] Additional tax attributable to an adjustment of a partnership item is assessed against each of the taxpayers who were partners in the year in which the understatement of tax liability arose. Accordingly, partners have rights to participate in administrative proceedings at the partnership level, can request an administrative adjustment or a refund for his own separate tax liability. Finally, to the extent that

[1296] Sec. 6229(d) and (g).

[1297] Secs. 6222 and 6230(b).

a settlement is reached with respect to partnership items, all partners are entitled to consistent treatment.[1298]

Electing large partnership audit rules

Definition of electing large partnership

In 1997, a new audit system was enacted for electing large partnerships.[1299] The 1997 legislation also enacted specific simplified reporting rules for electing large partnerships.[1300] The provisions define an electing large partnership as any partnership that elects to be subject to the specified reporting and audit rules, if the number of partners in the partnership's preceding taxable year is 100 or more.[1301]

The rationale stated in 1997 for adding new audit rules for large partnerships was that "[a]udit procedures for large partnerships are inefficient and more complex than those for other large entities. The IRS must assess any deficiency arising from a partnership audit against a large number of partners, many of whom cannot easily be located and some of whom are no longer partners. In addition, audit procedures are cumbersome and can be complicated further by the intervention of partners acting individually."[1302]

Unified audit rules

As under the TEFRA partnership audit rules, electing large partnerships and their partners are subject to unified audit rules. Thus, the tax treatment of partnership items is determined at the partnership, rather than the partner, level, and a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. The IRS may treat a partnership item that was reported inconsistently by a partner as a mathematical or clerical error and immediately assess any additional tax against that partner. Unlike the TEFRA partnership audit rules, however, partnership adjustments generally flow through to the partners for the year in which the adjustment takes effect and generally do not affect prior-year returns of any partners (except in the case of changes to any partner's distributive shares).

Partnership-level payment of tax, penalty and interest

In lieu of passing through an adjustment to its partners, the partnership may elect to pay an imputed underpayment. The imputed underpayment generally is calculated by netting the

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1298 Sec. 6224.

1299 The Taxpayer Relief Act of 1997, Pub. L. No. 105-34.

1300 Secs. 771-777.

1301 Sec. 775.

1302 See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, p. 363.

adjustments to the income and loss items of the partnership and multiplying that amount by the highest tax rate (whether individual or corporate). A partner may not file a claim for credit or refund of his allocable share of the payment. A partnership may make this election only if it meets requirements set forth in Treasury regulations designed to ensure payment (for example, in the case of a foreign partnership). The partnership, rather than the partners individually, generally is liable for any interest and penalties that result from a partnership adjustment. Payments for Federal income taxes, interest, or penalties are not deductible by an electing large partnership.

Regardless of whether a partnership adjustment passes through to the partners, an adjustment must be offset if it requires another adjustment in a year that is after the adjusted year and before the year the adjustment that was takes effect. For example, assume that an electing large partnership expenses a $1,000 item in year one. However, on audit in year four, it is determined that the item should have been capitalized and amortized ratably over 10 years rather than deducted in full in year one. The $900 adjustment for the improper deduction ($1,000 minus the year one amortization of $100) is offset by $200 of adjustments for amortization deductions in years two and three. The adjustment in year four is $700 (that is, $1,000 minus $300, the sum of the first three years' ratable amortization of $100 per year), apart from any interest or penalty. The year four partners are required to include an additional $700 in income for that year. The partnership ratably amortizes the $700 in years four to 10.

Interest is computed for the period beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment. Thus, in the above example, the partnership is liable for four years' worth of interest (on a declining principal amount).

Penalties (such as the accuracy and fraud penalties) are determined on a year-by-year basis (without offsets) based on an imputed underpayment. All accuracy penalty criteria and waiver criteria (such as reasonable cause or substantial authority) are determined as if the partnership were a taxable individual. Accuracy and fraud penalties are assessed and accrue interest in the same manner as if asserted against a taxable individual.

If a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to take the adjustment into account, as provided by regulations. Regulations are also authorized to prevent abuse and to enforce efficiently the audit rules in circumstances that present special enforcement considerations (such as partnership bankruptcy).

<u>Partners cannot request refunds separately</u>

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike the TEFRA partnership audit rules, however, partners have no right individually to participate in settlement conferences or to request a refund. Instead, the partnership proceeds through a representative that it designates to act on its behalf. The electing large partnership may designate a partner or other person to act as its representative. If an electing large partnership fails to designate such a person, the IRS is permitted to designate any one of the partners as the person authorized to act on the partnership's behalf. After the IRS's designation, an electing large partnership may still designate a replacement for the IRS-designated partner.

Notice requirements: separate partner notices not required

Unlike the TEFRA partnership audit rules, the IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS is authorized to send notice of a partnership adjustment to the partnership itself by certified or registered mail. The IRS may give proper notice by mailing the notice to the last known address of the partnership, even if the partnership had terminated its existence.

Adjudication of disputes concerning partnership items

As under the TEFRA partnership audit rules, an administrative adjustment can be challenged in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court. However, only the partnership, and not partners individually, can petition for a readjustment of partnership items.

If a petition for readjustment of partnership items is filed by the partnership, the court with which the petition is filed has jurisdiction to determine the tax treatment of all partnership items of the partnership for the partnership taxable year to which the notice of partnership adjustment relates, and the proper allocation of such items among the partners. Thus, the court's jurisdiction is not limited to the items adjusted in the notice.

Statute of limitations

Absent an agreement to extend the statute of limitations, the IRS generally cannot adjust a partnership item for a partnership taxable year if more than three years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return. The statute of limitations is extended in specified circumstances such as in the case of a false return, a substantial omission of income, or no return.

Timing of K-1s to partners

An electing large partnership is required to furnish copies of information returns (Schedule K-1, Partner's Share of Income, Deductions, Credits, etc.) to partners by March 15 following the close of the partnership's taxable year (often a calendar year).[1303] This differs from the timing rule applicable to other partnerships, which are required to furnish copies of Schedule K-1 to partners on or before the day on which the partnership return for the taxable year is required to be filed. This is generally the 15th day of the fourth month after the end of the partnership taxable year. For a partnership with a taxable year that is the calendar year, for example, the partnership return due date and the date by which Schedules K-1 must be furnished to partners is April 15. However, such a partnership can request a five-month extension of time

[1303] Sec. 6031(b).

to file the partnership return and the Schedule K-1 (to September 15 in the foregoing example).[1304]

Description of Proposal

Overview

The proposal repeals the substantive tax provisions and voluntary centralized audit procedures for electing large partnerships, as well as the audit procedures for TEFRA partnerships. In place of the repealed audit procedures, a single system of centralized audit, adjustment and collection of tax is mandated for all partnerships, except those eligible partnerships that have filed a valid election for a taxable year, as explained below. Under the proposed system, the audit and adjustments of all items are determined at the partnership level. These items include income, deduction, credits, and any partner's distributive share, as well as the taxes, interest or penalty attributable to such items. Unlike present law, distinctions among partnership items, non-partnership items and affected items are no longer made. An underpayment of tax determined as a result of an examination of a taxable year is imputed to the year during which the adjustment is finally determined, as explained below, and assessed against and collected from the partnership with respect to that year rather than the reviewed year.

Scope of the unified partnership audit rules

The new system is applicable to a partnership unless it has a valid election for a taxable year. A partnership is eligible to elect out of the centralized regime for a taxable year only if, as of the end of the partnership taxable year for which an election is made, it has 100 or fewer partners, each of whom is either an individual, a decedent's estate, a C corporation (other than a REIT or RIC), or a foreign entity that would be required to be treated as a C corporation if it were a domestic entity. If any partner is itself a partnership, the partnership is not eligible. The partnership must submit an election with a timely-filed return for the partnership taxable year to which the election relates; the election is valid only for that year. The election must include the names and taxpayer identification numbers of all partners. Finally, the partnership must notify each of its partners that it has exercised its election in order for the election to be respected. Notice to partners must be provided in the manner prescribed by the Secretary.

The centralized procedures generally require consistency between the partnership and partners, who are bound by all actions taken by the partnership under the procedures. The partnership acts through its designated partnership representative, who may be any partner or other person chosen by the partnership. If there is no one designated by the partnership, the Secretary may select one of the partners as a partnership representative. Thus, partners may not participate in or contest results of an examination of a partnership by the IRS. The requirement that there be consistency between the treatment of an item on a partnership return and the treatment of that item on the return of a partner is similar to the consistency requirement in present law. As in present law, underpayments that result from a failure of a partner to conform

[1304] Sec. 6031(b), and see Department of the Treasury, Internal Revenue Service, *2011 Instructions for Form 1065, U.S. Return of Partnership Income*, p. 3.

to the partnership reporting of an item is treated as a math error on the partner's return, cannot be abated under section 6213(b)(2), and may be subject to additions to tax.

Partnership adjustments

Partnership liability upon determination of adjustment to a partnership return

The taxable year under examination is the "reviewed year." After review, if adjustments are required, the IRS determines whether the partnership is liable for an imputed underpayment or has overstated its income. Adjustments may also arise as a result of requests for administrative adjustments initiated by the partnership, but only to the extent that the adjustments requested result in an imputed underpayment.

Imputed underpayments for years under review are determined as follows. All adjustments determined for the reviewed year are netted and multiplied by the highest rate of tax in effect and applicable to the reviewed year under section 1 or 11. A net increase or decrease in loss is treated as a net decrease or increase in income for purposes of this computation. Adjustments to items of credit are also taken into account as an increase or decrease in the net adjustments. If an adjustment reallocates the distributive shares of any item between partners, the netting of adjustments disregards the decrease in income or gain items and the increase in items of deduction, loss, or credit resulting from the reallocation.

Both imputed underpayments and reductions in income are to be reported on the partnership return for the adjustment year. Imputed underpayments must be paid by the adjustment year return due date, without regard to extensions of time to file. If the result of the adjustments reduces income of the partnership, the income of the partnership is adjusted consistent with the determinations in the notice. Although the proposal describes the case in which overstatements are determined as an "imputed overpayment," no actual overpayment is determined or paid at the entity level, because no tax was previously paid at the entity level. Instead, an imputed overpayment requires that the adjustments are reflected in the next filed partnership return as a reduction of non-separately stated income or an increase in non-separately stated loss, as appropriate under section 702(a)(8).

Adjustments that are the subject of a notice of final adjustment are given effect in the year in which the notice is issued, unless the notice is the subject of a court proceeding. In that event, the adjustment year is the year in which a decision in the proceeding becomes final. In contrast, if an adjustment is initiated by a request of the partnership, the adjustment year is the year in which the request is made.

The proposal includes a special rule that holds the partnership and all persons that were partners during either the reviewed year or the adjustment year to be jointly and severally liable for any imputed underpayment, including related additions to tax, penalties and interest.

Penalty and interest computation after an adjustment to the reviewed year

A partnership may incur penalties and interest related to an imputed underpayment. In determining the interest due from the partnership, two periods are relevant: the period in which the imputed underpayment of income tax exists, and the period attributable only to late payment of any imputed underpayment after notice and demand. For an imputed underpayment, interest accrues for the period from the due date of the return for the reviewed year until the due date of the adjustment year return, or, if earlier, payment of the imputed tax. If the imputed underpayment is not timely paid with the return for the adjustment year, interest is computed from the return due date for the adjustment year until payment.

Procedures for handling disputed partnership adjustments

The issuance of a notice of proposed partnership adjustment begins the running of a period of 180 days in which the partnership may establish that the imputed underpayment should be a different, lower amount, calculated on the basis of completed amended returns of each partner for the reviewed year. If a return of a partner is not available and submitted with any application to reduce the imputed underpayment, it is presumed that the partner whose return is not provided would be taxed as part of the proposed partnership adjustment at the maximum tax rate applicable in the adjustment year under sections 1, 11, etc., as applicable.

If a notice of final partnership adjustment is issued to the partnership, a 90-day period begins during which the partnership may seek judicial review of the partnership adjustment. The rules applicable to seeking judicial review are similar to those under present law for electing large partnerships. Further notices of adjustment or assessments of tax against the partnership are prohibited during the period in which judicial review may be sought or during which a judicial proceeding is pending.

Required notices and limitations period

If the IRS selects a partnership return or administrative adjustment request ("AAR") for examination, it must provide notice of administrative proceeding to the partnership. Any notice of a proposed adjustment issued to the partnership must identify all adjustments and inform the partnership of the amount of any imputed underpayment. The partnership generally has 180 days from the issuance of that notice to seek a modification of the imputed underpayment. The IRS may agree to extend the period of time in which the request for modification is submitted, under procedures to be established for submitting and reviewing requests for modification. The procedures are required to provide rules that exclude from any underpayment of tax the portion of adjustments that may have already been taken into consideration on amended returns filed by partners and for which the allocable underpayment of tax was paid.

A general three year limitations period is provided. If no adjustment is made by the IRS or requested by the partnership within three years of the date on which the partnership return was originally due (or the actual filing date if filed after its due date), no adjustments are permitted subsequently. However, if the partnership requests an administrative adjustment within that three year period, the IRS is permitted three years from the date that the request was made in which to review the request and make further adjustments.

A partnership may request an administrative adjustment for an earlier filed return within three years of the filing of that return, but only to the extent that the adjustment in question results in an imputed underpayment. If an overstatement of income is found, the partnership must take it into account as a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate) under section 702(a)(8) in the partnership taxable year for which the AAR is made. No request for administrative adjustment is available with respect to a taxable year with respect to which the IRS has mailed a notice of an administrative proceeding.

Example

The intended interaction of the notice requirements, limitations period with regard to adjustments to partnership returns, and interest on imputed underpayments is illustrated in this example.

Assume that for partnership taxable year 2014, the return of ABC Partnership is due March 15, 2015, and is filed timely. Absent any other events, the general three-year limitations period expires March 15, 2018. Within that period, on April 1, 2016, the partnership submits an AAR, correcting several errors that result in an underpayment of tax. The issues raised in that AAR are open for review by the IRS for three years from the date the AAR is submitted, ending in April 2019. All other issues on the return remain subject to the limitations period expiring in March 2018.

In March 2017, a timely return is filed for taxable year 2016, with a limitations period expiring in 2020. On that return, the adjustments identified in the AAR for 2014 are reflected in the non-separately stated income, and the imputed underpayment is paid with the return.

Errors in the adjustments made by the partnership in its AAR may be the subject of examination by the IRS in two ways: an examination of the AAR itself, with 2014 as the reviewed year, may be initiated, or errors in the adjustments may be identified as an outgrowth of issues examined during an audit of the 2016 return, which is the adjustment year for purposes of the AAR.

If the AAR is itself selected for examination, the IRS must open an audit of the AAR issues for taxable year 2014, and complete the audit and any adjustment by April 2019. Interest on any adjustment to the AAR accrues from the 2015 due date of the 2014 timely return.

If instead, the IRS did not select the AAR for audit, but did select the 2016 taxable year for audit, it is possible that it may identify an issue with respect to the AAR, and wish to determine its correctness. In order to do so, it may open a related audit of the 2014 year, issuing the notice of initiation of proceedings, and completing its audit of the reviewed year before the expiration of the statute of limitations for the AAR expires in April 2019. As in the case when there is no simultaneous audit of the 2016 return ongoing, the additional tax that should have been reported and paid on the 2016 adjustment year return will incur interest from the filing date of the 2014 return.

If the examination of the AAR is not completed by April 2019, the adjustments that the partnership carried to the 2016 return may nevertheless be corrected as part of the tax year 2016 examination. In order to determine whether there are erroneous items on the return that result from the AAR, information from 2014 remains relevant. However, for purposes of the limitations period for adjusting 2016 and for interest calculations, tax year 2016 is the reviewed year, and the adjustment year is the year in which the notice of final partnership adjustment to tax year 2016 becomes final. As a result, interest on the 2014 imputed underpayment that was reflected on the 2016 return accrues from the date of the 2016 return due date, not that of 2014.

Regulatory authority

The proposal grants specific regulatory authority to address the identification of foreign partners, the manner of notifying partners of an election out of centralized procedures, the manner in which a partnership representative is selected, and the extent to which the proposed system may be applied before the generally applicable effective date.

Effective Date

The proposal applies generally to partnership returns filed for taxable years ending after December 31, 2014. A partnership may elect to apply the centralized procedures to returns filed for years ending after date of enactment but before January 1, 2015, in accordance with rules prescribed by the Secretary.

Overview of Real Estate Investment Trusts ("REITs")

In general

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but elects to be taxed under a special REIT tax regime. In order to qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[1305] the REIT must derive most of its income from passive, generally real-estate-related, investments; and REIT assets must be primarily real-estate related. In addition, a REIT must have transferable interests, at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by 5 or fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[1306]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders as a dividend or qualifying liquidating distribution each year is deductible by the REIT (unlike the case of a regular subchapter C corporation, which cannot deduct such distributions).[1307] As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level. Although a REIT is not required to distribute more than the 90 percent of its income described above in order to retain REIT status, it is taxed at ordinary corporate rates on amounts not distributed or treated as distributed.[1308]

A REIT may designate a capital gain distribution to its shareholders, who treat the designated amount as capital gain when distributed. A REIT also may retain net capital gain and pay corporate income tax on the amount retained, while the shareholders include the undistributed capital gain in income, obtain a credit for the corporate tax paid, and step up the basis of their REIT stock for the amount included in income.[1309] In this manner, capital gain also is taxed only once, whether or not distributed, rather than at both the entity and investor level.

[1305] Even if a REIT meets the 90 percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under section 4981.

[1306] Secs. 856 and 857.

[1307] Liquidating distributions are covered to the extent of earnings and profits, and are defined to include redemptions of stock that are treated by shareholders as a sale of stock under section 302. Secs. 857(b)(2)(B), 561, and 562(b).

[1308] An additional four-percent excise tax is imposed, to the extent a REIT does not distribute at least 85 percent of REIT ordinary income and 95 percent of REIT capital gain net income within a calendar year period. In addition, to the extent a REIT distributes less than 100 percent of its ordinary income and capital gain net income in a year, the difference between the amount actually distributed and 100 percent is added to the distribution otherwise required in a subsequent year to avoid the excise tax. Sec. 4981.

[1309] Sec. 857(b)(3).

Income tests

In general

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real-estate-related income. Such income includes: rents from real property; income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test").[1310] Qualifying rents from real property include rents from interests in real property and charges for services customarily furnished or rendered in connection with the rental of real property,[1311] but do not include impermissible tenant service income. Impermissible tenant service income includes amounts for services furnished by the REIT to tenants or for managing or operating such property, other than amounts attributable to customary services that are provided by an independent contractor or taxable REIT subsidiary, or services that certain tax exempt organizations could perform under the 512(b)(3) rental exception from unrelated business taxable income.[1312] Qualifying rents from real property include rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, the lease.[1313]

[1310] Secs. 856(c)(3) and 1221(a)(1). Income from sales that are not prohibited transactions solely by virtue of section 857(b)(6) also is qualified REIT income.

[1311] Secs. 856(d)(1)(A) and (B).

[1312] Sec. 856(d)(7)(A) and (C). If impermissible tenant service income with respect to any real or personal property is more than one percent of all amounts received or accrued during the taxable year directly or indirectly with respect to such property, then the impermissible tenant service income with respect to such property includes all such amounts. Sec. 856(d)(7)(B). The amount treated as received for any service (or management or operation) shall not be less than 150 percent of the direct cost of the trust in furnishing or rendering the service (or providing the management or operation). Sec. 856(d)(7)(D). For purposes of the 75-percent and 95-percent income tests, impermissible tenant service income is included in gross income of the trust. Sec. 856(d)(7)(E).

Treasury regulations that interpret the term rents from real property for purposes of the exempt organization rental exception from unrelated business taxable income state that payments for the use or occupancy of rooms and other space where "services are also rendered to the occupant" does not constitute rents from real property. "Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant." Treas. Reg. sec. 1.512(b)-1(c)(5).

[1313] Sec. 856(d)(1)(C).

In addition, rents received from any entity in which the REIT owns more than 10 percent of the vote or value generally are not qualifying income. However, there is an exception for certain rents received from taxable REIT subsidiaries (described further below), in which a REIT may own more than 10 percent of the vote or value.

In addition, 95 percent of the gross income of a REIT for each taxable year must be from the 75-percent income sources and a second permitted category of other, generally passive investments such as dividends, capital gains, and interest income (the "95-percent income test").[1314]

A REIT must be a U.S. domestic entity, but it is permitted to hold foreign real estate or other foreign-based assets, provided the 75-percent and 95-percent income tests and the other requirements for REIT qualification are met.[1315]

Asset tests

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and Government securities[1316] (the "75-percent asset test"). Real estate assets are real property (including interests in real property and mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.[1317] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[1318]

Except with respect to a taxable REIT subsidiary (described further below), not more than 5 percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[1319] In addition, not more than 25 percent of the value of a REIT's assets may be securities of one or more taxable REIT subsidiaries.[1320]

[1314] Sec. 856(c)(3).

[1315] See Rev. Rul. 74-191, 1974-1 C.B. 170.

[1316] Government securities are defined for this purpose under section 856(c)(5)(F), by reference to the Investment Company Act of 1940. The term includes securities issued or guaranteed by the United States or persons controlled or supervised by and acting as an instrumentality thereof, but does not include securities issued or guaranteed by a foreign, state, or local government entity or instrumentality.

[1317] Sec. 856(c)(4)(A). Temporary investments in certain stock or debt instruments also can qualify if they are temporary investments of new capital, but only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[1318] Sec. 856(c)(4)(B)(i).

[1319] Sec. 856(c)(4)(B)(iii).

[1320] Sec. 856(c)(4)(B)(ii).

The asset tests must be met as of the close of each quarter of a REIT's taxable year. However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition.[1321]

Taxable REIT subsidiaries

A REIT generally cannot own more than 10 percent of the vote or value of a single entity. However, there is an exception for ownership of a taxable REIT subsidiary ("TRS") that is taxed as a corporation, provided that securities of one or more TRSs do not represent more than 25 percent of the value of REIT assets.

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility, or to provide to any other person (under a franchise, license, or otherwise) rights to any brand name under which any lodging facility or health care facility is operated.[1322]

However, a TRS may rent a lodging facility or health care facility from its parent REIT and is permitted to hire an independent contractor[1323] to operate such facility. Rent paid to the parent REIT by the TRS with respect to hotel, motel, or other transient lodging facility operated by an independent contractor is qualified rent for purposes of the REIT's 75-percent and 95-percent income tests. This lodging facility rental rule is an exception to the general rule that rent paid to a REIT by any corporation (including a TRS) in which the REIT owns 10 percent or more of the vote or value is not qualified rental income for purposes of the 75-percent or 95-percent REIT income tests. An exception to the general rule also exists in the case of a TRS that rents space in a building owned by its parent REIT if at least 90 percent of the space in the building is rented to unrelated parties and the rent paid by the TRS to the REIT is comparable to the rent paid by the unrelated parties.

REITs are subject to a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest. These are defined generally as the amounts of specified REIT

[1321] Sec. 856(c)(4). In the case of such an acquisition, the REIT also has a grace period of 30 days after the close of the quarter to eliminate the discrepancy.

[1322] The latter restriction does not apply to rights provided to an independent contractor to operate or manage a lodging or health care facility if such rights are held by the corporation as a franchisee, licensee, or in similar capacity and such lodging facility or health care facility is either owned by such corporation or is leased by such corporation from the REIT.

[1323] An independent contractor will not fail to be treated as such for this purpose because the TRS bears the expenses of operation of the facility under the contract, or because the TRS receives the revenues from the operation of the facility, net of expenses for such operation and fees payable to the operator pursuant to the contract, or both. Sec. 856(d)(9)(B).

transactions with a TRS of the REIT, to the extent such amounts differ from an arm's length amount.[1324]

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is "stock in trade of a taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business" (sec. 1221(a)(1))[1325] and is not foreclosure property. The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in sections 857(b)(6)(C) or (D), including an asset holding period of at least two years.[1326] If the conditions are met, a REIT may either i) make no more than seven sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or ii) sell either no more than 10 percent of the aggregate bases, or no more than 10 percent of the aggregate fair market value, of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.

REIT shareholder tax treatment

Although a REIT typically does not pay corporate level tax due to the deductible distribution of its income, and thus is sometimes compared to a partnership or S corporation, REIT equity holders are not treated as being engaged in the underlying activities of the REIT as are partners or S corporation shareholders, and the activities at the REIT level that characterize its income do not generally flow through to equity owners to characterize the tax treatment of REIT distributions to them. A distribution to REIT shareholders out of REIT earnings and profits is generally treated as an ordinary income REIT dividend and is treated as ordinary income taxed at the shareholder's normal rates on such income.[1327] However, a REIT is

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[1324] Sec. 857(b)(7).

[1325] This definition is the same as the definition of certain property the sale or other disposition of which would produce ordinary income rather than capital gain under section 1221(a)(1).

[1326] Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property, require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person.

[1327] Because a REIT dividend is generally paid out of income that was not taxed to the distributing entity, the dividend is not eligible for the dividends received deductions to a corporate shareholder. Sec. 243(d)(3). A REIT dividend is not eligible for the 20 percent qualified dividend rate to an individual shareholder, except to the extent such dividend is attributable to REIT income from nondeductible C corporation dividends, or to certain income of the REIT that was subject to corporate level tax. Sec. 857(c).

permitted to designate a "capital gain dividend" to the extent a distribution is made out of its net capital gain.[1328] Such a dividend is treated as capital gain to the shareholders.[1329]

REIT shareholders are not taxed on REIT income unless the income is distributed to them (except in the case of REIT net capital gain retained by the REIT and designated for inclusion in the shareholder's income as explained in the preceding footnote). However, since a REIT must distribute 90 percent of its ordinary income annually, and typically will distribute or designate its income as capital gain dividends to avoid a tax at the REIT level, REIT income generally is taxed in full at the shareholder level annually.

REIT shareholders are not entitled to any share of REIT losses to offset against other shareholder income. However, if the REIT itself has income, its losses offset its income in determining how much it is required to distribute to meet the distribution requirements. Also, REIT losses that reduce earnings and profits can cause REIT distributions that exceed its earnings and profits to be treated as a non-taxable return of capital to its shareholders.

Tax exempt shareholders

A tax exempt shareholder is exempt from tax on REIT dividends, and is not treated as engaging in any of the activities of the REIT. As one example, if the REIT borrowed money and its income at the REIT level were debt-financed, a tax exempt shareholder would not have debt-financed unrelated business income from the REIT dividend. This can make real estate investment through a REIT more attractive for tax exempt investors.

Foreign shareholders

Except as provided by the Foreign Investment in Real Property Tax Act ("FIRPTA")[1330] a REIT shareholder that is a foreign corporation or a nonresident alien individual normally treats its dividends as fixed and determinable annual and periodic income that is subject to withholding under section 1441 but not treated as active business income that is effectively connected with the conduct of a U.S. trade or business, regardless of the level of real estate activity of the REIT

[1328] Net capital gain is the excess of the net long term capital gain for the taxable year over the net short term capital loss for the taxable year. Sec. 1221.

[1329] A REIT may also retain its net capital gain without distribution, while designating a capital gain dividend for inclusion in shareholder income. In this case, the REIT pays corporate-level tax on the capital gain, but the shareholder includes the undistributed capital gain in income, receives a credit for the corporate level tax paid, and steps up the basis of the REIT stock for the amount included in income, with the result that the net tax paid is the shareholder level capital gain tax.

[1330] FIRPTA treats income of a foreign investor from the sale or disposition of U.S. real property interests as effectively connected with the operation of a trade or business in the U.S. Such income is taxed at regular U.S. rates and withholding obligations are imposed on payors of the income. Secs. 897 and 1445.

in the United States.[1331] A number of treaties permit a lower rate of withholding on REIT dividends than the Code would otherwise require.

Although FIRPTA applies in many cases to foreign investment in U.S. real property through a REIT, REITs offer foreign investors some ability to invest in U.S real property interests without subjecting gain on the sale of REIT stock to FIRPTA (for example, if the REIT is domestically controlled). Also, if the REIT stock is publicly traded and the foreign investor does not own more than five percent of such stock, the investor can receive distributions from the sale by the REIT of U.S. real property interests, without such distributions being subject to FIRPTA.

21. Prevention of tax-free spinoffs involving REITs (sec. 3631 of the discussion draft and sec. 355 of the Code)

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if the corporation had sold such property for its fair market value. In addition, the shareholders receiving the distributed property are ordinarily treated as receiving a dividend of the value of the distribution (to the extent of the distributing corporation's earnings and profits), or capital gain in the case of a stock buyback that significantly reduces the shareholder's interest in the parent corporation.

An exception to these rules applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355. If all the requirements are satisfied, there is no tax to the distributing corporation or to the shareholders on the distribution.

One requirement to qualify for tax-free treatment under section 355 is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period (the "active business test").[1332] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all its assets consist of stock and securities of one or more corporations that it controls that are engaged in the active conduct of a trade or business.[1333] For this purpose, the active business test is applied by reference to the relevant affiliated group rather than on a single corporation basis. For the parent distributing corporation, the relevant affiliated group consists of the distributing corporation as

[1331] As noted above, REITs are not permitted to receive income from property that is inventory or that is held for sale to customers in the ordinary course of the REIT's business. However, REITs may engage in certain activities, including acquisition, development, lease, and sale of real property, and may provide "customary services" to tenants.

[1332] Sec. 355(b).

[1333] Sec. 355(b)(1).

the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are otherwise includible corporations under section 1504(b)),[1334] immediately after the distribution. The relevant affiliated group for a controlled distributed subsidiary corporation is determined in a similar manner (with the controlled corporation as the common parent).

In determining whether a corporation is directly engaged in an active trade or business that satisfies the requirement, old IRS guidelines for advance ruling purposes required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[1335] The IRS suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of section 355 transactions in general.[1336]

Section 355 does not apply to an otherwise qualifying distribution if, immediately after the distribution, either the distributing or the controlled corporation is a disqualified investment corporation and any person owns a 50 percent interest in such corporation and did not own such an interest before the distribution. A disqualified investment corporation is a corporation of which two-thirds or more of its asset value is comprised of certain passive investment assets. Real estate is not included as such an asset.[1337]

The IRS has ruled that a REIT may satisfy the active business requirement though its rental activities.[1338] More recently, the IRS has issued a private ruling indicating that a REIT that has a taxable REIT subsidiary can satisfy the active business requirement by virtue of the active business of its taxable REIT subsidiary.[1339] Thus, a C corporation that owns REIT qualified assets may create a REIT to hold such assets and spin off that REIT without tax consequences. Following the spin-off, income from the assets held in the REIT is no longer subject to corporate

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[1334] Sec. 355(b)(3). Foreign corporations, insurance companies, and certain other types of corporations are not eligible to file consolidated tax returns with other corporations. However, these exceptions would not apply under the proposal for section 355 purposes, if the relevant stock ownership requirement is met.

[1335] Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113.

[1336] Rev. Proc. 2003-48, 2003-29 I.R.B. 86. More recently, the IRS announced it is discontinuing private rulings on whether a transaction qualifies for nonrecognition treatment under section 355. However, it may rule on certain significant issues. Rev. Proc. 2013-32, 2013-28 I.R.B. 55; Rev. Proc. 2014-1, 2014-1 I.R.B. 1; Rev. Proc. 2014-3, 2014-1 I.R.B. 111.

[1337] Sec. 355(g).

[1338] Rev. Rul. 2001- 29, 2001-1 C.B. 1348.

[1339] Priv. Ltr. Rul. 201337007. A private ruling may be relied upon only by the taxpayer to which it is issued. However, private rulings provide some indication of administrative practice.

level tax (unless there is a disposition of such assets that incurs tax under the built in gain rules).[1340]

Description of Proposal

The proposal makes a REIT ineligible to participate in a tax-free spin-off as either a distributing or controlled corporation under section 355. Also, if a corporation that is not a REIT was a distributing or controlled corporation with respect to any distribution to which section 355 applied, such corporation (and any successor corporation) shall not be eligible to make a REIT election for any taxable year prior to the 10th taxable year which begins after the taxable year in which such distribution was made.

Effective Date

The proposal generally applies to distributions on or after February 26, 2014. However, the proposal shall not apply to any distribution made pursuant to an agreement which was binding on February 26, 2014 and at all times thereafter.

22. Extension of period for prevention of REIT election following revocation or termination (section 3632 of the discussion draft and section 856(g)(3) of the Code)

Present Law

If an election to be a REIT has been terminated for failure to qualify, or has been revoked by the entity, the entity generally is not eligible to again elect to be a REIT for any taxable year prior to the fifth taxable year which begins after the first taxable year for which such revocation or termination is effective.[1341]

Description of Proposal

The proposal would change to 10 years the period during which a new REIT election cannot be made, following revocation or termination of a REIT election.

Effective Date

The proposal is effective for terminations and revocations after December 31, 2014.

[1340] The built-in gain rules applicable to REIT assets that were formerly held in a C corporation are the subject of a separate proposal under section 3647 of the discussion draft.

[1341] The five-year restriction does not apply to certain cases of failure to qualify that do not involve fraud and that the taxpayer can establish were due to reasonable cause and not willful neglect. Sec. 856(g)(4).

23. Certain short-life property not treated as real property for purposes of REIT provisions (section 3633 of the discussion draft and sec. 856 of the Code)

Present Law

The definition of real property for purposes of REIT qualification is significant because both the income and asset tests depend on that definition. Qualified income includes rents from real property, interest on obligations secured by mortgages on real property or interests in real property, and gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property). Qualified assets include real property, interests in real property, and interests in mortgages secured by such assets.[1342]

The definition of real property under present law has been based on concepts relating to whether an asset is an inherently permanent structure, generally referring to permanent attachment of an asset to real property (covering, for example, railroad track, certain billboards, transmission towers, pipelines, and oil and gas platform rigs).[1343]

Treasury Regulations under the REIT provisions state:

"The term 'real property' means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items that are structural components of those buildings or structures). In addition, real property includes interests in real property. Local law definitions do not control for purposes of determining the meaning of the term real property as used in section 856 and the regulations thereunder. The term includes, for example, the wiring of a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items that are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment that is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though those items may be termed fixtures under local law."[1344]

Under the depreciation rules, the tax depreciation treatment of assets such as an inherently permanent structure, or a structural component of such a structure, may be uncertain. Judicial authority looks to a number of factors to determine whether an asset is an inherently

[1342] See overview of present law, supra, for a discussion of the specific income and asset requirements.

[1343] See, *e.g.*, Rev. Rul. 69-94, 1969-1 C.B.189 (railroad properties including track and roadbed); Rev. Rul. 75-424, 1975-2 C.B. 269 (microwave transmission system); Priv. Ltr. Rul. 200937006 (gas pipeline system); Priv. Ltr. Rul. 201037005 (data center); Priv. Ltr. Rul. 20119007 (wireless and broadcast communication towers, sites, and generators); Priv. Ltr. Rul. 201143001l(billboards attached to building and also free standing tower structure billboards); Priv. Ltr. Rul. 201204006 (sign superstructures on façade of building); Priv. Ltr. Rul. 20125003 (offshore oil and gas platform). A private letter ruling may be relied upon only by the taxpayer to whom it is issued. However, private letter rulings provide some indication of administrative practice.

[1344] Treas. Reg. sec. 1.856-3(d).

permanent structure.[1345] The IRS has permitted taxpayers to use certain safe harbor methods for specific assets, allowing certain components to be depreciated over shorter periods than others.[1346] On the other hand, where a taxpayer has represented that assets it owns could be depreciated over shorter lives under such a safe harbor are in fact inherently permanent structures, the IRS has allowed treatment as longer lived land-improvement assets.[1347]

Description of Proposal

The proposal excludes tangible property that has a class life for depreciation purposes of less than 27.5 years from the definition of real property for purposes of the REIT provisions.

For this purpose, the class life is the greater of the class life of an asset in the hands of the REIT, or the class life which would be applicable if the asset were placed in service in the current taxable year, as determined under the relevant other provisions of the discussion draft.[1348]

Effective Date

The proposal is effective for taxable years beginning after December 31, 2016.

24. Repeal of special rules for timber held by REITs (sec. 3634 of the discussion draft and secs. 856 and 857 of the Code)

Present Law

Some REITs hold land on which trees are grown. Upon maturity of the trees, the standing trees are either sold outright by the REIT, disposed of under a contract in which the REIT retains an economic interest in the timber, or cut by a taxable REIT subsidiary that further processes the timber. The Internal Revenue Service has issued private letter rulings in particular instances stating that the income from the sale of the trees under section 631(b) can qualify as REIT real property income.[1349]

[1345] See, *e.g.*, *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664, acq., 1980-1 C.B. 1. No one factor is decisive. See, *JFM, Inc. and Subsidiaries v. Commissioner*, T.C.M. 1994-239.

[1346] See, *e.g.*, Rev. Proc. 2011-22, 2011-1 C.B.737 (providing a safe harbor method of accounting for determining the recovery periods for depreciation of certain tangible assets used by wireless communications systems (not applicable to cable systems).

[1347] Priv. Ltr. Rul. 201216029 (classification of certain cellular antenna towers not required to follow the safe harbor and may classify the assets as land improvements, where taxpayer represents that assets are inherently permanent structures under the factors described in *Whiteco Industries, Inc., supra*).

[1348] For a discussion of a proposal concerning depreciation, see section 3104, Reform of accelerated cost recovery system.

[1349] Timber income under section 631(b) has also been held to be qualified real estate income even if the one year holding period is not met. See, *e.g.*, Priv. Ltr. Rul. 200052021, see also Priv. Ltr. Rul. 199945055, Priv. Ltr. Rul. 199927021, Priv. Ltr. Rul. 8838016. A private letter ruling may be relied upon only by the taxpayer to

In 2008, a number of rules relating to timber and timberland held by REITs were enacted that applied only to REITs holding timber and timberland. Among those was a rule that is still in effect, providing a safe harbor from the prohibited transactions tax for certain REIT sales of timber property that was held by the REIT in connection with the trade or business of producing timber.

Other rules enacted in 2008 with respect to timber and timberland expressly included income from the different types of timber disposition as qualified REIT income and specified the tax consequences when timber is cut by a taxable REIT subsidiary. The rules also treated as income qualified under the 95-percent income test (but not the 75-percent income test) certain mineral royalties from real property held, or once held, by a REIT in connection with the trade or business of producing timber. All of those rules expired on the last day of a REIT's first taxable year beginning after the date of their enactment (May 22, 2008) and before the date that is one year after such date of enactment.

Description of Proposal

The proposal excludes timber from the definition of real property for all purposes of the REIT provisions.

As conforming amendments, the proposal also repeals each of the special rules applicable to REITs that hold or dispose of timber or timberland.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2016.

25. Limitation on fixed percentage rent and interest exceptions for REIT income tests (sec. 3635 of the discussion draft and sec. 856 of the Code)

Present Law

Rent from interests in real property (and certain related rent from a limited amount of personal property) is generally qualified income for purposes of the 75-percent and 95-percent REIT income tests. Qualified rental income does not include any amount that is dependent in whole or in part on the income or profits derived by any person from such real or personal

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which the ruling is issued. However, such rulings provide some indication of administrative practice. The rulings relate only to section 631(b) as in effect at the time the rulings were issued. Since that time, section 631(b) was expanded to include outright sales of standing timber. Compare Treas. Reg. sec. 1.512(b)-1(d) and Priv. Ltr. Rul. 8520132, interpreting section 512(b)(5), which does not allow a tax exempt organization that directly holds timberland or that holds it through a partnership to exclude from UBTI any gain from timber cutting that is treated as capital gain sales income under section 631. The regulations state that section 631(a) income of the taxpayer from its own cutting of timber is UBTI. The Private Letter Ruling concluded that income under section 631(b) was not UBTI.

property. However, rent is not disqualified solely by reason of being based on a fixed percentage or percentages of receipts or sales.[1350]

A similar rule applies to interest on mortgages secured by real property that qualify for the 75-percent and 95-percent income tests, and to interest that qualifies only for the 95-percent income test.[1351] Thus, such qualified interest income cannot be dependent in whole or in part on the income or profits derived by any person, except that amounts are not excluded from the term "interest" solely by reason of being based on a fixed percentage or percentages of receipts or sales.

Description of Proposal

Under the proposal, if the fixed percentage rent and interest income received or accrued by a REIT from a single C corporation (other than a taxable REIT subsidiary that is 100 percent owned by the REIT) for any taxable year exceeds either (A) 25 percent of the fixed percentage rent income received or accrued by such REIT for such taxable year, or (B) 25 percent of the fixed percentage interest income received or accrued by such REIT for such taxable year, then none of the fixed-percentage rent received or accrued from such corporation which is attributable to leases entered into after December 31, 2014, shall be treated as rents from real property, and none of the fixed percentage interest income received or accrued from such corporation which is attributable to debt instruments acquired by the REIT after December 31, 2014 is treated as interest.

Members of the same affiliated group (as defined in section 1504, applied by substituting 50 percent for 80 percent) are treated as one corporation.

For purposes of the proposal, any material modification (including any extension of their term) of a lease or debt instrument shall be treated as a new lease or debt instrument, as the case may be, entered into or acquired on the date of such modification.

Effective Date

The proposal applies to taxable years ending after December 31, 2014.

[1350] Sec. 856(d)(2)(A).

[1351] Sec. 856(f)(1). Income from a shared appreciation provision of a mortage is treated as gain from the sale of the secured property that is qualified income for purposes of the 75-percent and 95-percent income tests. Sec. 856(j).

26. Repeal of preferential dividend rule for publicly offered REITS; Authority for alternative remedies to address certain failures (secs. 3636 and 3637 of the discussion draftl and sec. 562 of the Code)

Present Law

A REIT is allowed a deduction for dividends paid to its shareholders.[1352] In order to qualify for the deduction, a dividend must not be a "preferential dividend."[1353] For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference.

Similar rules appliy to regulated investment companies ("RICs"). However, the preferential dividend rule does not apply to a publicly offered RIC (as defined in section 67(c)(2)(B)).[1354]

Description of Proposal

The proposal repeals the preferential dividend rule for publicly offered REITs. For this purpose, a REIT is publicly offered if it is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

For other REITs, the proposal provides the Secretary of the Treasury with authority to provide an appropriate remedy to cure the failure of the REIT to comply with the preferential dividend requirements in lieu of not considering the distribution to be a dividend for purposes of computing the dividends paid deduction where the Secretary determines the failure to comply is inadvertent or is due to reasonable cause and not due to willful neglect, or the failure is a type of failure identified by the Secretary as being of so described.

Effective Date

The proposal applies to distributions in taxable years beginning after December 31, 2014.

27. Limitations on designation of dividends by REITs (sec. 3638 of the discussion draft and sec. 857 of the Code)

Present Law

A REIT that has a net capital gain for a taxable year may designate dividends that it pays or is treated as paying during the year as capital gain dividends.[1355] A capital gain dividend is

[1352] Sec. 857(b)(2)(B).

[1353] Sec. 562(c).

[1354] Secs. 852(b), 562(c).

[1355] Sec. 857(b)(3)(A).

treated by the shareholder as gain from the sale or exchange of a capital asset held more than one year. The amount that may be designated as capital gain dividends for any taxable year may not exceed the REIT's net capital gain for the year. Special rules apply to gains that are taxed at different rates to the shareholders.

Also a REIT may designate dividends that it pays or is treated as paying during the year as qualified dividend income.[1356] Qualified dividend income is taxed to individuals at the same tax rate as net capital gain, under rules enacted by the Taxpayer Relief Act of 1997.[1357] The amount that may be designated as qualified dividend income for any taxable year is limited to qualified dividend income received by the REIT plus some amounts subject to corporate taxation at the REIT level.

The IRS has ruled that a RIC may designate the maximum amount permitted under each of the provisions allowing a RIC to designate dividends even if the aggregate of all the designated amounts exceeds the total amount of the RIC's dividends distributions.[1358]

The IRS also has ruled that if a RIC has two or more classes of stock and it designates the dividends that it pays on one class as consisting of more than that class' proportionate share of a particular type of income, the designations are not effective for federal tax purposes to the extent that they exceed the class' proportionate share of that type of income.[1359] The Internal Revenue Service announced that it would provide guidance that RICs and REITs must use in applying the capital gain provision enacted by the Taxpayer Relief Act of 1997.[1360] The announcement referred to the designation limitations of Revenue Ruling 89-91.

Description of Proposal

The proposal limits the aggregate amount of dividends designated by a REIT for a taxable year under all of the designation provisions to the amount of dividends paid with respect to the taxable year (including dividends described in section 858 that are paid after the end of the REIT taxable year but treated as paid by the REIT with respect to the taxable year).

The proposal provides the Secretary of the Treasury authority to prescribe regulations or other guidance requiring the proportionality of the designation for particular types of dividends (for example, capital gain dividends) among shares or beneficial interests in a REIT.

[1356] Sec. 857(c)(2).

[1357] Sec. 1(h)(11) enacted in Pub. L. No. 105-34.

[1358] Rev. Rul 2005-31, 2005-1 C.B.1084.

[1359] Rev. Rul. 89-81,1989-1 C.B.226.

[1360] Notice 97-64, 1997-2 C.B. 323.

Effective Date

The proposal applies to distributions in taxable years beginning after December 31, 2014.

28. Non-REIT earnings and profits required to be distributed by REIT in cash (sec. 3639 of the discussion draft and sec. 857 of the Code)

Present Law

An entity cannot qualify as a REIT for any taxable year unless, as of the close of that taxable year, the REIT has no earnings and profits accumulated in any non-REIT year.[1361] Thus, if a C corporation that has earnings and profits accumulated in a non-REIT year elects to become a REIT, all such non-REIT earnings and profits must be distributed to shareholders by the end of the entity's first taxable year as a REIT.[1362] Also, an existing REIT will not satisfy this requirement if, at the close of a taxable year, it has non-REIT earnings and profits that were succeeded to in a reorganization with a company that was not taxable as a REIT.[1363] To meet the requirement, a C corporation that intends to become a REIT or to combine with a REIT may choose to reduce or eliminate its earnings and profits by paying a dividend prior to the first taxable year for which it elects REIT status. In addition, the entity can distribute any remaining non-REIT earnings and profits during its first taxable year for which it elects REIT status.

In some situations, in order to conserve cash, a C corporation or a REIT may wish to pay a portion of any dividend to shareholders in the form of the corporation's own stock. A pro-rata distribution of a corporation's own stock to its shareholders is not treated as a dividend. However, if the stock distribution is not entirely pro-rata, it can be treated as a dividend to shareholders that reduces earnings and profits of the distributing entity. As one example, if a distribution is, at the election of the shareholders, payable either in the corporation's stock or in other property, then the value of the stock and of the other property distributed to shareholders is a dividend.[1364]

In a number of private letter rulings, the IRS has concluded that a REIT or C corporation distribution made for purposes of cleansing accumulated earnings and profits from non-REIT years in connection with a REIT election would be treated as a dividend when shareholders could elect to receive stock or cash, the total amount of cash payable is limited, but at least 20

[1361] There is an exception for any REIT that has continually been a REIT for all taxable years beginning after February 28, 1986.

[1362] Sec. 857(a)(2). This requirement is separate from and in addition to the requirement that a REIT must distribute at least 90 percent of its taxable income (other than net capital gains) in order to be qualified as a REIT for the taxable year. Sec. 857(a)(1).

[1363] Treas. Reg. sec. 1.857-11.

[1364] Sec. 305(b)(1).

percent of the value of the dividend is paid in cash and at least 20 percent of the amount payable to shareholders electing cash would be paid in cash, in case proration is necessary.[1365]

During the years 2008 through 2011, IRS also issued several temporarily applicable revenue procedures stating that the IRS would treat elective stock-or-cash distributions as dividends in the case of a publicly traded REIT, provided that at least 10 percent of the value of the dividend was paid in cash and each shareholder electing cash would receive at least 10 percent cash if proration is necessary.[1366]

Description of Proposal

For purposes of the requirement that a REIT must not have earnings and profits accumulated from a non-REIT year, the proposal would require that, for distributions made during a specified period prior to and after electing REIT status, only distributions made in cash would be taken into account.

The period during which only cash distributions are counted toward reducing non-REIT earnings and profits is the period of taxable years beginning with the last taxable year (other than a short taxable year) which was a non-REIT year, and ending with the close of the first taxable year for which the entity is treated as a REIT.

If an existing REIT acquires another C corporation's assets and earnings and profits, the proposal is applied by reference to the last full taxable year of the acquired C corporation and the first taxable year of the REIT to which the prohibition against non-REIT earnings and profits applies as a result of the transaction.

Effective Date

The proposal applies to distributions made on or after February 26, 2014.

[1365] See, *e.g.*, Priv. Ltr. Ruls. 201247004, 200618009, 200615024, 200406031, and 200348020. A 20-percent cash approach has also been applied by IRS in the case of REIT dividend distributions made to meet the requirement that 90 percent of REIT income (other than net capital gains) be distributed. See, *e.g.*, Priv. Ltr. Rul. 200817031. A private letter ruling may not be relied upon except by the taxpayer to which the ruling was issued. However, private letter rulings provide some indication of IRS administrative practice.

[1366] Rev. Proc. 2008-68, 2008-2 C.B. 1373 (for REIT distributions on or after January 1, 2008), superseded by Rev. Proc. 2009-15, 2009-1 C.B. 356 (for RIC as well as REIT dividends paid for taxable years 2008 and 2009) and by Rev. Proc. 2010-12, 2010-3 C.B. 302 (for RIC and REIT distributions declared on or before December 31, 2012 for the 2011 taxable year).

29. Debt instruments of publicly offered REITs and mortgages treated as real estate assets (sec. 3640 of the discussion draft and sec. 856 of the Code)

Present Law

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and Government securities (the "75-percent asset test").[1367] Real estate assets are real property (including interests in real property and mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITS.[1368] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[1369]

Except with respect to a taxable REIT subsidiary, not more than five percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[1370] No more than 25 percent of the value of a REIT's assets may be securities of one or more taxable REIT subsidiaries.[1371]

The asset tests must be met as of the close of each quarter of a REIT's taxable year.[1372]

At least 75 percent of a REIT's gross income must be from certain real estate related and other items. In addition, at least 95 percent of a REIT's gross income must be from specified sources that include the 75 percent items and also include interest, dividends, and gain from the sale or other disposition of securities (whether or not real estate related).

Description of Proposal

Under the proposal, debt instruments issued by publicly offered REITs are treated as real estate assets, as are interests in mortgages on interests in real property (for example, an interest in a mortgage on a leasehold interest in real property). Such assets therefore are qualified assets for

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[1367] Sec. 856(c)(4)(A).

[1368] Such term also includes any property (not otherwise a real estate asset) attributable to the temporary investment of new capital, but only if such property is stock or a debt instrument, and only for the one year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[1369] Sec. 856(c)(4)(B)(i).

[1370] Sec. 856(c)(4)(B)(iii).

[1371] Sec. 856(c)(4)(B)(ii).

[1372] Sec. 856(4)(B)(ii).

[1372] However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. Sec. 856(c)(4).

purposes of meeting the 75-percent asset test, but are subject to special limitations described below.

As under present law, income from debt instruments issued by publicly offered REITs that is interest income or gain from the sale or other disposition of a security is treated as qualified income for purposes of the 95-percent gross income test.

Income from publicly offered REIT debt instruments that would not have been treated as real estate assets but for the new provision is not qualified income for purposes of the 75-percent income test, and not more than 25 percent of the value of a REIT's total assets is permitted to be represented by such debt instruments.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

30. Asset and income test clarification regarding ancillary personal property (sec. 3641 of the discussion draft and sec. 856 of the Code)

Present Law

75-percent income test

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate related income. Such income includes: rents from real property; income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test"). Amounts attributable to most types of services provided to tenants (other than certain "customary services"), or to more than specified amounts of personal property, are not qualifying rents.

The Code definition of rents from real property includes rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property lease under, or in connection with, such lease.[1373]

For purposes of determining whether interest income is from a mortgage secured by real property, Treasury regulations provide that where a mortgage covers both real property and other property, an apportionment of the interest must be made. If the loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income is apportioned to the real property. However, if the amount of the loan exceeds the loan value of the real property,

[1373] Sec. 856(d)(1)(C).

then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property and the denominator of which is the amount of the loan.[1374] The remainder of the interest income is apportioned to the other property.

The loan value of real property is defined as the fair market value of the property determined as of the date on which the commitment by the REIT to make the loan becomes binding on the REIT. In the case of a loan purchased by a REIT, the loan value of the real property is the fair market value of the real property determined as of the date on which the commitment of the REIT to purchase the loan becomes binding.[1375]

75 percent asset test

At the close of each quarter of the taxable year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items, and Government securities.

Real estate assets generally mean real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.

Neither the Code nor regulations address the allocation of value in cases where real property and personal property may both be present.

Description of Proposal

The proposal allows certain ancillary personal property leased with real property to be treated as real property for purposes of the 75-percent asset test, applying the same threshold that applies under present law for purposes of determining rents from real property under section 856(d)(l)(C) for purposes of the 75-percent income test.

The proposal also modifies the present law rules for determining when an obligation secured by a mortgage is considered secured by a mortgage on real property if the security includes personal property as well. Under the proposal, in the case of an obligation secured by a mortgage on both real property and personal property, if the fair market value of such personal property does not exceed 15 percent of the total fair market value of all such property, such personal property is treated as real property for purposes of the 75-percent income and 75-percent asset test computations.[1376] In making this determination, the fair market value of all property (both personal and real) is determined at the same time and in the same manner as the fair market value of real property is determined for purposes of apportioning interest income

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[1374] Treas. Reg. sec. 1.856-5(c)(1). The amount of the loan for this purpose is defined as the highest principal amount of the loan outstanding during the taxable year. Treas. Reg. sec. 1.856-5(c)(3).

[1375] Special rules apply to construction loans. Treas. Reg. sec. 1.856-5(c)(2).

[1376] Secs. 856(e)(3)(8) and 856(e)(4)(A).

between real property and personal property under the rules for determining whether interest income is from a mortgage secured by real property.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

31. Hedging provisions (sec. 3642 of the discussion draft and sec. 857 of the Code)

Present Law

Except as provided by Treasury regulations, income from certain REIT hedging transactions that are clearly identified, including gain from the sale or disposition of such a transaction, is not included as gross income under either the 95-percent income or 75-percent income test. Under section 856(c)(5)(G)(i) and (ii), transactions eligible for this exclusion include transactions that hedge indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets and transactions entered primarily to manage risk of currency fluctuations with respect to items of income or gain described in sections 856(c)(2) or (3).[1377]

Description of Proposal

The proposal expands the scope of the present law exception of certain hedging income from gross income for purposes of the income tests, under section 856(c)(5)(G). Under the provision, if (1) a REIT enters into one or more positions described in clause (i) of section 856(c)(5)(G) with respect to indebtedness described therein or one or more positions described in clause (ii) of section 856(c)(5)(G) with respect to property that generates income or gain described in section 856(c)(2) or (3); (2) if any portion of such indebtedness is extinguished or any portion of such property is disposed of; and (3) in connection with such extinguishment or disposition, such REIT enters into one or more transactions which would be hedging transactions described in subparagraph (B) or (C) of section 1221(b)(2) with respect to any position referred to in (1) above, if such position were ordinary property[1378], then any income of such REIT from any position referred to in (1) and from any transaction referred to in (3) (including gain from the termination of any such position or transaction) shall not constitute gross income for purposes of the 75-percent or 95-percent gross income tests, to the extent that such transaction hedges such position.

The proposal is intended to extend the current treatment of income from certain REIT hedging transactions as income that is disregarded for purposes of the 75-percent and 95-percent income tests to income from positions that primarily manage risk with respect to a prior hedge, that a REIT enters in connection with the extinguishment or disposal (in whole or in part) of the liability or asset (respectively) related to such prior hedge, to the extent the new position

[1377] Sec. 856(c)(5)(G).

[1378] Such definition of a hedging transaction is applied for purposes of this provision without regard to whether the position referred to is ordinary property or not.

qualifies as a section 1221 hedge or would so qualify if the hedged position were ordinary property.

The proposal also clarifies that the identification requirement that applies to all hedges under the hedge gross income rules is the requirement described in section 1221(a)(7), determined after taking account of any curative provisions provided under the regulations referred to therein.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

32. Modification of real estate investment trust earnings and profits calculation to avoid duplicate taxation (sec. 3643 of the discussion draft and secs. 562 and 857 of the Code)

Present Law

The current earnings and profits of a REIT are not reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year.[1379] In addition, for purposes of computing the deduction for dividends paid by a REIT for a taxable year, earnings and profits are increased by the total amount of gain on the sale or exchange of real property by the trust during the year.[1380]

In the case of depreciation of tangible property, earnings and profits are determined under the alternative depreciation system, which generally is less accelerated than the system used in determining taxable income. Also, certain amounts treated as currently deductible for purposes of computing taxable income are allowed as a deduction ratably over a period of five years for computing earnings and profits. Finally, the installment method is not allowed in computing earnings and profits from the installment sale of property.[1381]

These rules can by illustrated by the following example:

Example.—Assume that a REIT had $100 of taxable income and earnings and profits in each of five consecutive taxable years (determined without regard to any energy efficient commercial building deduction)[1382] and without regard to any deduction for dividends paid).

[1379] Sec. 857(d)(1). This provision applies to a REIT without regard to whether it meets the requirements of section 857(a) for the taxable year.

[1380] Sec. 562(e).

[1381] Sec. 312(k)(3) and (n)(5).

[1382] Sec. 179D.

Assume that in 2013 (the first of the five years)[1383], the REIT had an energy efficient commercial building deduction in computing its taxable income of $10, reducing its pre-dividend taxable income to $90. Assume further that the deduction is allowable at a rate of $2 per year over the five-year period beginning with the first year in computing its earnings and profits.

Under present law, the REIT's earnings and profits in the first year are $98 ($100 less $2). In each of the next four years, the REIT's current earnings and profits are $100 ($98 as computed for year 1 plus an additional $2 under section 857(d)(1) for the $2 not deductible in computing taxable income for the year).

Assume the REIT distributes $100 to its shareholders at the close of each of the five years. Under present law, the shareholders have $98 dividend income in the first year and a $2 return of capital and $100 dividend income in each of the following four years, for a total of $498 dividend income, notwithstanding that the REIT had only $490 pre-dividend taxable income over the period. The dividends paid by the REIT reduce its taxable income to zero in each of the taxable years.

Description of Proposal

Under the proposal, the current earnings and profits of a REIT for a taxable year are not reduced by any amount that is not allowable as a deduction in computing its taxable income for the current taxable year and was not so allowable for any prior taxable year. Thus, under the proposal, if an amount is allowable as a deduction in computing taxable income in year one and is allowable in computing earnings and profits in year two (determined without regard to present-law section 857(d)(1)), section 857(d)(1) no longer applies and the deduction in computing the year two earnings and profits of the REIT is allowable. Thus, a lesser maximum amount will be a dividend to shareholders in that year. This proposal does not change the present-law determination of current earnings and profits for purposes of computing a REIT's deduction for dividends paid.

In addition, the proposal provides that the current earnings and profits of a REIT for a taxable year for purposes of computing the deduction for dividends paid are increased by any amount of gain on the sale or exchange of real property taken into account in determining the taxable income of the REIT for the taxable year (to the extent the gain is not otherwise so taken into account). Thus, in the case of an installment sale of real property, current earnings and profits for purposes of the REIT's deduction for dividends paid for a taxable year are increased by the amount of gain taken into account in computing its taxable income for the year and not otherwise taken into account in computing the current earnings and profits.

[1383] The energy efficient commercial buildings deduction under section 179D has currently expired for property placed in service after December 31, 2013. Sec. 179D(h). See Sec. 3113 of the discussion draft for a proposal to repeal this deduction permanently.

The following illustrates the application of the proposal:

Example.–Assume the same facts as in the above example. Under the proposal, as under present law, in the first taxable year, the earnings and profits of the REIT were $98 and the shareholders take into account $98 dividend income and $2 is a return of capital. Under the proposal, in each of the next four years, the earnings and profits are $98 (*i.e.*, section 857(d)(1) does not apply) so that the shareholders take into account $98 of dividend income in each year and $2 is a return of capital each year.

For purposes of the REIT's deduction for dividends paid, present law remains unchanged so that the REIT's taxable income will be reduced to zero in each of the taxable years.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

33. Reduction in percentage limitation on assets of REIT which may be taxable REIT subsidiaries (sec. 3644 of the discussion draft and sec. 856 of the Code)

Present Law

A REIT generally is not permitted to own securities representing more than 10 percent of the vote or value of any entity, nor is it permitted to own securities of a single issuer comprising more than 5 percent of REIT value.[1384] In addition, rents received by a REIT from a corporation of which the REIT directly or indirectly owns more than 10 percent of the vote or value generally are not qualified rents for purposes of the 75-percent and 95-percent income tests.[1385]

There is an exception from these rules in the case of a taxable REIT subsidiary. However, no more than 25 percent of the value of total REIT assets may consist of securities of one or more taxable REIT subsidiaries.

Description of Proposal

The proposal reduces to 20 percent the permitted percentage of total REIT assets that may be securities of one or more taxable REIT subsidiaries.

Effective Date

The proposal applies to taxable years beginning after December 31, 2016.

[1384] Sec. 856(c)(4)(b)(iii).

[1385] Sec. 856(d)(2).

34. Treatment of certain services provided by taxable REIT subsidiaries (sec. 3645 of the discussion draft and sec. 857 of the Code)

Present Law

Taxable REIT subsidiaries

A REIT generally cannot own more than 10 percent of the vote or value of a single entity. However, there is an exception for ownership of a taxable REIT subsidiary ("TRS") that is taxed as a corporation, provided that securities of one or more TRSs do not represent more than 25 percent of the value of REIT assets.

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility, or to provide to any other person (under a franchise, license, or otherwise) rights to any brand name under which any lodging facility or health care facility is operated.

REITs are subject to a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest. These are defined generally as the amounts of specified REIT transactions with a TRS of the REIT, to the extent such amounts differ from an arm's length amount.

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions.[1386] For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is stock in trade of a taxpayer or other property that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business and is not foreclosure property. The PTT for a REIT does not apply to a sale of property which is a real estate asset if the REIT satisfies certain criteria in sections 857(b)(6)(C) or (D).

Section 857(b)(6)(C) provides that a prohibited transaction does not include a sale of property which is a real estate asset (as defined in section 856(c)(5)(B)) and which is described in section 1221(a)(1) if (1) the REIT has held the property for not less than two years; (2) aggregate expenditures made by the REIT, or any partner of the REIT, during the two year period preceding the date of sale which are includible in the basis of the property do not exceed 30 percent of the net selling price of the property; (3) either: (A) the REIT does not make more than seven sales of property[1387] during the taxable year, or (B) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property[1388] sold during the

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[1386] Sec. 857(b)(6).

[1387] Sales of foreclosure property or sales to which section 1033 applies are excluded.

[1388] Sales of foreclosure property or sales to which section 1033 applies are excluded.

taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year, or (C) the fair market value of property[1389] sold during the taxable year does not exceed 10 percent of the aggregate fair market value of all the assets of the REIT as of the beginning of the taxable year; (4) in the case of land or improvements, not acquired through foreclosure (or deed in lieu of foreclosure), or lease termination, the REIT has held the property for not less than two years for production of rental income; and (5) if the requirement of (3)(A) above is not satisfied, substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor (as defined in section 856(d)(3)) from whom the REIT does not derive or receive any income.

Section 857(b)(6)(D) provides that a prohibited transaction does not include a sale of property which is a real estate asset (as defined in section 856(c)(5)(B)) and which is described in section 1221(a)(1) if (1) the REIT has held the property for not less than two years in connection with the trade or business of producing timber; (2) the aggregate expenditures made by the REIT, or any partner of the REIT, during the two year period preceding the date of sale which (A) are includible in the basis of the property (other than timberland acquisition expenditures), and (B) are directly related to operation of the property for the production of timber or for the preservation of the property for use as a timberland, do not exceed 30 percent of the net selling price of the property; (3) the aggregate expenditures made by the REIT, or a partner of the REIT, during the two year period preceding the date of sale which (A) are includible in the basis of the property (other than timberland acquisition expenditures), and (B) are not directly related to operation of the property for the production of timber or for the preservation of the property for use as a timberland, do not exceed five percent of the net selling price of the property; (4) either: (A) the REIT does not make more than seven sales of property[1390] during the taxable year, or (B) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property[1391] sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year, or (C) the fair market value of property[1392] sold during the taxable year does not exceed 10 percent of the aggregate fair market value of all the assets of the REIT as of the beginning of the taxable year; (5) if the requirement of (4)(A) above is not satisfied, substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor (as defined in section 856(d)(3)) from whom the REIT does not derive or receive any income, or, in the case of a sale on or before the termination date, a TRS; and (6) the sales price of the property sold by the trust is not based in whole or in part on income or profits derived from the sale or operation of such property.

[1389] Sales of foreclosure property or sales to which section 1033 applies are excluded.

[1390] Sales of foreclosure property or sales to which section 1033 applies are excluded.

[1391] Sales of foreclosure property or sales to which section 1033 applies are excluded.

[1392] Sales of foreclosure property or sales to which section 1033 applies are excluded.

Description of Proposal

For purposes of the exclusion from the prohibited transactions excise tax, the proposal modifies the requirement of section 857(b)(6)(C)(v), that substantially all of the development expenditures with respect to the property were made through an independent contractor from whom the REIT itself does not derive or receive any income, to allow a TRS to have developed the property.[1393]

The proposal also allows a TRS to make marketing expenditures with respect to property under section 857(b)(6)(C)(v) without causing property that is otherwise eligible for the prohibited transaction exclusion to lose such qualification.

The proposal allows a TRS to operate foreclosure property without causing loss of foreclosure property status, under section 856(e)(4)(C).

The items subject to the 100-percent excise tax on certain non-arm's length transactions between a TRS and a REIT are expanded to include "redetermined TRS service income." Such income is defined as gross income of a TRS of a REIT attributable to services provided to, or on behalf of, such REIT (less the deductions properly allocable thereto) to the extent the amount of such income (less such deductions) would be increased on distribution, apportionment, or allocation under section 482 (but for the exception from section 482 if the 100-percent excise tax applies). The term does not include gross income attributable to services furnished or rendered to a tenant of the REIT (or deductions properly attributable thereto), since that income is already subject to a separate provision of the 100-percent excise tax rules.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

35. Study relating to taxable REIT subsidiaries (sec. 3646 of the discussion draft)

Present Law

A REIT may own a taxable REIT subsidiary ("TRS") and may receive certain rent, interest, and other payments from that entity. A 100 percent tax is imposed on the REIT in the amount of any redetermined rents, redetermined deductions, and excess interest. Such amounts are the amounts by which rents received by the REIT would be reduced under the principles of section 482 to reflect the value of services provided by the TRS to REIT tenants, and the amounts by which interest or other payments deducted by the TRS but would be reapportioned to

[1393] The requirement limiting the amount of expenditures added to basis that the REIT, or a partner of the REIT, may make within two years prior to the sale, as well as other requirements for the exclusion, are retained. See discussion draft Section 3634, *supra*, for a proposal to repeal section 857(b)(6)(D) for taxable years beginning after December 31, 2016.

the REIT under the principles of section 482.[1394] This tax attempts to police the incentive to shift income from the taxable REIT subsidiary to the REIT.

The 1999 legislation that originally authorized taxable REIT subsidiaries required the Secretary of the Treasury to conduct a study to determine how many TRSs were in existence and the aggregate amount of taxes paid by such subsidiaries, and to submit a report to the Congress describing the results of such study.[1395] Treasury conducted and published a study of returns for 2001, the first year for which the legislation was in effect.[1396] A follow-up study was conducted, covering the period 2001-2004.[1397] No further studies have been conducted.

Description of Proposal

The proposal requires the Secretary of the Treasury to conduct studies to determine how many TRSs are in existence and the aggregate amount of taxes paid by such subsidiaries. The studies are also to determine the amount by which transactions between a REIT and a TRS reduce taxable income of the TRS (whether or not such transactions are conducted at arm's length). The studies shall be conducted biannually.

The proposal requires the Secretary of the Treasury to submit reports describing the results of each such study to the Committee on Ways and Means of the House of Representatives and the Finance Committee of the Senate.

Effective Date

The proposal is effective on date of enactment.

36. C corporation election to become, or transfer assets to, a RIC or REIT (sec. 3647 of the discussion draft and new sec. 1062 of the Code)

Present Law

In general

Section 1374

A "small business corporation" (as defined in section 1361(b)) may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level tax.

[1394] Interest paid by a TRS to a controlling REIT, or guaranteed by such a REIT, also is subject to the rules of section 162(j).

[1395] Ticket to Work and Work Incentives Improvement Act, Pub. L. .No.106-170 (1999).

[1396] Thornton Matheson, "Taxable REIT Subsidiaries: Analysis of the First Year's Returns 2001," available at http://www.irs.gov/pub/irs-soi/01reit.pdf.

[1397] Thornton Matheson. "The Development of Taxable REIT Subsidiaries, 2001-2004," available at http://www.irs.gov/pub/irs-soi/01-04coreitbul.pdf.

Instead, items of income, gain, and loss of an S corporation pass through to its shareholders. Each shareholder takes into account separately its share of these items on its own income tax return.[1398]

Under section 1374, a corporate level built-in gains tax, at the highest marginal rate applicable to corporations (currently 35 percent), is imposed on an S corporation's net recognized built-in gain[1399] that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period.[1400]

The originally-enacted 10-year recognition period has been reduced for temporary periods. Most recently, a temporary reduction of the period to five years expired for transactions occurring in taxable years beginning after December 31, 2013.[1401]

<u>Section 337 and regulations relating to REITs and RICs</u>

If a C corporation liquidates into a tax-exempt distributee, or otherwise converts to tax exempt status, the C corporation must immediately recognize all built-in gain.[1402]

If a C corporation converts to REIT or RIC status, or if a C corporation transfers assets to a REIT or RIC in a transaction in which gain or loss is determined in whole or in part by reference to the basis of the transferor, Treasury regulations under section 337 impose rules to prevent the sale of the former C corporation assets by the REIT or RIC without incurring C corporation tax. The regulations provide that the C corporation may elect to recognize all net built-in gain immediately prior to the conversion or transfer, as if it had sold its assets to an unrelated party as of the end of the last day of the C corporation's last taxable year before the first taxable year in which is qualifies to be taxed as a RIC or a REIT, or as of the end of the day before the asset transfer, in the case of a transfer of assets to a RIC or REIT. The deemed sale treatment does not apply, however, if its application would result in the recognition of a net loss. When the deemed sale treatment applies and a net gain is recognized, the basis of the property in the hands of the RIC or REIT is then the fair market value of such property on the deemed sale date.[1403]

1398 Sec. 1366.

1399 Certain built-in income items are treated as recognized built-in gain for this purpose. Sec. 1374(d)(5).

1400 The built-in gain tax also applies to net recognized built-in gain attributable to any asset received by an S corporation from a C corporation in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to the basis of such asset (or other property) in the hands of the C corporatiou.

1401 Sec. 1374(d)(7)(C).

1402 Sec. 337(b)(2); Treas. Reg. sec. 1.337(d)-4.

1403 Treas. Reg. sec. 1.337(d)-6(b).

Alternatively, an election can be made to treat the built-in gain generally "as if the REIT or RIC were an S corporation" subject to the built-in gain rules of section 1374.[1404]

Description of Proposal

The proposal requires recognition of net built-in gain on assets when a C corporation converts to REIT or RIC status, or when a REIT or RIC acquires assets from a C corporation in a carryover basis transaction. The provision does not apply if a net loss would be recognized. For purposes of the provision, a RIC or REIT is excluded from the definition of a C corporation. The proposal eliminates the option to treat the transaction under the rules of section 1374.

Effective Date

The proposal applies to elections and transfers on or after February 26, 2014.

37. Interests in RICs and REITs not excluded from definition of United States real property interests (sec. 3648 of the discussion draft and sec. 897 of the Code)

Present Law

In general

A foreign person that is not engaged in the conduct of a trade or business in the United States (and is not an individual who is present in the U.S. at least 183 days in the year) generally is not subject to any U.S. tax on capital gain from U.S. sources.[1405]

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[1406] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with the conduct of a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain.

USRPIs include interests in real property located in the United States or the U.S. Virgin Islands, and stock[1407] of a domestic U.S. real property holding company ("USRPHC"), generally

[1404] Treas. Reg. sec. 1.337(d)-6(c).

[1405] Secs. 871(b), 882(a). However, property is treated as held by a person for use in connection with the conduct of a trade or business in the United States, even if not so held at the time if sale, if it was so held within 10 years prior to the sale (sec. 864(c)(7)). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received (sec. 864(c)(6)).

[1406] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, 6652(f).

[1407] Such stock interests are defined as any interest in the corporations that is not an interest solely as a creditor. Sec. 897(c)(1)(A)(ii).

defined as any corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business, at all times during the shorter of the taxpayer's ownership of the stock or the five-year period ending on the date of the taxpayer's disposition of the stock.[1408]

Stock of a corporation is not a USRPI, however, if as of the date of disposition of such stock, such corporation did not hold any USRPIs and all of the USRPIs held by such corporation at any time during the shorter of (i) the period after June 18, 1980, during which the taxpayer held such stock of the corporation or (ii) the five-year period ending on the date of the disposition of such stock were disposed of in transactions in which the full amount of gain (if any) was recognized.[1409]

REITs and RICs are U.S. corporations that satisfy specific requirements including rules relating to the composition of their assets and their gross income, and that make an election to be taxed under a special tax regime as a REIT or RIC under subchapter M of the Code.[1410] Very generally, a REIT must primarily hold real estate assets and receive real estate related income and gain, and a RIC must primarily hold stock and securities and receive income and gain from such assets. A REIT or RIC generally must distribute at least 90 percent of its income (other than net capital gain). Unlike other corporations, a REIT or RIC may deduct distributed income, so the entity does not pay corporate level tax on income or gain that is distributed. Also, a REIT or RIC that liquidates may deduct any gain recognized during its liquidation and distributed to shareholders.[1411]

Any income (including net capital gain) that is retained by a REIT or RIC is taxed at regular corporate rates. A REIT or RIC may also retain its net capital gain without distribution, while designating a capital gain dividend for inclusion in shareholder income. In this case, the REIT or RIC pays corporate-level tax on the capital gain, but the shareholder receives a credit for the corporate level tax paid, and a basis increase in the REIT or RIC stock, with the result that the net tax paid is the shareholder level capital gain tax (if any).[1412] If the shareholder is not taxable on the capital gain, it may file a return and claim a refund for the corporate tax paid by the entity.

[1408] Secs. 897(c)(1)(A)(ii), 897(c)(2). However, any class of stock that is regularly traded on an established securities market is treated as a USRPI only if the seller held more than five percent of the stock at any time during such period. Sec. 897(c)(3).

[1409] See Notice 2007-55, 2007-2 C.B.13, with respect to section 897(h)(1) distributions to shareholders from sales of U.S. real property interests by any REIT or RIC that is a qualified investment entity. See also IRS AM 2008-003, February 2008.

[1410] Secs. 851-855 (RICs) and Secs. 856-859 (REITs).

[1411] Sec. 562.

[1412] Secs. 856(b)(3)(D) and 852(b)(3)(D).

Description of Proposal

The proposal modifies the rule that stock of a corporation is not a USRPI on disposition if, as of the time of disposition, such corporation does not own any USRPIs, and all of the USRPIs held by such corporation at any time during the five-year period ending with the date of disposition (or the period after June 18, 1980, during which the interest was held, if shorter), were disposed of in transactions in which the full amount of gain (if any) was recognized.

Under the proposal, that rule would not apply to any interest in a corporation that is or was taxable as a REIT or RIC under subchapter M during the relevant time period, or that is a successor to a corporation taxable under subchapter M in which the taxpayer held an interest at any time during the five year period ending with the date of disposition of the interest in the successor. Thus, for example, no portion of recognized gain of such entity (or a predecessor) during the five-year period ending on the date of disposition can have been deductible by the corporation, or taxed to the corporation with such tax eligible to be refunded to nontaxable shareholders, under subchapter M.

Effective Date

The proposal applies to dispositions after December 31, 2014.

38. Dividends from RICs and REITs ineligible for deduction for United States source portion of dividends from certain foreign corporations (sec. 3649 of the discussion draft and sec. 245 of the Code)

Present Law

A corporation is generally allowed to deduct a portion of the dividends it receives from another corporation. The deductible amount is a percentage of the dividends received. The percentage depends on the level of ownership that the corporate shareholder has in the corporation paying the dividend. The dividends-received deduction is 70 percent of the dividend if the recipient owns less than 20 percent of the stock of the payor corporation, 80 percent if the recipient owns at least 20 percent but less than 80 percent of the stock of the payor corporation, and 100 percent if the recipient owns 80 percent or more of the stock of the payor corporation.[1413]

Real estate investment trusts ("REITs") and regulated investment companies ("RICs") are U.S. domestic corporations that qualify and elect to be taxed under a special tax regime that allows them (unlike other corporations) to deduct dividend distributions to shareholders. REITs and RICs are restricted to certain types of assets and income, and generally must distribute 90

[1413] Sec. 243.

percent of their income annually (except for net capital gains).[1414] REITs generally must invest in real estate related assets. RICs generally must invest in stocks and securities.[1415]

Dividends from REITs are not eligible for the corporate dividends received deduction.[1416] Dividends from a RIC are eligible only to the extent attributable to dividends received by the RIC from certain other corporations, and are treated as dividends from a corporation that is not 20-percent owned.[1417]

Dividends received from a foreign corporation are not generally eligible for the dividends-received deduction. However, section 245 provides that if a U.S. corporation is a 10-percent shareholder of a foreign corporation, the U.S. corporation is generally entitled to a dividends-received deduction for the portion of dividends received that are attributable to the post-1986 undistributed U.S. earnings of the foreign corporation. The post-1986 undistributed U.S. earnings are measured by reference to earnings of the foreign corporation effectively connected with the conduct of a trade or business within the United States, or received by the foreign corporation from an 80-percent owned U.S. corporation.[1418] A 2013 IRS chief counsel advice memorandum advised that dividends received by a 10-percent U.S. corporate shareholder from a foreign corporation controlled by the shareholder are not eligible for the dividends-received deduction where the dividends were attributable to interest income of an 80-percent owned RIC.[1419]

<u>Description of Proposal</u>

The proposal excludes RICs and REITs from the category of domestic corporations whose dividends to a foreign corporation are treated as U.S. source, for purposes of the 10-percent qualified shareholder dividends received deduction under section 245.

1414 Even though some income retention is permitted, a REIT or RIC still must pay corporate tax on undistributed amounts. In addition, an excise tax is imposed to the extent certain income is not distributed within a calendar year. Secs. 4981 and 4982.

1415 Secs. 851-860.

1416 Secs. 243(d)(3) and 857(c)(1).

1417 Secs. 243(d)(2) and 854(b)(1)(A) and (C).

1418 Sec. 245.

1419 IRS Chief Counsel Advice 201320014. The situation addressed in the memorandum involved a controlled foreign corporation that had terminated its "CFC" status before year end, through a transfer of stock to a partnership. The advice was internal IRS advice to the Large Business and International Division. Such advice is not to be relied upon or cited as precedent by taxpayers, but may offer some indication of administrative practice. Treasury regulations section 1.246-1 states that the deductions provided in sections "243... 244... and 245 (relating to dividends received from certain foreign corporations)" are not allowable with respect to any dividend received from certain entities, one of which is a REIT.

Effective Date

The proposal is effective for dividends received from a RIC or REIT on or after February 26, 2014. No inference is intended as to the treatment of dividends from a RIC or REIT under present law.

39. Exclusion of dividends from controlled foreign corporations from the definition of personal holding company income for purposes of the personal holding company rules (sec. 3661 of the discussion draft and sec. 543 of the Code)

Present Law

Personal holding company tax

In addition to the regular corporate tax, a corporation that is a personal holding company must pay an additional tax, at the maximum rate imposed on individuals with respect to qualified dividends (20 percent), on the corporation's undistributed personal holding company income above a threshold amount.[1420] A personal holding company is a closely held corporation at least 60 percent of the adjusted ordinary gross income (as defined) of which is personal holding company income.[1421] Personal holding company income includes dividends, interest, certain rents, and other generally passive investment income.[1422]

Controlled foreign corporations

In general, the U.S. does not impose tax on the income of a foreign corporation unless and until that income is distributed to U.S. shareholders. However, there is an exception for certain passive or readily movable income of a foreign corporation that, for a period of at least 30 days during the taxable year, is more than 50-percent owned by U.S. shareholders each of which owns at least 10 percent of the corporate stock after applying attribution rules (a controlled foreign corporation). The pro rata share of such corporate earnings is currently included as income of the 10-percent (or greater) shareholders that hold their stock on the last day of the taxable year. Except as otherwise provided for specific purposes of the Code, the inclusions are not treated as dividends. When the earnings are distributed to the U.S. shareholders, they are not again subject to tax.[1423]

[1420] Sec. 541.

[1421] Sec. 542.

[1422] Sec. 543.

[1423] Secs. 951-965. A separate set of rules applies to income of a foreign corporation that is a passive foreign investment corporation, generally defined as a foreign corporation 75 percent or more of the gross income of which is passive income, or 50 percent or more of the assets of which produce or are held for the production of passive income (sec. 1297). Such income is either subject to an interest charge for deferral when it is ultimately distributed to a U.S. shareholder, or an election can be made to include income currently even if not distributed (secs. 1291-1298). A corporation is not treated as a passive foreign investment corporation with respect to any U.S.

When a controlled foreign corporation distributes a dividend to its U.S. shareholders that is not out of earnings previously taxed to a shareholder, that amount is treated as ordinary income.[1424]

Description of Proposal

Under the proposal, dividends received by a 10-percent U.S. shareholder (as defined in section 951(b)) from a controlled foreign corporation (as defined in section 957(a)) are excluded from the definition of personal holding company income for purposes of the personal holding company tax.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

shareholder during the period such corporation is a controlled foreign corporation of which the shareholder is a 10-percent or greater owner under the rules relating to controlled foreign corporations (sec. 1297(d)).

[1424] No dividends-received deduction to a corporate shareholder is allowed except to the extent the dividend is attributable to certain U.S. source income (sec. 245). A dividend received by an individual is a qualified dividend, eligible for the maximum 20-percent tax rates, if the dividend is from a qualified foreign corporation (generally, a corporation (i) that is eligible for certain treaty benefits or is incorporated in a U.S. possession, or (ii) the stock of which with respect to which the dividend is paid is readily tradable on a U.S. securities market; and that in either case is not a passive foreign investment company (sec. 1(h)(11)(C)).

H. Taxation of Foreign Persons

1. Prevent avoidance of tax through reinsurance with non-taxed affiliates (sec. 3701 of the discussion draft and new sec. 849 of the Code)

Present Law

Insurance companies in general

Subchapter L of the Code provides special rules for determining the taxable income of insurance companies. Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Insurance companies are subject to tax at regular corporate income tax rates.

Life insurance companies

For Federal income tax purposes, an insurance company is treated as a life insurance company if the sum of its (1) life insurance reserves and (2) unearned premiums and unpaid losses on noncancellable life, accident or health contracts not included in life insurance reserves, comprise more than 50 percent of its total reserves.[1425]

Reserves

In determining life insurance company taxable income, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[1426] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

Reinsurance premiums

A deduction is permitted for consideration – including reinsurance premiums – paid in respect of assumption of liabilities under insurance and annuity contracts.[1427]

Proration of deductions for untaxed income

Because reserve increases might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. Similarly, a life insurance company is allowed a dividends received deduction only in proportion to the company's share of such dividends. For this purpose, the policyholders' share

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[1425] Sec. 816(a).

[1426] Sec. 807.

[1427] Sec. 805(a)(6).

of any item is 100 percent of the item reduced by the company's share of the item. The company's share is determined in relation to net investment income of the company.[1428]

Property and casualty insurance companies

Under present law, the taxable income of a property and casualty insurance company is determined as the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.[1429] For this purpose, underwriting income and investment income are generally computed on the basis of the underwriting and investment exhibit of the annual statement approved by the NAIC.[1430]

Deduction for unpaid loss reserves

Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred.[1431] Losses incurred include certain unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported, resisted claims, and unpaid loss adjustment expenses). The deduction for loss reserves is discounted to take account partially of the time value of money.[1432] Thus, the deduction for unpaid losses is limited to the amount of discounted unpaid losses. Any net decrease in the amount of unpaid losses results in income inclusion, and the amount included is computed on a discounted basis. The discounted reserves for unpaid losses are calculated using a prescribed interest rate that is based on the applicable Federal mid-term rate ("AFR"). The discount rate is the average of the mid-term AFRs effective at the beginning of each month over the 60-month period preceding the calendar year for which the determination is made.

Reinsurance premiums deductible

In determining premiums earned for the taxable year, a property and casualty company deducts from gross premiums written on insurance contracts during the taxable year the amount of premiums paid for reinsurance.[1433]

Unearned premiums

Further, the company deducts from gross premiums the increase in unearned premiums for the year.[1434] The company is required to reduce the deduction for increases in unearned

[1428] Sec. 812.

[1429] Sec. 832.

[1430] Sec. 832(b)(1)(A).

[1431] Sec. 832(b)(3).

[1432] Sec. 846.

[1433] Sec. 832(b)(4)(A).

premiums by 20 percent. This amount serves to represent the allocable portion of expenses incurred in generating the unearned premiums, so as to provide a degree of matching of the timing of inclusion of income and deduction of associated expenses.

Proration of deductions relating to untaxed income

In calculating its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns.[1435] This rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from wholly or partially deductible dividends, or from other untaxed amounts.

Treatment of reinsurance

In general

A rule enacted in 1984 provides authority to the Treasury Department to reallocate items and make adjustments in reinsurance transactions to prevent tax avoidance or evasion.[1436]

The rule permits the Treasury Department to make reallocations in related party reinsurance transactions. The rule was amended in 2004 to provide the Treasury Department with additional authority to allocate among the parties to a reinsurance agreement or to recharacterize income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and any other items related to the reinsurance agreement, or to make any other adjustment to reflect the proper source, character, or amount of the item.[1437] In expanding this authority to the amount (not just the source and character) of any such item, Congress expressed the concern that "reinsurance transactions were being used to allocate income, deductions, or other items inappropriately among U.S. and foreign related persons," and that "foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base."[1438]

The rule also provides that if the Secretary determines that a reinsurance contract between insurance companies, whether related or unrelated, has a significant tax avoidance effect

[1434] Sec. 832(b)(4)(B). Unearned premiums are generally those premiums received for insurance coverage in a future taxable year of the insurance company.

[1435] Sec. 832(b)(5).

[1436] Sec. 845. See Conference Report to accompany H.R. 4170, The Deficit Reduction Act of 1984, H. Rep. No. 98-861 (June 23, 1984), 1060.

[1437] Section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

[1438] See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, (JCS-5-05), May 2005, p. 351; Senate Finance Committee Report to S. 1637, Jumpstart Our Business Strength (JOBS) Act, S. Rep. No. 108-192, November 7, 2003, p.161.

on any party to the contract, the Secretary may make an adjustment to one or both parties to eliminate the tax avoidance effect, including treating the contract as terminated on December 31 of each year and reinstated on January 1 of the next year. The legislative history provides that in determining whether a reinsurance agreement between unrelated parties has a significant tax avoidance effect with respect to one or both of the parties, appropriate factors for the Treasury Department to take into account are (1) the duration or age of the business reinsured, which bears on the issue of whether significant economic risk is transferred between the parties, (2) the character of the business (as long-term or not), (3) the structure for determining potential profits, (4) the duration of the reinsurance agreement, (5) the parties rights to terminate and the consequences of termination, such as the existence of a payback provision, (6) the relative tax positions of the parties, and (7) the financial situations of the parties.[1439]

Reinsurance premiums received by foreign persons

The United States employs a worldwide tax system under which U.S. persons (including U.S. citizens, U.S. resident individuals, and domestic corporations) generally are taxed on all income, whether derived in the United States or abroad. In contrast, foreign persons (including nonresident alien individuals and foreign corporations) are taxed in the United States only on income that has a sufficient nexus to the United States.

Foreign tax credit

A foreign tax credit is provided for income and withholding taxes paid to a foreign country, to prevent taxation of the income both in the United States and in the other country.[1440] The amount of the credit is subject to a foreign tax credit limitation, which provides generally that the credit is limited to the amount of the taxpayer's U.S. tax on foreign-source income. The foreign tax credit limitation is generally computed separately for income in two categories: passive and general. Excess credits may be carried back one year and forward 10 years.

Effectively connected income

Foreign persons are subject to U.S. tax on income that is effectively connected with the conduct of a trade or business in the United States.[1441] Such income may be derived from U.S. or foreign sources. This income generally is taxed in the same manner and at the same rates as income of a U.S. person. For this purpose, deductions are allowed only if and to the extent that they are connected with the income that is effectively connected with the conduct of a trade or business within the United States. In addition, foreign persons generally are subject to U.S. tax

[1439] Conference Report to accompany H.R. 4170, The Deficit Reduction Act of 1984, H.R. Rep. No. 98-861, June 23, 1984, p. 1063-4. In *Trans City Life Insurance Company v. Commissioner*, 106 T.C. 274 (1996), nonacq., 1997-2 C.B. 1, the Tax Court held that two reinsurance agreements did not have significant tax avoidance effects, based on the application of these factors.

[1440] Secs. 901-909.

[1441] Sec. 882.

withheld at a 30-percent rate on certain gross income (such as interest, dividends, rents, royalties, and premiums) derived from U.S. sources.[1442]

A foreign company carrying on an insurance business in the United States that would be treated as a life insurer or a property and casualty insurer for Federal tax purposes if it were a domestic corporation is subject to U.S. tax under subchapter L on its income effectively connected with its conduct of any trade or business within the United States.[1443] Special rules apply to calculate the minimum effectively connected net investment income for this purpose.[1444]

30-percent gross basis withholding

Other U.S.-source income of such a foreign company carrying on an insurance business in the United States is subject to the 30-percent gross-basis withholding tax applicable generally to U.S.-source income of any foreign corporation.

Treasury regulations provide, however, that insurance premiums subject to the insurance or reinsurance excise tax (described below) are not subject to the 30-percent gross-basis withholding requirement applicable for income tax purposes.[1445]

Securities trading safe harbor

Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[1446] Under these rules (colloquially referred to as trading safe harbors), trading in stock, securities, or commodities by a foreign person through an independent agent such as a resident broker generally is not treated as the conduct of a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which the trading is effected. Trading in stock, securities, or commodities for the foreign person's own account, whether by the foreign person or the foreign person's employees or through a resident broker or other agent (even if that agent has discretionary authority to make decisions in effecting the trading) also generally is not treated as the conduct of a U.S. business provided that the foreign person is not a dealer in stock, securities, or commodities.

[1442] Sec. 881.

[1443] Sec. 842.

[1444] Sec. 842(b). In *North West Life Assurance Co. of Canada v. Commissioner*, 107 T.C. 363 (1996), the Tax Court held that the business profits article of the United States-Canada income tax treaty permits a Canadian insurer doing business in the United States through a U.S. permanent establishment to attribute income to the permanent establishment based on its "real facts," not under the minimum investment income calculation of section 842(b).

[1445] Treas. Reg. sec. 1.1441-2(a)(7); see also Treas. Reg. sec. 1.881-2(b).

[1446] Sec. 864(b)(2).

Exemption from 30-percent withholding for certain investment income

The United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are significant exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax.[1447] Original issue discount on obligations maturing in six months or less is also exempt from tax.[1448] An additional exception is provided for certain interest paid on portfolio obligations.[1449] Portfolio interest generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) that is not received by a 10-percent shareholder.[1450] This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person.[1451] Moreover, this exception is not available for certain contingent interest payments.[1452]

Subpart F

Under the subpart F rules,[1453] 10-percent U.S. shareholders of a controlled foreign corporation are subject to U.S. tax currently on certain income earned by the controlled foreign corporation, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income (including foreign personal holding company income). The subpart F rules generally do not apply in the case of a foreign corporation that is controlled by foreign persons.

Active financing exception under subpart F

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct

[1447] Secs. 871(i)(2)(A), 881(d).

[1448] Sec. 871(g)(1)(B)(i).

[1449] Secs. 871(h), 881(c).

[1450] Sec. 871(h).

[1451] Sec. 881(c)(3).

[1452] Sec. 871(h)(4).

[1453] Secs. 951-965.

of an insurance business (so-called "active financing income").[1454] In general, the availability of the exception for income derived in the active conduct of a banking, financing, or similar business requires that the controlled foreign corporation directly receive at least 70 percent of its gross income from the active and regular conduct of a lending or finance business from transactions with customers who are unrelated persons. Similarly, the exception for income derived in the active conduct of an insurance business generally applies only to income received from unrelated persons.

Related person insurance income under subpart F

Special rules apply under subpart F with respect to related person insurance income.[1455] Enacted in 1986, these rules address the concern that "the related person insurance income of many offshore 'captive' insurance companies avoided current taxation under the subpart F rules of prior law because, for example, the company's U.S. ownership was relatively dispersed."[1456] For purposes of these rules, the U.S. ownership threshold for controlled foreign corporation status is reduced to 25 percent or more. Any U.S. person who owns or is considered to own any stock in a controlled foreign corporation, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation's related person insurance income. Related person insurance income is defined for this purpose to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (within the meaning of the provision) in the foreign corporation receiving the income or a person related to such a shareholder.

Branch level taxes

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As discussed above, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Similarly, as discussed above, interest payments made by a U.S. corporation to foreign creditors are subject to a U.S. withholding tax in certain circumstances. Pursuant to the branch tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest deducted by, the U.S. branch of the foreign corporation.[1457] The branch level taxes are comparable to these second-level taxes. In addition, if a foreign corporation is not subject to the branch profits tax as the result of a treaty, it may be liable for withholding tax on actual dividends it pays to foreign shareholders.

[1454] Secs. 953(e) and 954(h) and (i), which expires December 31, 2011.

[1455] Sec. 953(c).

[1456] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, May 4, 1987, p. 968.

[1457] Sec. 884.

Insurance and reinsurance excise tax

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.[1458] The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Exemption from the excise tax

The United States has entered into comprehensive income tax treaties with more than 50 countries, including a number of countries with well-developed insurance industries such as Barbados, Germany, Switzerland, and the United Kingdom. The United States has also entered into a tax treaty with Bermuda, another country with a significant insurance industry, which applies only with respect to the taxation of insurance enterprises.[1459]

Certain U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Switzerland, and the United Kingdom.[1460] To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).[1461]

[1458] Secs. 4371-4374.

[1459] The U.S.-Bermuda treaty generally exempts from U.S. taxation the business profits of a Bermuda insurance enterprise from carrying on the business of insurance (including insubstantial amounts of income incidental to such business), unless the insurance enterprise carries on business in the United States through a U.S. permanent establishment. For the purposes of the treaty, an insurance enterprise is defined as an enterprise whose predominant business activity is the issuing of insurance or annuity contracts or acting as the reinsurer of risks underwritten by insurance companies, together with the investing or reinvesting of assets held in respect of insurance reserves, capital, and surplus incident to the carrying on of the insurance business. The treaty also includes a mutual assistance provision.

[1460] Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.

[1461] In Rev. Rul. 2008-15, 2008-1 C.B. 633, the IRS provided guidance to the effect that the excise tax is imposed separately on each reinsurance policy covering a U.S. risk. Thus, if a U.S. insurer or reinsurer reinsures a U.S. risk with a foreign reinsurer, and that foreign reinsurer in turn reinsures the risk with a second foreign reinsurer, the excise tax applies to both the preminm to the first foreign reinsurer and the premium to the second foreign reinsurer. In addition, if the first foreign reinsurer is resident in a jurisdiction with a tax treaty containing an excise tax exemption, the Revenue Ruling provides that the excise tax still applies to both payments to the extent that the transaction violates an anti-conduit rule in the applicable tax treaty. Even if no violation of an anti-conduit rule occurs, under the Revenue Ruling, the excise tax still applies to the premiums paid to the secoud foreign reinsurer, unless the second foreign reinsurer is itself entitled to an excise tax exemption.

The U.S. tax treaties with Barbados and Bermuda also provide an exemption from the excise tax, although the Senate's ratification of the U.S.-Bermuda treaty was subject to a reservation with respect to the treaty's application to the excise tax. Moreover, section 6139 of the Technical and Miscellaneous Revenue Act of 1988 provides that neither the U.S.-Barbados nor the U.S.-Bermuda treaty will prevent imposition of the excise tax on premiums, regardless of when paid or accrued, allocable to insurance coverage for periods after December 31, 1989.[1462] Accordingly, no exemption from the excise tax is available under those two treaties with respect to premiums allocable to insurance coverage beginning on or after January 1, 1990.

Earnings stripping rules

A foreign parent corporation with a U.S. subsidiary may seek to reduce the group's U.S. tax liability by having the U.S. subsidiary pay deductible amounts such as interest, rents, royalties, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments. Although the United States generally subjects foreign corporations to a 30-percent withholding tax on the receipt of such payments, this tax may be reduced or eliminated under an applicable income tax treaty. Consequently, foreign-owned domestic corporations may seek to use certain treaties to facilitate earnings stripping transactions without having their deductions offset by U.S. withholding taxes.[1463]

Present law limits the ability of corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions involving interest payments. A deduction for "disqualified interest" paid or accrued by a corporation in a taxable year is generally disallowed if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1 (the so-called "safe harbor" ratio); and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion).[1464] Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest; or (2) unrelated parties in certain instances in which a related party guarantees the debt. Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

The earnings stripping rules generally apply to interest, but do not apply to other deductible payments such as insurance or reinsurance premiums.

[1462] Pub. L. No. 100-647.

[1463] For example, it appears that the U.S.-Barbados income tax treaty was used to facilitate earnings stripping arrangements in the context of corporate inversions. That treaty was amended in 2004 to make it less amenable to such use. It is possible, however, that other treaties in the U.S. network might be used for similar purposes. For a discussion of this issue, see Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty between the United States and Barbados* (JCX-55-04), September 16, 2004, pp. 12-20, 22.

[1464] Sec. 163(j).

Description of Proposal

General rule of nondeduction and noninclusion

Under the proposal, an insurance company is not allowed a deduction for nontaxed reinsurance premiums paid.[1465] In addition, its income is determined by not taking into account (so no deduction is allowed for) any additional amount paid with respect to the reinsurance for which the nontaxed reinsurance premium is paid to the extent the additional amount is properly allocable to the premium. Finally, the insurance company's income is determined by not taking into account any return premium, ceding commission, reinsurance recovered or other amount received by the insurance company with respect to the reinsurance for which the nontaxed reinsurance premium is paid to the extent the item is properly allocable to the premium. Thus, these items of income (to the extent they arise with respect to reinsurance for which nontaxed reinsurance premiums were paid) generally are excluded from the insurance company's income. The proposal applies in the case of reinsurance of risks other than life insurance, annuity, or noncancellable accident and health insurance risks.

The exclusion for the return premium, ceding commission, reinsurance recovered, or other amount received is allowed to the same extent that no deduction was allowed for the reinsurance premium paid (and for additional amounts paid by the insurance company with respect to the reinsurance with respect to which the premium was paid). The exclusion does not apply to any greater extent.

For example, if the amount of the reinsurance premium (and any additional amount) totaling 100 for which a deduction is not allowed is 80, then 80 percent of the total amount of the return premium, ceding commission, reinsurance recovered, and other amount received is excluded. Thus, if the total amount of the return premium, ceding commission, reinsurance recovered, and other amount received is 200, then 80 percent, or 160, may be excluded, and the balance is included in the company's income. It is intended that the Treasury Secretary provide prompt guidance as to the method of allocation among items of income, and in the absence of guidance, a pro rata allocation is the appropriate method (i.e., the same percentage of each item is excluded (80 percent of each item in the above example)).

Application to insurance companies

The proposal applies to an insurance company for purposes of determining its taxable income under section 831 or its life insurance company taxable income under section 801 (to the extent the company pays reinsurance premiums with respect to risks other than life insurance, annuity, or noncancellable accident and health insurance risks). Thus, for example, a property and casualty insurance company subject to tax in the United States is subject to the proposal with respect to reinsurance of risks other than life insurance, annuity, or noncancellable accident and health insurance risks. A life insurance company subject to tax in the United States is subject to

[1465] A nontaxed reinsurance premium is any reinsurance premium paid directly or indirectly to an affiliated corporation with respect to certain contracts, to the extent that the income attributable to the premium is not subject to Federal income tax, as described below.

the proposal only with respect to reinsurance of risks other than life insurance, annuity, or noncancellable accident and health insurance risks. The fact that a company has no U.S. income tax liability for the taxable year (for example, due to losses) does not cause the company not to be considered as subject to the proposal.

Nontaxed reinsurance premiums

A nontaxed reinsurance premium is any reinsurance premium paid directly or indirectly to an affiliated corporation with respect to certain contracts, to the extent that the income attributable to the premium is not subject to Federal income tax. Nontaxed reinsurance premiums do not include premiums for reinsurance with respect to any life insurance, annuity, or noncancellable accident and health insurance contract (including a life insurance or annuity contract combined with noncancellable accident and health insurance).[1466] Thus, the risks to which the proposal applies are property and casualty insurance risks, not life insurance risks. For purposes of the proposal, the income is not subject to U.S. income tax if it is neither included in the income of the affiliated corporation, nor included in income by a United States shareholder under section 951 pursuant to the rules of subpart F.

The excise tax under section 4371 is disregarded for purposes of determining whether income attributable to the premium is subject to U.S. income taxation. Thus, for example, a foreign insurer or reinsurer that issues policies, premiums on which are subject to the excise tax under section 4371, and that is not subject to U.S. income tax as an insurance company, is not considered an affiliated corporation the income of which is subject to U.S. income taxation for purposes of this proposal.

As a further example, assume that a controlled foreign corporation with a 15-percent minority interest held by persons that are not 10-percent U.S. shareholders receives a reinsurance premium. The 10-percent U.S. shareholders are subject to current U.S. income taxation on their shares of income attributable to the reinsurance premium, but the holders of the 15-percent minority interest are not. Assume further that the corporation is not subject to U.S. corporate income tax. Under these circumstances, 15 percent of the income attributable to the premium is not subject to U.S. income tax for purposes of the proposal.

Affiliated corporation

For purposes of the proposal, a corporation is treated as affiliated with an insurance company if both corporations would be treated as members of the same controlled group of corporations under section 1563(a), but applying a standard of at least 50 percent (rather than at least 80 percent) of total vote or value of shares. Foreign corporations and life insurance companies are not excluded, and no attribution of stock ownership through a tax-exempt employee's trust described in section 401(a) is made, for purposes of this determination.

[1466] Thus, premiums for reinsurance with respect to contracts, reserves for which constitute life insurance reserves for purposes of determining whether a company is a life insurance company, are not nontaxed reinsurance premiums. See section 816(a), (b), (c), (e), (f), and (h).

Election to treat specified reinsurance income as effectively connected

The proposal provides an election for an affiliated foreign reinsurer that is a specified affiliated corporation to be subject to U.S. tax on premiums and net investment income that is specified reinsurance income. This election is intended to provide another option to ensure that these foreign affiliates are not treated less favorably than U.S. reinsurers. Under the election, the deduction disallowance for reinsurance premiums and additional amounts with respect to such reinsurance does not apply, and the exclusion for return premiums, ceding commissions, reinsurance recovered, or other amounts received with respect to such reinsurance does not apply.

Effects of election

The election provides that an affiliated corporation treats specified reinsurance income (which is intended to include both premium income and net investment income) as effectively connected with the conduct of a trade or business in the United States and, for purposes of any treaty between the United States and any foreign country, as income attributable to a permanent establishment in the United States. The effect of the election is that the deduction otherwise disallowed for nontaxed reinsurance is not disallowed, because the premiums are subject to U.S. income taxation under the election. In addition, the excise tax under section 4371 with respect to reinsurance does not apply to the premiums treated as effectively connected with the conduct of a trade or business in the United States by reason of the election.

Specified reinsurance income is subject to tax under subchapter L of the Code to the same extent and in the same manner as if such income were the income of a domestic insurance company.

Foreign tax credit treatment

For purposes of the foreign tax credit, the proposal provides that specified reinsurance income treated as effectively connected under the election is treated as foreign source income and is placed in a separate category for purposes of the section 904 limitation on the foreign tax credit, and sections 902, 907, and 960 are applied separately with respect to each item of such income. Treasury Department guidance may permit aggregation of related items of specified reinsurance income for purposes of the separate category under the section 904 limitation and sections 902, 907, and 960, provided such aggregation is consistent with the purpose of the proposal.

Specified reinsurance income

Specified reinsurance income for this purpose means all income of a specified affiliated corporation that is attributable to reinsurance to which the proposal would apply but for the election.

It is intended that under the proposal, specified reinsurance income include with respect to any taxable year, not only (1) all reinsurance premiums (and additional amounts) for which (but for this election) a deduction would be disallowed under the proposal and that are received by an electing specified affiliated corporation during the taxable year directly or indirectly, but also (2) the net investment income (within the meaning of section 842(b)) for the taxable year allocable to reinsurance premiums (and additional amounts) with respect to which an election applies (whether for the current or a prior taxable year). As under present law, for purposes of this election, deductions are allowed only if and to the extent that they are connected with the income that is treated under this election as effectively connected with the conduct of a trade or business within the United States. The Treasury Department is directed to strictly ensure that, for purposes of determining net investment income, only those deductible items are allowed that are directly allocable to gross investment income that is allocable to premiums (and other amounts that would otherwise be nondeductible to the paying insurance company) taxed as specified reinsurance income under the election.

Specified affiliated corporation

A specified affiliated corporation means any affiliated corporation (within the meaning of the proposal) that is a foreign corporation. The corporation must also meet any other requirements imposed by the Treasury Secretary to ensure that tax on specified reinsurance income is properly determined and paid.

The election may be revoked only with the consent of the Secretary.

Regulatory authority

The proposal grants regulatory authority to carry out or to prevent the avoidance of the purposes of this proposal. In particular, the Treasury Department is directed to identify, and prevent avoidance of the proposal through, transactions that are alternatives to traditional reinsurance, through fronting transactions, conduit and reciprocal transactions, and through any economically equivalent transactions. The Treasury Department is directed to publish guidance relating to prevention of avoidance of the purposes of the proposal as promptly as possible, and is directed to make such guidance effective at a time consonant with the statutory effective date.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

2. Taxation of passenger cruise gross income of foreign corporations and nonresident alien individuals (sec. 3702 of the discussion draft and secs. 871, 882, 883 and 887 of the Code)

Present Law

General

The passenger cruise industry is subject to both Federal excise tax, in the form of a passenger tax, as well as the Federal income tax. To the extent that the operator of the cruise line is foreign, the ownership structure, maritime law applicable for determining what constitutes international shipping as well as specific income tax provisions combine to create an industry-specific departure from the rules generally applicable to profits from cross-border activities.[1467] Although the United States taxes U.S. persons[1468] on their worldwide income, nonresident aliens and foreign corporations are generally subject to U.S. tax only with respect to income with a U.S. nexus, either on a gross basis at a rate of 30 percent[1469] on their U.S.-source income from (mostly) passive activities, or on a net basis at graduated rates on income that is effectively connected with a U.S. trade or business.[1470] With respect to income from shipping, the gross basis tax potentially applicable is four percent,[1471] unless the income is effectively connected with a U.S. trade or business, and thus subject to the graduated rates, as determined under rules specific to U.S.-source gross transportation income rather than the more broadly applicable rules defining effectively connected income in section 864(c). Even if the income is within the purview of those special rules, it may nevertheless be exempt if the income is derived from the international operation of a ship or aircraft by a foreign entity organized in a jurisdiction which provides a reciprocal exemption to U.S. entities.

U.S. law on navigation is codified in U.S. Code at title 33, and is in turn consistent with the body of international maritime law. The normative principles of international maritime law for determining the maritime zones and territorial sovereignty over seas are embodied in the United Nations Convention on the Law of the Sea, first opened for signature in 1982.[1472] The treaty details the extent to which any state may assert full or partial maritime sovereignty. Full territorial sovereignty applies within 12 nautical miles of one's coast; the contiguous waters beyond 12 nautical miles but up to 24 nautical miles are subject to some regulation. Within 200 nautical miles, a country may assert an economic zone for exploitation of living marine resources and some minerals. Beyond 200 nautical miles are the "high seas" in which no sovereign state may assert exclusive jurisdiction.

[1467] Due to the regulatory framework for aviation, an international flight must either originate or conclude in the country of residence of the airline's owner, where income tax for the international flight is assessed. In contrast to international shipping, international aviation cannot be carried out using flags-of-convenience. Thus, although tax law treats shipping and aviation similarly, the differences between the two industries and the applicable regulatory regimes produce different tax outcomes.

[1468] Section 7701(a)(30) defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, estates and certain trusts. Whether a noncitizen is a resident is determined under rules in section 7701(b).

[1469] Secs. 871(a) and 881.

[1470] Secs. 871(b) and 882.

[1471] Sec. 887.

[1472] Since 1983, the Executive Branch has agreed that the treaty is generally consistent with existing international norms of the law of the sea and that the United States would act in conformity to the principles of the treaty other than those portions regarding deep seabed exploitation, even in the absence of ratification of the treaty. See, Senate Executive Report 110-9, page 2, describing the statement of President Ronald Reagan in 1983. In 1994, an Agreement on Implementation was concluded and entered into force with respect to 162 conntries and the European Union. Although signed by the United States and sent to the U.S. Senate on October 6, 1994, and referred to the Committee on Foreign Relations on October 7, 1994, the treaty has not been ratified by the United States. Treaty Doc. 103-39; Senate Executive Reports 108-10 and 110-09. Numerous hearings have been held with respect to the treaty, most recently on May 23, 2012, June 14, 2012 and June 28, 2012.

Passenger tax

A tax of $3 is imposed for each passenger on a covered voyage, payable by the person providing the covered voyage.[1473] A covered voyage is a voyage of (1) a commercial passenger vessel that extends over one or more nights, or (2) a commercial vessel transporting passengers engaged in gambling aboard the vessel beyond the territorial waters of the United States, all of which involve passengers embarking or disembarking the vessels in the United States. Covered voyages do not include voyages of a passenger vessel of less than 12 hours between two ports in the United States. A passenger vessel is any vessel having berth or stateroom accommodations for more than 16 passengers.

Income tax imposed on profits from operation of passenger cruises

Whether and how U.S. income tax is imposed with respect to income from shipping and aviation depends upon the source and type of income received, as well as the country of residence of the foreign taxpayer.

The source of shipping income is determined by the rules for transportation income, which is defined as any income derived from, or in connection with, the use (or hiring or leasing for use) of a vessel or aircraft (or a container used in connection therewith) or the performance of services directly related to such use.[1474] Transportation income attributable to transportation that begins and ends in the United States is treated as wholly derived from sources in the United States,[1475] but transportation income attributable to transportation that begins in, and ends outside, the United States or that begins outside, and ends in, the United States, is generally treated as 50 percent from U.S. source and 50 percent from foreign source.[1476] That definition does not encompass land transport except to the extent that it is directly related to shipping by vessel or aircraft, but regulations extend a similar rule for determining the source of income from transportation services other than shipping or aviation.[1477]

A subcategory of transportation income, "U.S. source gross transportation income" is subject to taxation on a gross basis at the rate of four percent. Income is within the scope of this special tax if it is considered to be U.S. source because travel begins or ends in the United States, is not effectively connected, and is not of a kind to which the exemption from tax applies. Transportation income from U.S. sources is treated as effectively connected with a foreign person's conduct of a U.S. trade or business only if the foreign person has a fixed place of business in the United States that is involved in the earning of such income and substantially all

[1473] Sec. 4471. The tax is imposed either at the time of first embarkation or disembarkation in the United States, but not both.

[1474] Sec. 863(c)(3). The term "vessel or aircraft" includes any container used in connection with a vessel or aircraft.

[1475] Sec. 863(c)(1).

[1476] Sec. 863(c)(2).

[1477] Treas. Reg. sec. 1.863-4(a), *et seq.*

of such income of the foreign person is attributable to regularly scheduled transportation.[1478] If the transportation income is effectively connected with conduct of a U.S. trade or business, the transportation income, along with transportation income that is from U.S. sources because the transportation both begins and ends in the United States, may be subject to the graduated rates. Under the applicable coordination rule, the four-percent tax is not imposed if the income is subject to the provisions of sections 871, or 882.

Reciprocal exemption from U.S. tax

An exemption from U.S. tax is provided for transportation income of foreign persons from countries that extend reciprocal relief to U.S. persons. A nonresident alien individual with income from the international operation of a ship may qualify, provided that the foreign country in which such individual is resident grants an equivalent exemption to individual residents of the United States.[1479] A similar exemption from U.S. tax is provided for gross income derived by a foreign corporation from the international operation of a ship, provided that the foreign country in which the corporation is organized grants an equivalent exemption to corporations organized in the United States.[1480] To determine whether income from shipping or aviation is eligible for an exemption under section 883, one must examine the extent to which the foreign jurisdiction has extended reciprocity for U.S. businesses; whether the party claiming an exemption is eligible for the tax relief; and the nature of the activities that give rise to the income.

Eligible foreign jurisdictions and entities

At present, shipping income is specifically exempted by sections 872(b) and 883(a) if the operators are resident in a jurisdiction which provides a reciprocal exemption for U.S. operators. Such exemptions are broadly granted, and generally include both operating income and capital gains. A special rule provides that the requirement for a reciprocal exemption may be disregarded if the relevant foreign jurisdiction imposes tax on the basis of residence as determined under provisions of foreign law under standards prescribed by the Secretary.

The most recent compilation of countries that the United States recognizes as providing exemptions lists countries in three groups: Twenty-seven countries are eligible for exemption on the basis of a review of the legislation in the foreign jurisdiction; 39 nations exchanged diplomatic notes with the United States that grant exemption to some extent; and more than 50 nations are parties with the United States to bilateral income tax treaties that include a shipping article.[1481] An exemption provided by treaty is not automatically treated as an equivalent exemption for purposes of the statute, because the eligibility requirements and extent of relief

[1478] Sec. 887(b)(4).

[1479] Sec. 872(b)(1).

[1480] Sec. 883(a)(1). In addition, to the extent provided in regulations, income from shipping and aviation is not subject to the four-percent gross basis tax if the income is of a type that is not subject to the reciprocal exemption for net basis taxation. See sec. 887(b)(1).

[1481] Rev. Rul. 2008-17, 2008-1 C.B. 626, modified by Ann. 2008-57, 2008-C.B. 1192, 2008.

under treaties vary in scope.[1482] Although the general exemption in section 883(a) is limited to companies whose stock is owned by individuals who are residents of the country of organization or a country that grants a similar exemption to U.S. shippers, that limitation is inapplicable to CFCs and to publicly traded corporations. As a result, income of publicly traded shipping companies is largely exempt from income tax, regardless of source.

International operation of ships or aircraft

The shipping or transportation income that may be eligible for an exemption is limited to income from the international operation of a ship or aircraft. Regulations enumerate categories of activities that constitute international shipping or aviation operations, including transportation of passengers, if the trip includes a foreign port of call; the transportation of cargo if either the final destination or point of origin is foreign; charters of a ship or aircraft, provided that the ship is used for international carriage of passengers or cargo; and income from activities that are incidental to the international operations. Activities that do not constitute operation of a ship or aircraft include ship or aircraft management, acting as ship agent or broker, freight forwarding, the activities of travel agents, tour operators, concessionaires and non-vessel operating common carriers (persons who arrange transportation for hire and assume liability as a common carrier but do not have actual control over any part of a vessel).[1483]

Whether or not income is incidental to the international operations within the meaning of the regulations depends upon whether the activity generating the income is so closely related to the international operation of the vessels or aircraft that they are incidental to the operations, and warrants deeming the income to be derived from the operations. The regulations include a non-exclusive list of examples of activities that are always incidental to the international shipping or aviation operations is provided, as well as a non-exclusive list of examples of non-incidental activities.

Numerous tax treaties to which the United States is a party include rules for the treatment of profits from shipping, inland waterways transportation and air transport.[1484] In such treaties, profits from the operation of ships or aircraft in international traffic are taxable only by the country in which the operator of the ship or aircraft is a resident and generally include profits from the transport of both property or passengers, and all incidental activities, including inland transportation incidental to international traffic. This special rule takes precedence over the general business profit rules, and applies regardless of whether the profits are received through operations of a permanent establishment. According to the Technical Explanation accompanying the U.S. Model treaty, the purpose of the rule is to avoid complexities that arise by reason of the

[1482] Treas. Reg. sec. 1.883-1(h)(3)(i) (adopting the position first taken in Rev. Rul. 2001-48, 2001-2 CB 324). Prior to the ruling in 2001, an exemption under treaty was considered to be an equivalent exemption for purposes of section 883.

[1483] Treas. Reg. Sec. 1.883-1(e)(3).

[1484] See, Article 8, Model United States Income Tax Convention (November 15, 2006) [U.S. Model treaty]. That article is in turn consistent with provisions in the Model Tax Convention on Income and on Capital of the Organisation for Economic Cooperation and Development.

likelihood that shipping or aviation enterprises have multiple permanent establishments to which income is attributable.

Whether a foreign person claims exemption by reason of the statutory exemption or application of a treaty, the claim must be disclosed to the IRS. A foreign person that claims to be exempt from tax by reason of the reciprocal exemption from U.S. tax under section 883 or 873 due to the international operation of a ship must file a U.S. income tax return and must attach to such return a statement claiming the exemption.[1485] If a foreign person claims an exemption based on an applicable income tax treaty, the basis for that claim must also be disclosed as required by the Secretary of the Treasury.[1486] The penalty for failure to make the required disclosure of a treaty-based position is $1,000 for an individual and $10,000 for a corporation.[1487]

Description of Proposal

The proposal creates a category of income defined as passenger cruise gross income, provides specific rules for determining the extent to which such income is effectively connected with the conduct of a trade or business in the United States, and removes such income from eligibility for the reciprocal exemptions of sections 873 and 883. As a result, effectively connected passenger cruise income is subject to net basis taxation. A conforming amendment to the definition of effectively connected income for purposes of the gross basis tax on international shipping income is made.

Passenger cruise gross income is all income from the operation of a commercial vessel on a covered voyage. A covered voyage is generally defined in as a voyage that would be subject to the passenger tax, described above. An antiabuse provision is included such that if passengers embark a ship in the United States and more than ten percent of the passengers disembark in the United States, the operation of the ship at all times between such events is treated as a covered voyage. A cruise in which all persons who embark in the United States later disembark in a foreign port, with no intervening stops, is covered.

In determining whether income is from the operation of a passenger cruise, one includes all income from actions incidental to the operation, as well as any amounts received with respect to any on- or off-board activities, services or sales, with respect to passengers, whether or not the activities, sales or services are provided onboard the vessel. This includes any income from any agreement with any person with respect to the provision of the activities, services, or sales.

To determine what portion of passenger cruise gross income is effectively connected, the provision requires a computation of the length (measured in calendar days) of the covered voyage and the portion of the voyage that occurs in U.S. territorial waters, defined as 12 nautical miles from low tide on the U.S. coastline or within the international boundary between the

[1485] Rev. Proc. 91-12, 1991-1 C.B. 473.

[1486] Sec. 6114.

[1487] Sec. 6712.

United States and a contiguous country. The time that the vessel is considered to be in U.S. territorial waters is compared to the total time of the voyage to arrive at the U.S. territorial waters percentage of the gross income. For purposes of this computation, any vessel in a U.S. port or within U.S. waters for any portion of a calendar day is considered to be in U.S. waters for an entire calendar day. Days during which a ship is out of service in a U.S. port for major repairs are not counted. In addition, under no circumstances is a single calendar day to be counted twice. Thus, a ship that leaves one U.S. port, exits U.S. waters and later the same calendar day again enters U.S. waters is in U.S. waters only one day.

The provision explicitly requires that any income considered to be effectively connected under general rules without regard to the U.S. territorial percentage continues to be treated as such, even if the U.S. territorial percentage of passenger gross income is a lesser amount.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

3. Modification of insurance exception to the passive foreign investment company rules (sec. 3703 of the discussion draft and sec. 1297 of the Code)

Present Law

Passive foreign investment companies

A U.S. person who is a shareholder of a passive foreign investment company ("PFIC") is subject to U.S. tax in respect of that person's share of the PFIC's income under one of three alternative anti-deferral regimes. A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[1488] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[1489] A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[1490] A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year

[1488] Sec. 1297.

[1489] Secs. 1293-1295.

[1490] Sec. 1291.

and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[1491]

Passive income

Passive income means any income which is of kind that would be foreign personal holding company income, including dividends, interest, royalties, rents, and certain gains on the sale or exchange of property, commodities, or foreign currency. However, among other exceptions, passive income does not include any income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.[1492]

Description of Proposal

The proposal modifies the requirements for a corporation the income of which is not included in passive income for purposes of the PFIC rules. The proposal replaces the test based on a whether a corporation is predominantly engaged in an insurance business with a test based on the gross receipts of the corporation consisting of premiums. The requirement that the foreign corporation would be subject to tax under subchapter L if it were a domestic corporation is retained.

Under the proposal, passive income does not include income derived in the active conduct of an insurance business by a corporation (1) more than 50 percent of the gross receipts of which for the taxable year consist of premiums; (2) that would be subject to tax under subchapter L if it were a domestic corporation; and (3) the applicable insurance liabilities of which constitute more than 35 percent of its total assets as reported on the company's applicable financial statement for the year.

For this purpose, applicable insurance liabilities means (1) loss and loss adjustment expenses, (2) unearned premiums, and (3) reserves (other than deficiency or contingency reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality risks (not to exceed the amount of such reserve that is required to be reported to the home country insurance regulatory body). An applicable financial statement is a statement for financial reporting purposes that (1) is made on the basis of generally accepted accounting principles or international financial reporting standards, or (2) except as otherwise provided by the Secretary in regulations, is the annual statement required to be filed with the home country insurance regulatory body.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

[1491] Sec. 1296.

[1492] Sec. 1297(b)(2)(B).

4. Limitation on deduction for interest on certain indebtedness (sec. 3704 of the discussion draft and sec. 163(j) of the Code)

Present Law

Foreign corporations are limited in their ability to reduce the U.S. tax on the income derived from their U.S. subsidiaries' operations through certain earnings stripping transactions involving interest payments. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for "disqualified interest" paid or accrued by the payor in a taxable year is generally disallowed to the extent of the payor's "excess interest expense."[1493] Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;[1494] to unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"); or to a REIT by a taxable REIT subsidiary of that REIT. Excess interest expense is the amount by which the payor's "net interest expense" (that is, the excess of interest paid or accrued over interest income) exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (that is, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

Description of Proposal

The proposal modifies the definition of excess interest expense. Under the proposal, excess interest expense means the excess of the corporation's net interest expense over 40-percent of the adjusted taxable income of the corporation. Under the proposal, excess limitation from taxable years beginning after December 31, 2014 may not be carried forward.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

[1493] Sec. 163(j).

[1494] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

5. Limitation on treaty benefits for certain deductible payments (sec. 3705 of the discussion draft and sec. 894(d) of the Code)

Description of Proposal

The proposal limits tax treaty benefits with respect to U.S. withholding tax imposed on deductible related-party payments. Under the proposal, the amount of U.S. withholding tax imposed on deductible related-party payments may not be reduced under any U.S. income tax treaty unless such withholding tax would have been reduced under a U.S. income tax treaty if the payment were made directly to the foreign parent corporation of the payee. A payment is a deductible related-party payment if it is made directly or indirectly by any person to any other person, if it is allowable as a deduction for U.S. tax purposes, and if both persons are members of the same foreign controlled group of entities.

For purposes of the proposal, a foreign controlled group of entities is a controlled group of corporations as defined in section 1563(a)(1), modified as described below, in which the common parent company is a foreign corporation. Such common parent company is referred to as the foreign parent corporation. A controlled group of corporations consists of a chain or chains of corporations connected through direct stock ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations. For purposes of the proposal, the relevant ownership threshold is lowered from at least 80 percent to more than 50 percent, certain members of the controlled group of corporations that would otherwise be treated as excluded members are not treated as excluded members,[1495] and insurance companies are not treated as members of a separate controlled group of corporations. In addition, a partnership or other noncorporate entity is treated as a member of a controlled group of corporations if such entity is controlled (within the meaning of section 954(d)(3)) by members of the group.

The Secretary may prescribe regulations or other guidance necessary or appropriate to carry out the purposes of the proposal, including regulations or other guidance providing for the treatment of two or more persons as members of a foreign controlled group of entities if such persons would be the common parent of such group if treated as one corporation, and regulations providing for the treatment of any member of a foreign controlled group of entities as the common parent of that group if such treatment is appropriate taking into account the economic relationships among the group entities.

As an example of the operation of the proposal, a deductible payment made by a U.S. entity to an intermediate foreign entity (the payee) with a foreign parent corporation that is resident in a country with respect to which the United States does not have an income tax treaty

[1495] Under section 1563(b)(2), a corporation that is a member of a controlled group of corporations on December 31 of a taxable year is treated as an excluded member of the group for the taxable year that includes such December 31 if such corporation (A) is a member of the group for less than one-half the number of days in such taxable year which precedes such December 31; (B) is exempt from taxation under section 501(a) for such taxable year; (C) is a foreign corporation subject to tax under section 881 for such taxable year; (D) is an insurance company subject to taxation under section 801; or (E) is a franchised corporation (as defined in section 1563(f)(4)).

is always subject to the statutory U.S. withholding tax rate of 30 percent, irrespective of whether the payee qualifies for benefits under a tax treaty. If, instead, the foreign parent corporation is a resident of a country with respect to which the United States does have an income tax treaty that would reduce the withholding tax rate on a payment made directly to the foreign parent corporation (regardless of the amount of such reduction), and the payment would qualify for benefits under that treaty if the payment were made directly to the foreign parent corporation, then the payee entity will continue to be eligible for the reduced withholding tax rate under the U.S. income tax treaty with the payee entity's residence country (even if such reduced treaty rate is lower than the rate that would be imposed on a hypothetical direct payment to the foreign parent corporation).

Effective Date

The proposal is effective for payments made after the date of enactment.

I. Provisions Related to Compensation

1. Nonqualified deferred compensation (sec. 3801 of the discussion draft and new sec. 409B of the Code)

Present Law

In general

Compensation may be received currently or may be deferred to a later time. The tax treatment of deferred compensation depends on whether it is qualified (that is, eligible for tax-favored treatment)[1496] or nonqualified and, if nonqualified, whether it is funded or unfunded. In the case of a funded nonqualified deferred compensation arrangement, funded amounts are included in income when the right to the compensation vests, that is, when it is no longer subject to a substantial risk of forfeiture.[1497]

Under general tax principles, unfunded nonqualified deferred compensation generally is not included in income until actually or constructively received.[1498] However, under statutory rules generally applicable to nonqualified deferred compensation arrangements, income inclusion is delayed until receipt only if specific requirements are met. Otherwise, deferred amounts are included in income at vesting. In addition, in the case of certain arrangements, statutory rules require nonqualified deferred compensation to be included in income at vesting.

General rules for nonqualified deferred compensation

In general

Various requirements apply to a nonqualified deferred compensation plan in order to avoid income inclusion at vesting.[1499] Absent a specific exception, these requirements apply in addition to any special rules for particular types of nonqualified deferred compensation plans.

[1496] For a discussion of present law relating to tax-favored retirement plans, see Joint Committee on Taxation, *Report to the House Committee on Ways and Means on Present Law and Suggestions for Reform Submitted to the Tax Reform Working Groups* (JCS-3-13), May 6, 2013, Part II.I.

[1497] Depending on the funding vehicle, the tax treatment of funded nonqualified deferred compensation may be governed by section 83, 402(b) or 403(c). Similar treatment applies under a common law doctrine of economic benefit, as applied, for example, in *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952), and Rev. Rul. 60-31, Situation 4, 1960-1 C.B. 174. Under section 404(a)(5), (b), and (d), nonqualified deferred compensation is generally deductible by the service recipient for the taxable year in which the amount is includible in the service provider's income, subject to any applicable limits on deductibility.

[1498] Treas. Reg. secs. 1.451-1(a) and 1.451-2; Rev. Rul. 60-31, 1960-1 C.B. 174.

[1499] Section 409A, generally effective for amounts deferred in taxable years beginning after December 31, 2004. For further discussion of the tax treatment of nonqualified deferred compensation before 2005 and concerns that led to the enactment of section 409A, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005.

A nonqualified deferred compensation plan must provide that compensation for services performed during a taxable year generally may be deferred at the service provider's election only if the election to defer is made no later than the close of the preceding taxable year (or at such other time as provided in Treasury regulations). In the case of any performance-based compensation for services performed over a period of at least 12 months, the election may be made no later than six months before the end of the service period. The time and form of distributions from the plan must be specified at the time of initial deferral. However, subject to certain requirements, a plan may allow later changes in the time and form of distributions.

Distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary of the Treasury), death, a specified time (or pursuant to a fixed schedule), change in control of a corporation (to the extent provided by the Secretary of the Treasury), occurrence of an unforeseeable emergency, or if the service provider becomes disabled.[1500] A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations by the Secretary of the Treasury, may not permit acceleration of a distribution.

If these requirements are not met, all amounts deferred by a service provider under the plan are currently includible in income to the extent such amounts are not subject to a substantial risk of forfeiture and not previously included in gross income.[1501] For this purpose, a person's rights to compensation are subject to a substantial risk of forfeiture if the rights are conditioned on the future performance of substantial services by any person or the occurrence of a condition related to a purpose of the compensation, provided that the possibility of forfeiture is substantial.[1502]

[1500] Under a special rule, when a "specified employee" separates from service, distributions may not be made earlier than six months after the date of the separation from service or, if earlier, the date of the employee's death. Specified employees are key employees (as defined in section 416(i)) of publicly-traded corporations and generally include officers (limited to 50 employees) having annual compensation greater than $170,000 (for 2014), five-percent owners, and one-percent owners having annual compensation from the employer greater than $150,000.

[1501] In the case of an employee, under section 3401(a), the amount included in income constitutes wages subject to income tax withholding. In addition to current income inclusion, interest at the rate applicable to underpayments of tax plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax. Under section 409A(b), current income inclusion, interest, and a 20-percent additional tax may also result from certain arrangements involving offshore assets set aside to fund nonqualified deferred compensation (regardless of whether the assets are available to satisfy claims of the general creditors of the service recipient), the restriction of assets to provide nonqualified deferred compensation in connection with a change in the employer's financial health, or assets set aside to provide nonqualified deferred compensation during a period when the employer (or controlled group member) maintains an underfunded defined benefit plan.

[1502] Sec. 409A(d)(4) and Treas. Reg. sec. 1.409A-1(d). The Secretary of the Treasury is authorized to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 409A.

Definition of nonqualified deferred compensation plan

A nonqualified deferred compensation plan subject to these rules generally includes any plan, agreement or arrangement (including an agreement or arrangement that includes one person) that provides for the deferral of compensation (including actual or notional income on deferred compensation), other than a qualified employer plan, or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.[1503] A qualified employer plan for this purpose means a qualified retirement plan, a tax-deferred annuity plan, a simplified employee pension plan, a simple retirement account plan, an eligible deferred compensation plan of a tax-exempt or State or local government employer, a plan established before June 25, 1959, and funded only by employee contributions, or a qualified governmental excess benefit arrangement.[1504]

Under Treasury regulations, certain other types of arrangements are not considered a deferral of compensation and thus are not subject to these rules.[1505] For example, an exception applies to amounts that are not deferred beyond a short period of time after the amount is no longer subject to a substantial risk of forfeiture (referred to as a "short-term deferral").[1506] Under this exception, a deferral of compensation generally does not occur if the service provider actually or constructively receives the amount on or before the last day of the applicable 2½ month period. The applicable 2½ month period is the period ending on the later of the 15th day of the third month following the end of: (1) the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture; or (2) the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.

Treasury regulations also provide exceptions for certain stock options and stock appreciation rights ("SARs") with respect to service recipient stock, referred to collectively as "stock rights."[1507] In general, under the regulations, a stock option or SAR does not provide for the deferral of compensation if the exercise price of the stock option or SAR cannot be less than the fair market value, on the date the option or SAR is granted, of the stock subject to the option or SAR and the stock right does not otherwise include a deferral feature. Similar exceptions apply to arrangements involving mutual company units and partnership interests. Exceptions

[1503] Sec. 409A(d)(1).

[1504] Secs. 401(a) and 403(a), 403(b), 408(k), 408(p), 457(b), 501(c)(18), and 415(m).

[1505] For a discussion of intended exceptions for certain arrangements, see Conference Report to accompany H.R. 4520, the American Jobs Creation Act of 2004, H.R. Rep. No. 108-755, October 7, 2004, p. 735.

[1506] Treas. Reg. sec. 1.409A-1(b)(4).

[1507] Treas. Reg. sec. 1.409A-1(b)(5). A SAR is a right to compensation based on the appreciation in value of a specified number of shares of stock occurring between the date of grant and the date of exercise of the right. In the case of a SAR, the exercise price is the amount subtracted from the fair market value of the stock on the date the SAR is exercised to determine the appreciation in value since the date of grant.

apply also for incentive stock options and options under an employee stock purchase plan ("statutory options").[1508]

Additional rules

Under Treasury regulations, the term "service provider" includes an individual or any of specified entities for any taxable year for which the individual or entity accounts for income from the performance of services under the cash receipts and disbursements method of accounting.[1509] The relevant entities are a corporation, an S corporation, a partnership, a personal service corporation, a noncorporate entity that would be a personal service corporation if it were a corporation, a qualified personal service corporation, and a noncorporate entity that would be a qualified personal service corporation if it were a corporation. However, an exception applies for a service provider engaged in the trade or business of providing services (other than as an employee or director of a corporation or in a similar position in the case of an entity that is not a corporation) if the service provider provides significant services to at least two service recipients that are not related to each other or the service provider. This exception does not apply to the extent the service provider provides management services, that is, services involving the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient, or investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets (including real estate investments), such as a hedge fund or real estate investment trust.

Nonqualified deferred compensation of State or local government or tax-exempt employers

Special rules apply to "eligible" and "ineligible" deferred compensation plans of State and local government and tax-exempt employers.[1510]

Amounts deferred under an eligible deferred compensation plan generally are not included in income until received. In order for a plan to be an eligible plan, the plan must limit deferrals to a dollar amount ($17,500 for 2014, plus an additional "catch-up" amount for older participants) or, if less, the participant's includible compensation. The plan must also meet various other requirements.

Some aspects of the rules for eligible deferred compensation plans are quite different for plans of State or local government employers and plans of tax-exempt employers. In particular, an eligible deferred compensation plan of a State or local government is a tax-favored, funded arrangement, similar to a qualified defined contribution plan, whereas an eligible deferred compensation plan of a tax-exempt employer must be unfunded. These rules in effect limit the

[1508] Secs. 421-424.

[1509] Treas. Reg. sec. 1.409A-1(f).

[1510] Sec. 457, which also contains exceptions for various arrangements.

amount of unfunded nonqualified deferred compensation that can be provided on a tax-deferred basis by a tax-exempt employer.

In the case of a plan that does not meet the requirements to be an eligible plan (an ineligible plan), deferred amounts are includible in income for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation, even though the plan is unfunded. For this purpose, a person's rights to compensation are subject to a substantial risk of forfeiture if the rights are conditioned on the future performance of substantial services by any individual.[1511]

Nonqualified deferred compensation from certain tax indifferent parties

In general

Under special rules, any compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity is generally includible in income by the service provider when there is no substantial risk of forfeiture of the service provider's rights to such compensation, regardless of the method of accounting used by the service provider.[1512] For this purpose, a service provider's rights to compensation are subject to a substantial risk of forfeiture only if the rights are conditioned on the future performance of substantial services by any individual.[1513] A condition related to a purpose of the compensation (other than future performance of substantial services) does not result in a substantial risk of forfeiture.

If the amount of any deferred compensation is not determinable at the time the compensation is otherwise includible in income, the compensation is includible when the amount becomes determinable. In that case, the income tax attributable to the compensation includible in income is increased by the sum of (1) an interest charge, and (2) an amount equal to 20 percent of the includible compensation. The interest charge is equal to the interest at the rate applicable to underpayments of tax plus one percentage point imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture.

Nonqualified entity

The term "nonqualified entity" includes certain foreign corporations and certain partnerships (either domestic or foreign). A foreign corporation is a nonqualified entity unless substantially all of its income is effectively connected with the conduct of a U.S. trade or

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[1511] Sec. 457(f)(3)(B).

[1512] Section 457A, generally effective for deferred amounts attributable to services performed after December 31, 2008.

[1513] Under section 457A(d)(1)(B), to the extent provided in regulations, if compensation is determined solely by reference to the amount of gain recognized on the disposition of an investment asset, the compensation is treated as subject to a substantial risk of forfeiture until the date of such disposition. No regulations or other guidance applying this rule has been issued.

business or is subject to a comprehensive foreign income tax. A partnership is a nonqualified entity unless substantially all of its income is allocated to persons other than foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and organizations exempt from U.S. income tax.

The term comprehensive foreign income tax means with respect to a foreign person, the income tax of a foreign country if (1) the person is eligible for the benefits of a comprehensive income tax treaty between the foreign country and the United States, or (2) the person demonstrates to the satisfaction of the Secretary of the Treasury that the foreign country has a comprehensive income tax.

Nonqualified deferred compensation

For purposes of these special rules, the term "nonqualified deferred compensation plan" is generally defined in the same manner as under the general rules for nonqualified deferred compensation (and includes any agreement or arrangement, as well as actual or notional income on deferred compensation) with certain modifications.

Nonqualified deferred compensation includes any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient.[1514] However, IRS guidance provides some exceptions.[1515] In general, under the guidance, a stock option is not treated as nonqualified deferred compensation for this purpose if the exercise price of the stock option cannot be less than the fair market value, on the date the option is granted, of the stock subject to the option and the option does not otherwise include a deferral feature. A similar exception applies to arrangements involving the right to purchase an equity interest in a noncorporate entity. Exceptions apply also for statutory options. Finally, an exception applies for a SAR if the exercise price of the SAR cannot be less than the fair market value, on the date the SAR is granted, of the stock subject to the SAR and the SAR does not otherwise include a deferral feature, but only if the SAR by its terms at all times must be settled in service recipient stock and is settled in service recipient stock.

A special "short-term deferral" exception applies, under which compensation is not treated as deferred if the service provider receives payment of the compensation not later than 12 months after the end of the taxable year of the service recipient during which the right to the payment of such compensation is no longer subject to a substantial risk of forfeiture (within the meaning of the special rules).

[1514] Sec. 457A(d)(3)(A). The Secretary of the Treasury is authorized to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 457A.

[1515] Notice 2009-8, 2009-1 C.B. 347, A-2(b). For a discussion of intended exceptions for certain arrangements, see Committee on Ways and Means Report to accompany H.R. 6049, the Renewable Energy and Job Creation Act of 2008, H.R. Rep. No. 110-658, May 20, 2008, pp. 195-196.

Description of Proposal

In general

Under the proposal, any compensation deferred under a nonqualified deferred compensation plan is includible in gross income by the service provider when there is no substantial risk of forfeiture of the service provider's rights to such compensation. For this purpose, the rights of a service provider to compensation are treated as subject to a substantial risk of forfeiture only if the rights are conditioned on the future performance of substantial services by any individual. Under the proposal, a condition related to a purpose of the compensation other than the future performance of substantial services (such as a condition based on achieving a specified performance goal) does not create a substantial risk of forfeiture, regardless of whether the possibility of forfeiture is substantial.

The proposal applies without regard to the method of accounting of the service provider. Because of the definition of substantial risk of forfeiture under the proposal, a taxpayer using either the cash method of accounting or the accrual method of accounting may be required to include deferred compensation in income earlier than the method of accounting would otherwise require.

Nothing under the proposal is to be construed to prevent the inclusion of amounts in income under any other income tax provision or any other rule of law earlier than the time provided in the proposal. Any amount included in income under the proposal is not required to be included in income under any other income tax provision or any other rule of law later than the time provided under the proposal.

Nonqualified deferred compensation

For purposes of the proposal, the term "nonqualified deferred compensation plan" means any plan that provides for the deferral of compensation, other than a qualified employer plan, a bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan, and any other plan or arrangement designated by the Secretary of the Treasury consistent with the purposes of the proposal. A qualified employer plan for this purpose means a qualified retirement plan, a tax-deferred annuity plan, a simplified employee pension plan, a simple retirement account plan, an eligible deferred compensation plan of a State or local government employer, or a plan established before June 25, 1959, and funded only by employee contributions.

Nonqualified deferred compensation plan for purposes of the proposal specifically includes any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient. Such a compensation right does not fail to provide for the deferral of compensation merely because the compensation is to be paid in cash or by the transfer of equity units or, in the case of an option, the purchase price of an equity unit is not less than the fair market value of the equity unit on the date that the option is granted. Thus, it is intended that stock options and SARs (and similar arrangements involving noncorporate entities) are subject to the proposal, regardless of how the exercise price compares to the value of the related stock on the date the option or SAR is issued, and that no exceptions are to be provided in regulations or other administrative guidance. However, it is intended that statutory options are not considered nonqualified deferred compensation for purposes of the proposal.

For purposes of the proposal, a plan includes any agreement or arrangement, including an agreement or arrangement that includes one person. In addition, references to deferred compensation are treated as including references to income (whether actual or notional) attributable to deferred compensation or income. However, compensation is not treated as deferred for purposes of the proposal if the service provider receives payment of the compensation not later than six months after the end of the service recipient's taxable year during which the right to the payment of such compensation is no longer subject to a substantial risk of forfeiture (within the meaning of the proposal).

Additional rules

The Secretary of Treasury is directed to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal, including regulations disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of the proposal. Except as provided by the Secretary of the Treasury, for purposes of the proposal, rules similar to the controlled group rules for qualified retirement plans apply.[1516]

Under the proposal, the present-law general rules for nonqualified deferred compensation and the present-law rules for nonqualified deferred compensation from certain tax indifferent parties are repealed. In addition, the present-law rules for eligible and ineligible deferred compensation plans of tax-exempt employers and for ineligible deferred compensation plans of State and local governments do not apply with respect to deferred amounts attributable to services performed after December 31, 2014.

Effective Date

The proposal generally applies to amounts attributable to services performed after December 31, 2014. In the case of any deferred compensation amount to which the proposal does not apply solely by reason of the fact that the amount is attributable to services performed before January 1, 2015, to the extent such amount is not includible in gross income in a taxable year beginning before 2023, such amount is includible in income in the later of (1) the last taxable year before 2023, or (2) the taxable year in which there is no substantial risk of forfeiture of the rights to such compensation (determined in the same manner as determined under the proposal). Earnings on deferred amounts attributable to services performed on or before January 1, 2015, are subject to the proposal only to the extent that the amounts to which the earnings are attributable are subject to the proposal.

The Secretary of the Treasury is directed to issue guidance, no later than 120 days after enactment of the proposal, providing a limited period of time during which a nonqualified deferred compensation arrangement attributable to services performed on or before

[1516] Secs. 414(b) and (c).

December 31, 2014, may, without violating the general rules for nonqualified deferred compensation, be amended to conform the date of distribution to the service provider to the date amounts are required to be included in income under the proposal. If the service provider-taxpayer is also a service recipient and maintains one or more nonqualified deferred compensation arrangements for its service providers under which any amount is attributable to services performed on or before December 31, 2014, the guidance is to permit any such arrangement to be amended to conform the dates of distribution under that arrangement to the date amounts are required to be included in the income of the taxpayer. An amendment to a nonqualified deferred compensation arrangement made pursuant to the guidance is not to be treated as a material modification of the arrangement for purposes of the general rules for nonqualified deferred compensation.

2. Modification of limitation on excessive employee remuneration (sec. 3802 of the discussion draft and sec. 162(m) of the Code)

Present Law

In general

An employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense. Section 162(m) provides an explicit limitation on the deductibility of compensation expenses in the case of corporate employers. The otherwise allowable deduction for compensation paid or accrued with respect to a covered employee of a publicly held corporation[1517] is limited to no more than $1 million per year.[1518] The deduction limitation applies when the deduction would otherwise be taken.

Covered employees

Section 162(m) defines a covered employee as (1) the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year and (2) the four most highly compensated officers for the taxable year (other than the chief executive officer). Treasury regulations under section 162(m) provide that whether an employee is the chief executive officer or among the four most highly compensated officers should be determined pursuant to the executive compensation disclosure rules promulgated under the Securities Exchange Act of 1934 ("Exchange Act").

In 2006, the Securities and Exchange Commission amended certain rules relating to executive compensation, including which officers' compensation must be disclosed under the Exchange Act. Under the new rules, such officers are (1) the principal executive officer (or an individual acting in such capacity), (2) the principal financial officer (or an individual acting in

[1517] A corporation is treated as publicly held if it has a class of common equity securities that is required to be registered under section 12 of the Securities Exchange Act of 1934.

[1518] Sec. 162(m). This deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.

such capacity), and (3) the three most highly compensated officers, other than the principal executive officer or financial officer.

In response to the Securities and Exchange Commission's new disclosure rules, the Internal Revenue Service issued updated guidance on identifying which employees are covered by section 162(m).[1519] The new guidance provides that "covered employee" means any employee who is (1) the principal executive officer (or an individual acting in such capacity) defined in reference to the Exchange Act, or (2) among the three most highly compensated officers for the taxable year (other than the principal executive officer), again defined by reference to the Exchange Act. Thus, under current guidance, only four employees are covered under section 162(m) for any taxable year. Under Treasury regulations, the requirement that the individual meet the criteria as of the last day of the taxable year applies to both the principal executive officer and the three highest compensated officers.[1520]

Remuneration subject to the deduction limitation

In general

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in section 280G) that are not deductible by the corporation.

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account: (1) remuneration payable on a commission basis; (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met ("performance-based compensation"); (3) payments to a tax-favored retirement plan (including salary reduction contributions); (4) amounts that are excludable from the executive's gross income (such as employer-provided health benefits and miscellaneous fringe benefits[1521]); and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993. In addition, remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (*e.g.*, is not performance-based compensation) because the payment of compensation is deferred until after termination of employment.

1519 Notice 2007-49, 2007-25 I.R.B. 1429.

1520 Treas. Reg. sec. 1.162-27(c)(2).

1521 Secs. 105, 106, and 132.

Performance-based compensation

Compensation qualifies for the exception for performance-based compensation only if (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation committee consisting solely of two or more outside directors,[1522] (3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.

Compensation (other than stock options or other stock appreciation rights) is not treated as paid solely on account of the attainment of one or more performance goals unless the compensation is paid to the particular executive pursuant to a pre-established objective performance formula or standard that precludes discretion. Stock options or other stock appreciation rights generally are treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval are met (without the need for certification that the performance standards have been met), because the amount of compensation attributable to the options or other rights received by the executive would be based solely on an increase in the corporation's stock price. Stock-based compensation is not treated as performance-based if it is dependent on factors other than corporate performance.

Description of Proposal

Performance-based compensation exceptions

With respect to the limit on compensation of a covered employee that is deductible for a year, the proposal eliminates the exceptions from the definition of compensation subject to the limit for compensation payable on a commission basis and for other performance-based compensation. Thus, such compensation is taken into account in determining the amount of compensation with respect to a covered employee for a taxable year that exceeds $1 million and is thus not deductible under section 162.

Definition of covered employee

The definition of covered employee is revised to include both (1) the principal executive officer (or an individual acting in such capacity) and (2) the principal financial officer (or an individual acting in such capacity). Further, an individual is a covered employee if the individual holds one of these positions at any time during the taxable year. Thus, it is possible for more than two individuals to be covered employees for the taxable year based on this rule. The definition is

[1522] A director is considered an outside director if he or she is not a current employee of the corporation (or related entities), is not a former employee of the corporation (or related entities) who is receiving compensation for prior services (other than benefits under a qualified retirement plan), was not an officer of the corporation (or related entities) at any time, and is not currently receiving compensation for personal services in any capacity (*e.g.*, for services as a consultant) other than as a director.

also revised to include the three most highly compensated officers for the taxable year (other than the principal executive officer or financial officer) rather than the four most highly compensated officers (other than the principal executive officer).

In addition, if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2013, the individual remains a covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died. Compensation does not fail to be compensation with respect to a covered employee and thus subject to the deduction limit for a taxable year merely because the compensation is includible in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the employee's death, or to a former spouse pursuant to a domestic relations order.

Effective Date

The proposal applies to taxable years beginning after December 31, 2014.

3. Excise tax on excess tax-exempt organization executive compensation (sec. 3803 of the discussion draft and new sec. 4960 of the Code)

Present Law

Taxable employers and other service recipients are generally allowed a deduction for reasonable compensation expenses.[1523] However, in some cases, compensation in excess of specific levels is not deductible.

In the case of a publicly held corporation, subject to certain exceptions, the deduction for a taxable year for compensation of the corporation's principal executive officer or for any of the corporation's three most highly compensated officers other than the principal executive officer is limited to $1 million ("$1 million limit on deductible compensation").[1524]

A "parachute payment" (generally a payment of compensation that is contingent on a change in corporate ownership or control) made to an officer, shareholder or highly compensated individual is generally not deductible if the aggregate present value of all such payments to an individual equals or exceeds three times the individual's base amount (an "excess parachute payment").[1525] An individual's base amount is the average annual compensation includible in the individual's gross income for the five taxable years ending before the date the change in ownership or control occurs. Certain amounts are not considered parachute payments, including

[1523] Sec. 162(a)(1).

[1524] Sec. 162(m)(1). Under section 162(m)(6), limits apply to deductions for compensation of individuals performing services for certain health insurance providers.

[1525] Sec. 280G.

payments under a qualified retirement plan, a simplified employee pension plan or a simple retirement account.[1526]

These deduction limits generally do not affect a tax-exempt organization.

Description of Proposal

Under the proposal, an employer is liable for an excise tax of 25 percent of the sum of the (1) remuneration (other than an excess parachute payment) in excess of $1 million paid to a covered employee by an applicable tax-exempt organization for a taxable year, and (2) any excess parachute payment paid by the applicable tax-exempt organization to a covered employee. Accordingly, the excise tax applies as a result of an excess parachute payment, even if the covered employee's remuneration does not exceed $1 million.

For purposes of the proposal, a covered employee is an employee (including any former employee) of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for the taxable year or was a covered employee of the organization (or a predecessor) for any preceding taxable year beginning after December 31, 2013. An "applicable tax-exempt organization" is an organization exempt from tax under the Code,[1527] an exempt farmers' cooperative,[1528] or a Federal, State or local governmental entity with excludable income.[1529]

Remuneration means wages as defined for income tax withholding purposes,[1530] but does not include any designated Roth contribution.[1531] Remuneration of a covered employee includes any remuneration paid with respect to employment of the covered employee by any person or governmental entity related to the applicable tax-exempt organization. A person or governmental entity is treated as related to an applicable tax-exempt organization if the person or governmental entity (1) controls, or is controlled by, the organization, (2) is controlled by one or more persons that control the organization, (3) is a supported organization[1532] during the taxable year with respect to the organization, (4) is a supporting organization[1533] during the taxable year

[1526] Secs. 401(a) and 403(a), 408(k) and 408(p).

[1527] Sec. 501(a).

[1528] Sec. 521(b).

[1529] Sec. 115(1).

[1530] Sec. 3401(a).

[1531] Under section 402A(c), a designated Roth contribution is an elective deferral (that is, a contribution to a tax-favored employer-sponsored retirement plan made at the election of an employee) that the employee designates as not being excludable from income.

[1532] Sec. 509(f)(3).

[1533] Sec. 509(a)(3).

with respect to the organization, or (5) in the case of a voluntary employees' beneficiary association ("VEBA"),[1534] establishes, maintains, or makes contributions to the VEBA. However, remuneration of a covered employee that is not deductible by reason of the $1 million limit on deductible compensation is not taken into account for purposes of the proposal.

Under the proposal, an excess parachute payment is the amount by which any parachute payment exceeds the portion of the base amount allocated to the payment. A parachute payment is a payment in the nature of compensation to (or for the benefit of a covered employee) if the payment is contingent on the employee's separation from employment and the aggregate present value of all such payments is three times or more the base amount. The base amount is the average annual compensation includible in the covered employee's gross income for the five taxable years ending before the date of the employee's separation from employment. Parachute payments do not include payments under a qualified retirement plan, a simplified employee pension plan, a simple retirement account, a tax-deferred annuity,[1535] or an eligible deferred compensation plan of a State or local government employer.[1536]

The employer of a covered employee is liable for the excise tax. If remuneration of a covered employee from more than one employer is taken into account in determining the excise tax, each employer is liable for the tax in an amount that bears the same ratio to the total tax as the remuneration paid by that employer bears to the remuneration paid by all employers to the covered employee.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

4. Denial of deduction as research expenditure for stock transferred pursuant to an incentive stock option (sec. 3804 of the discussion draft and sec. 421(a)(2) of the Code)

Present Law

The Code provides rules for two types of stock options granted to employees as compensation: statutory options, including incentive stock options ("ISOs") and options provided under an employee stock purchase plan ("ESPP"), and nonqualified options, which are any other options granted to employees in connection with the performance of services.[1537]

If an employee exercises a nonqualified option and receives stock that is substantially vested, the difference between the value of the stock received and the amount the employee paid

[1534] Sec. 501(c)(9).

[1535] Sec. 403(b).

[1536] Sec. 457(b).

[1537] Sections 421-424 govern statutory options. Rules relating to nonqualified options apply under section 83, property transferred in connection with the performance of services.

for the stock (referred to as the "spread" on acquisition of the stock) is included in the employee's income and wages. The employer is allowed a deduction for the amount included in the employee's income.

No amount is includable in the gross income or wages of the option recipient on the grant or exercise of a statutory option.[1538] Thus, the spread on an employee's exercise of an ISO or purchase of stock under an ESPP is not includable in an employee's income. No deduction as a trade or business expense is allowable to the employer with respect to the grant or exercise of a statutory option.[1539] Thus, an employer may not deduct the spread on an employee's exercise of an ISO or purchase of stock under an ESPP.

If an employee disposes of stock acquired upon exercise of a statutory option, the employee generally is taxed at capital gains rates with respect to the excess of the fair market value of the stock on the date of disposition over the option price, and no compensation expense deduction is allowable to the employer, unless the employee fails to meet a holding period requirement. The employee fails to meet this holding period requirement if the disposition occurs within two years after the date the option is granted or one year after the date the option is exercised. A disposition that occurs prior to the expiration of the applicable holding periods (a "disqualifying disposition") does not qualify for capital gains treatment. Instead, the income realized on the disqualifying disposition, up to the spread on the acquisition of the stock, is treated by the employee as compensation received in the taxable year in which the disposition occurs (but is excluded from wages), and a corresponding deduction is allowable to the employer for the taxable year in which the disposition occurs.[1540]

A memorandum issued by the IRS Office of Chief Counsel considers the issue of whether an employer may deduct the spread on an employee's exercise of an ISO or purchase of stock under an ESPP as a research or experimental expenditure[1541] and concludes that the rules relating to statutory options do not permit such a deduction.[1542]

Description of Proposal

The proposal amends the rules relating to statutory options to remove the reference to trade or business expense, thus clarifying that under present law no deduction is allowable to an employer on an employee's exercise of an ISO or purchase of stock under an ESPP.

[1538] Sec. 421(a)(1). For purposes of the individual alternative minimum tax, the transfer of stock on the exercise of an incentive stock option is treated as the transfer of stock pursuant to a nonqualified option.

[1539] Sec. 421(a)(2), referring to trade or business expenses deductible under section 162.

[1540] Sec. 421(b).

[1541] Sec. 174.

[1542] RS NSAR 20094301F, June 24, 2009.

Effective Date

The proposal is effective is effective for stock transferred on or after February 26, 2014.

5. Determination of worker classification (sec. 3811 of the discussion draft and new secs. 7707, 3402(s) and 6041A(g) of the Code)

Present Law

In general

The classification of a worker as an employee or not as an employee (that is, a self-employed individual in most cases) is relevant for many tax purposes. These purposes include employment tax requirements, exclusions from gross income for certain types of compensation, and expense deductions. Some purposes favor employee status, while others favor self-employed status. For example, an employee may exclude employer-provided health benefits from gross income. On the other hand, a self-employed individual may deduct work-related expenses in determining adjusted gross income.

Common-law test and section 530 of the Revenue Act of 1978

The largest body of tax law relating to worker classification has developed in connection with employment taxes.[1543] Employment tax responsibility generally rests with the person who is the employer of an employee under a common-law test that has been incorporated into Treasury regulations.[1544] Under the regulations, an employer-employee relationship generally exists if the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer, not only as to what is to be done, but also as to how it is to be done. It is not necessary that the employer actually control the manner in which the services are performed, rather it is sufficient that the employer have a right to control. Whether the requisite control exists is determined on the basis of all the relevant facts and circumstances.

Various cases and administrative guidance have identified various facts or factors that are relevant in determining whether an employer-employee relationship exists. Based on an examination of cases and rulings, the Internal Revenue Service ("IRS") developed a list of 20 factors that may be examined in determining whether an employer-employee relationship

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[1543] Employment taxes consist of taxes under the Federal Insurance Contributions Act ("FICA"), secs. 3101-3128, the Railroad Retirement Tax Act ("RRTA"), secs. 3201-3233, and the Federal Unemployment Tax Act ("FUTA"), secs. 3301-3311, and required income tax withholding, secs. 3401-3404.

[1544] Treas. Reg. secs. 31.3121(d)-1(c)(1), 31.3306(i)-1(a), and 31.3401(c)-1.

exists.[1545] The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed.

More recently, the IRS has identified three categories of evidence that may be relevant in determining whether the requisite control exists under the common-law test and has grouped illustrative factors under these three categories: (1) behavioral control; (2) financial control; and (3) relationship of the parties.[1546] The IRS emphasizes that factors in addition to the 20 identified factors may be relevant, that the weight of the factors may vary based on the circumstances, that relevant factors may change over time, and that all facts must be examined.

Generally, individuals who follow an independent trade, business, or profession in which they offer services to the public are not employees. Courts have recognized that a highly educated or skilled worker does not require close supervision; therefore, the degree of day-to-day control over the worker's performance of services is not particularly helpful in determining the worker's status. Courts have considered other factors in these cases, tending to focus on the individual's ability to realize a profit or suffer a loss as evidenced by business investments and expenses.

Under section 530 of the Revenue Act of 1978[1547] ("section 530"), if certain requirements are met, a taxpayer may generally treat a worker as not being an employee for employment tax purposes, regardless of the worker's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment. For this purpose, a reasonable basis exists if the taxpayer reasonably relied on (1) past IRS audit practice with respect to the taxpayer, (2) published rulings or judicial precedent, (3) long-standing recognized practice in the industry of which the taxpayer is a member, or (4) any other reasonable basis. Relief under section 530 also requires that the taxpayer not have treated the worker as an employee for any period, and, for periods after 1978, all Federal tax returns, including information returns, must have been filed on a basis consistent with treating the worker as not being an employee. Further, the taxpayer (or a predecessor) must not have treated any worker holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977.

[1545] Rev. Rul. 87-41, 1987-1 C.B. 296. The 20 factors identified by the IRS are: (1) instructions, (2) training, (3) integration of the worker's services into business operations, (4) services to be rendered personally, (5) hiring, supervision, and paying assistants, (6) continuing relationship, (7) set hours of work, (8) full-time services required, (9) work on service recipient's premises, (10) required order or sequence of work, (11) oral or written reports required, (12) payment by the hour, week, or month, (13) payment of business or travel expenses, (14) furnishing of tools and materials by service recipient, (15) significant investment by the worker, (16) ability to realize a profit or loss by the worker, (17) working for more than one firm at a time, (18) services available to the general public, (19) service recipient has right to discharge, and (20) worker has right to terminate relationship.

[1546] Department of the Treasury, Internal Revenue Service, *Independent Contractor or Employee? Training Materials*, Training 3320-102 (10-96) TPDS 84238I, pp. 2-7. This document is publicly available through the IRS website.

[1547] Pub. L. No. 95-600. The relief provided under section 530 was initially temporary to give Congress time to resolve the many complex issues regarding worker classification. However, after being extended more than once, it was made permanent and has been amended several times over the years.

Section 530 also generally prohibits Treasury and the IRS from publishing regulations and revenue rulings with respect to the employment status of any individual for employment tax purposes. However, a service provider or service recipient may generally obtain a written determination from the IRS regarding the status of a particular worker as an employee or independent contractor for purposes of Federal employment taxes and income tax withholding.[1548]

Statutory employee or nonemployee status

The Code contains various provisions that prescribe treatment of a specific category or type of worker as an employee or as not being an employee. Some of these provisions apply for Federal tax purposes generally; for example, certain real estate agents and direct sellers are treated for all tax purposes as not being employees.[1549] Others apply only for specific purposes; for example, full-time life insurance salesmen are treated as employees for social security and Medicare tax and employee benefit purposes,[1550] and certain other salesmen are treated as employees for social security and Medicare tax purposes.[1551]

Description of Proposal

In general

The proposal provides a safe harbor under which, for all Code purposes (and notwithstanding any Code provision to the contrary), if certain requirements are met with respect to service performed by a service provider, with respect to such service: (1) the service provider is not treated as an employee, (2) the service recipient is not treated as an employer, (3) a payor (defined below) is not treated as an employer, and (4) the compensation paid or received for the service is not treated as paid or received with respect to employment.

For purposes of the proposal, a service provider is any qualified person who performs service for another person, and a qualified person is any natural person or any entity if substantially all of the services are performed by natural persons who directly own interests in such entity. The service recipient is the person for whom the service provider performs service. A payor is a person (other than the service recipient) that pays the service provider for performing the service.

The proposal does not apply with respect to any service provided by a service provider to a service recipient if the service provider owns any interest in the service recipient, with the

[1548] IRS Form SS-8 (Rev. 11-2006). A written determination with regard to prior employment status may be issued by the IRS. The IRS will not issue a written determination with respect to prospective employment status. Section 3.01(81) of Rev. Proc. 2014-3, 2014-1 I.R.B. 111, 116.

[1549] Sec. 3508.

[1550] Sec. 3121(d)(3)(B) and 7701(a)(20).

[1551] Sec. 3121(d)(3)(D).

exception of a service recipient, the stock of which is regularly traded on an established securities market. In addition, the proposal does not apply with respect to service unless the service is performed in furtherance of a trade or business of the service recipient.

Under the proposal, notwithstanding section 530 of the Revenue Act of 1979, the Secretary of the Treasury is directed to issue such regulations as the Secretary determines are necessary to carry out the purposes of the proposal.

Service provider requirements

In order for this treatment to apply to service, in connection with performing the service, the service provider generally must (1) incur significant unreimbursed expenses; (2) agree to perform the service for a particular amount of time, to achieve a specific result, or to complete a specific task; (3) be primarily compensated on a basis not tied to the number of hours worked; and (4) have a significant investment in assets or training, not be required to perform services exclusively for the service recipient, or have not performed services for the service recipient as an employee during the one-year period ending with the date of commencement of services under a contract meeting the requirements described below. Alternatively, in the case of a service provider engaged in the trade or business of selling (or soliciting the sale of) goods or services, the service provider must be compensated primarily on a commission basis, and substantially all the compensation for the service must be directly related to sales of goods or services rather than to the number of hours worked. In addition, any service provider must have a principal place of business, must not primarily provide the service in the service recipient's place of business, must pay a fair market rent for use of the service recipient's place of business, or must provide the service primarily using equipment supplied by the service provider.

Contract and reporting requirements

The service performed by the service provider must be pursuant to a written contract between the service provider and the service recipient (or the payor) that meets certain requirements. First, the contract must include the service provider's name, taxpayer identification number, and address; a statement that the service provider will not be treated as an employee for purposes of the Code with respect to the service provided pursuant to the contract; a statement that the service recipient (or the payor) will, consistent with Code requirements, withhold on and report to the IRS the compensation payable pursuant to the contract; a statement that the service provider is responsible for the payment of Federal, State, and local taxes, including self-employment taxes, on compensation payable pursuant to the contract; and a statement that the contract is intended to be a contract meeting the applicable requirements. Second, the contract must be signed by both the service recipient and the service provider no later than the date on which aggregate payments made by the service recipient to the service provider exceed $600. Third, the term of the contract generally must not exceed one year; however, a contract can be renewed in writing for up to a year if the required information in the contract is updated in connection with the renewal.

If, for a taxable year, the service recipient or payor fails to meet the reporting requirements applicable with respect to any service provider ("applicable" reporting requirements),[1552] the safe harbor does not apply for purposes of making any determination with respect to the tax liability of the service recipient or payor with respect to such service provider for the year (unless the failure is due to reasonable cause and not willful neglect).

Prospective application of reclassification

In the case of a determination by the IRS that a service recipient or a payor should have treated a service provider as an employee, if certain requirements are met, the determination will not be effective earlier than the "notice date." In order for this rule to apply, the service recipient or payor must have entered into a written contract with the service provider that meets the requirements described above, for all relevant taxable years the service recipient or the payor must have satisfied the applicable withholding and reporting requirements with respect to the service provider (unless the failure to satisfy the requirements is due to reasonable cause and not willful neglect), and the service recipient or the payor must demonstrate a reasonable basis for determining that the service provider is not an employee under the safe harbor and that the determination was made in good faith.

Similarly, with respect to the service provider, a determination that the service provider should have been treated as an employee will not be effective earlier than the notice date if the service provider entered into a written contract with the service recipient or payor that meets the requirements described above, for all relevant taxable years the service provider satisfied applicable income tax and self-employment tax return requirements[1553] with respect to the service recipient or payor (unless the failure to satisfy the requirements is due to reasonable cause and not willful neglect), and the service provider demonstrates a reasonable basis for determining that the service provider is not an employee under the safe harbor and that the determination was made in good faith.

For this purpose, the "notice date" is the 30th day after the earlier of (1) the date on which the first letter of proposed deficiency that allows the service provider, service recipient, or payor an opportunity for administrative review in the IRS Office of Appeals is sent, (2) the date on which a deficiency notice is sent, or (3) the date on which a notice of determination that a service provider is an employee is sent. Nothing in the prospective reclassification rule is to be construed as limiting any provision of law that provides an opportunity for administrative or judicial review of a determination by the IRS.

[1552] The applicable reporting requirements relate to, under section 6041(a), a person engaged in a trade or business that makes payments of $600 or more to another person or, under section 6041A(a), a service recipient engaged in a trade or business that pays $600 or more in remuneration to another person for services.

[1553] Secs. 6012(a) and 6017.

Withholding and reporting requirements

The proposal imposes an income tax withholding requirement with respect to compensation paid pursuant to a contract between a service provider and a service recipient (or payer) that meets the requirements described above. For this purpose, a payment of compensation is treated as a payment of wages by an employer to an employee. However, the amount required to be withheld is five percent of compensation and only on compensation up to $10,000 paid pursuant to the contract.

In the case of any service recipient required to make an information return to the IRS and provide a statement to the service provider with respect to compensation of $600 or more to which the safe harbor applies, the return and statement shall include the aggregate amount of the compensation paid to the service provider, the aggregate amount deducted and withheld from the compensation, and an indication of whether a copy of the contract required under the proposal is on file with the service recipient or payor.

Effective Date

The proposal is effective for services performed after December 31, 2014 and amounts paid for such services after such date.

J. Zones and Short-Term Regional Benefits

1. Empowerment Zones, Enterprise Communities, and Rural Development Investment Areas (sec. 3821 of the discussion draft and secs. 1391-1394, 1396, 1397, 1397A-1397F of the Code)

Present Law

The Omnibus Budget Reconciliation Act of 1993 ("OBRA 93")[1554] authorized the designation of nine empowerment zones ("Round I empowerment zones") to provide tax incentives for businesses to locate within certain targeted areas[1555] designated by the Secretaries of the Department of Housing and Urban Development ("HUD") and the U.S. Department of Agriculture ("USDA"). The first empowerment zones were established in large rural areas and large cities. OBRA 93 also authorized the designation of 95 enterprise communities, which were located in smaller rural areas and cities. For tax purposes, the areas designated as enterprise communities continued as such for the ten-year period starting in the beginning of 1995 and ending at the end of 2004.

The Taxpayer Relief Act of 1997[1556] authorized the designation of two additional Round I urban empowerment zones, and 20 additional empowerment zones ("Round II empowerment zones"). The Community Renewal Tax Relief Act of 2000 ("2000 Community Renewal Act")[1557] authorized a total of ten new empowerment zones ("Round III empowerment zones"), bringing the total number of authorized empowerment zones to 40.[1558] In addition, the 2000 Community Renewal Act conformed the tax incentives that are available to businesses in the Round I, Round II, and Round III empowerment zones, and extended the empowerment zone

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[1554] Pub. L. No. 103-66.

[1555] The targeted areas are those that have pervasive poverty, high unemployment, and general economic distress, and that satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations.

[1556] Pub. L. No. 105-34.

[1557] Pub. L. No. 106-554.

[1558] The urban part of the program is administered by HUD and the rural part of the program is administered by the USDA. The eight Round I urban empowerment zones are Atlanta, GA; Baltimore, MD, Chicago, IL; Cleveland, OH; Detroit, MI; Los Angeles, CA; New York, NY; and Philadelphia, PA/Camden, NJ. Atlanta relinquished its empowerment zone designation in Round III. The three Round I rural empowerment zones are Kentucky Highlands, KY; Mid-Delta, MI; and Rio Grande Valley, TX. The 15 Round II urban empowerment zones are Boston, MA; Cincinnati, OH; Columbia, SC; Columbus, OH; Cumberland County, NJ; El Paso, TX; Gary/Hammond/East Chicago, IN; Ironton, OH/Huntington, WV; Knoxville, TN; Miami/Dade County, FL; Minneapolis, MN; New Haven, CT; Norfolk/Portsmouth, VA; Santa Ana, CA; and St. Louis, Missouri/East St. Louis, IL. The five Round II rural empowerment zones are Desert Communities, CA; Griggs-Steele, ND; Oglala Sioux Tribe, SD; Southernmost Illinois Delta, IL; and Southwest Georgia United, GA. The eight Round III urban empowerment zones are Fresno, CA; Jacksonville, FL; Oklahoma City, OK; Pulaski County, AR; San Antonio, TX; Syracuse, NY; Tucson, AZ; and Yonkers, NY. The two Round III rural empowerment zones are Aroostook County, ME; and Futuro, TX.

incentives through December 31, 2009.[1559] The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("TRUIRJCA") extended for two years, through December 31, 2011, the period for which the designation of an empowerment zone was in effect, thus extending for two years the empowerment zone tax incentives discussed below.[1560] TRUIRJCA also extended for two years, through December 31, 2016, the exclusion of 60 percent of gain for qualified small business stock (of a corporation which is a qualified business entity) acquired on or before February 17, 2009. The American Taxpayer Relief Act of 2012 ("ATRA") extended the designation period and tax incentives for two additonal years, through December 31, 2013.[1561] ATRA also extended for two additional years, through December 31, 2018, the exclusion of 60 percent of gain for qualified small business stock (of a corporation which is a qualified business entity) acquired on or before February 17, 2009.

The tax incentives available within the designated empowerment zones include a Federal income tax credit for employers who hire qualifying employees (the "wage credit"), accelerated depreciation deductions on qualifying equipment, tax-exempt bond financing, deferral of capital gains tax on sale of qualified assets sold and replaced, and partial exclusion of capital gains tax on certain sales of qualified small business stock.

The following is a description of the tax incentives:

Wage credit

A 20-percent wage credit is available to employers for the first $15,000 of qualified wages paid to each employee (*i.e.*, a maximum credit of $3,000 with respect to each qualified employee) who (1) is a resident of the empowerment zone, and (2) performs substantially all employment services within the empowerment zone in a trade or business of the employer.[1562]

The wage credit rate applies to qualifying wages paid before January 1, 2012. Wages paid to a qualified employee who earns more than $15,000 are eligible for the wage credit (although only the first $15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable

[1559] If an empowerment zone designation were terminated prior to December 31, 2009, the tax incentives would cease to be available as of the termination date.

[1560] Pub. L. No. 111-312, sec. 753 (2010). In the case of a designation of an empowerment zone the nomination for which included a termination date which is December 31, 2009, termination shall not apply with respect to such designation if the entity which made such nomination amends the nomination to provide for a new termination date in such manner as the Secretary may provide.

[1561] Pub. L. No. 112-240, sec. 327 (2013).

[1562] Sec. 1396. The $15,000 limit is annual, not cumulative such that the limit is the first $15,000 of wages paid in a calendar year which ends with or within the taxable year.

business carrying out activities in the empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an "enterprise zone business."[1563]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[1564] Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.[1565] In addition, the $15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.[1566] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[1567]

Increased section 179 expensing limitation

An enterprise zone business is allowed an additional $35,000 of section 179 expensing (for a total of up to $535,000 in 2010 and 2011)[1568] for qualified zone property placed in service before January 1, 2012.[1569] The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds $2,000,000.[1570] The term "qualified zone property" is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer. Special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such

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[1563] Secs. 1397C(b) and 1397C(c). However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B), including a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or liquor store, or certain farming activities. In addition, wages are not eligible for the wage credit if paid to: (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

[1564] Sec. 280C(a).

[1565] Secs. 1396(c)(3)(A) and 51A(d)(2).

[1566] Secs. 1396(c)(3)(B) and 51A(d)(2).

[1567] Sec. 38(c)(2).

[1568] The Small Business Jobs Act of 2010, Pub. L. No. 111-240, sec. 2021.

[1569] Secs. 1397A, 1397D.

[1570] Sec. 1397A(a)(2), 179(b)(2). For 2010-2013 the limit is $2,000,000. For taxable years beginning after 2013, the limit is $200,000.

year: (1) every trade or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.[1571]

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business (whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35 percent of such employees are residents of an empowerment zone; (6) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.[1572]

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any business prohibited in connection with the employment credit.[1573] In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

[1571] Sec. 1397C(b).

[1572] Sec. 1397C(c).

[1573] Sec. 1397C(d). Excluded businesses include any private or commercial golf course, country club, massage parlor, hot tub facility, sun tan facility, racetrack, or other facility used for gambling or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption. Sec. 144(c)(6).

Expanded tax-exempt financing for certain zone facilities

States or local governments can issue enterprise zone facility bonds to raise funds to provide an enterprise zone business with qualified zone property.[1574] These bonds can be used in areas designated enterprise communities as well as areas designated empowerment zones. To qualify, 95 percent (or more) of the net proceeds from the bond issue must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property.

The term enterprise zone business is the same as that used for purposes of the increased section 179 deduction limitation (discussed above) with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period, and (2) the business makes bona fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of (1) the issue date of the bond issue financing the qualified zone property, and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).[1575]

Second, a business that qualifies as an enterprise zone business at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

The face amount of the bonds may not exceed $60 million for an empowerment zone in a rural area, $130 million for an empowerment zone in an urban area with zone population of less than 100,000, and $230 million for an empowerment zone in an urban area with zone population of at least 100,000.

Elective roll over of capital gain from the sale or exchange of any qualified empowerment zone asset

Taxpayers can elect to defer recognition of gain on the sale of a qualified empowerment zone asset[1576] held for more than one year and replaced within 60 days by another qualified

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[1574] Sec. 1394.

[1575] Sec. 1394(b)(3).

[1576] The term "qualified empowerment zone asset" means any property which would be a qualified community asset (as defined in section 1400F, relating to certain tax benefits for renewal communities) if in section 1400F: (i) references to empowerment zones were substituted for references to renewal communities, (ii) references to enterprise zone businesses (as defined in section 1397C) were substituted for references to renewal community businesses, and (iii) the date of the enactment of this paragraph were substituted for "December 31, 2001" each place it appears. Sec. 1397B(b)(1)(A).

A "qualified community asset" includes: (1) qualified community stock (meaning original-issue stock purchased for cash in an enterprise zone business), (2) a qualified community partnership interest (meaning a empowerment zone asset in the same zone.[1577] The deferral is accomplished by reducing the basis of the replacement asset by the amount of the gain recognized on the sale of the asset.

Partial exclusion of capital gains on certain small business stock

Generally, individuals may exclude a percentage of gain from the sale of certain small business stock acquired at original issue and held at least five years.[1578] For stock acquired prior to February 18, 2009, or after December 31, 2013, the percentage is generally 50 percent, except that for empowerment zone stock the percentage is 60 percent for gain attributable to periods before January 1, 2019. For stock acquired after February 17, 2009, and before January 1, 2014, a higher percentage applies to all small business stock with no additional percentage for empowerment zone stock.

Other tax incentives

Other incentives not specific to empowerment zones but beneficial to these areas include the work opportunity tax credit for employers based on the first year of employment of certain targeted groups, including empowerment zone residents (up to $2,400 per employee), and qualified zone academy bonds for certain public schools located in an empowerment zone, or expected (as of the date of bond issuance) to have at least 35 percent of its students receiving free or reduced lunches.

Description of Proposal

The proposal repeals the zone designations, which expired at the end of 2013, and all of the tax incentives available within designated empowerment zones except for (i) the treatment of bonds issued before 2014 which proceeds were used for any enterprise zone facility, and (ii) the rollover treatment for sales of qualified empowerment zone assets before 2014.

Effective Date

The proposal is effective on date of enactment.

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partnership interest acquired for cash in an enterprise zone business), and (3) qualified community business property (meaning tangible property originally used in a enterprise zone business by the taxpayer) that is purchased or substantially improved after the date of the enactment of this paragraph.

[1577] Sec. 1397B.

[1578] Sec. 1202.

2. DC Zone (sec. 3822 of the discussion draft and secs. 1400, 1400A-1400C of the Code)

Present Law

In general

The Taxpayer Relief Act of 1997[1579] designated certain economically depressed census tracts within the District of Columbia as the "District of Columbia Enterprise Zone," or "DC Zone," within which businesses and individual residents are eligible for special tax incentives. The census tracts that comprise the District of Columbia Enterprise Zone are (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (*i.e.*, portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District of Columbia), and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The District of Columbia Enterprise Zone designation was originally in effect for the period from January 1, 1998, through December 31, 2009 and then extended for two years through December 31, 2011.

The following tax incentives are provided in the Code in connection with the District of Columbia Enterprise Zone: (1) 20-percent wage credit;[1580] (2) an additional $35,000 of section 179 expensing for qualified zone property; and (3) expanded tax-exempt financing for certain zone facilities (as discussed below).[1581]

In addition, a zero-percent capital gains rate applies to qualified capital gain from the sale of any DC Zone asset held for more than five years (and acquired or substantially improved before January 1, 2012).[1582] In general, a "DC Zone asset" means stock or partnership interests held in, or tangible property held by, a DC Zone business. For purposes of the zero-percent capital gains rate, the DC Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than ten percent.

In general, gain eligible for the zero-percent tax rate is that from the sale or exchange of a DC Zone asset that is (1) a capital asset or (2) property used in a trade or business, as defined in section 1231(b). Gain that is attributable to real property, or to intangible assets, qualifies for the zero-percent rate, provided that such real property or intangible asset is an integral part of a

[1579] Pub. L. No. 105-34.

[1580] Unlike the empowerment zone employment credit, this credit is available to employers for the first $15,000 of qualified wages paid to each employee, regardless of whether the qualified employee is a resident of the DC Zone. An employer is entitled to the credit as long as the qualified employee lives in the District of Columbia. Secs. 1396, 1400(d), 1400(e).

[1581] These bonds could only be issued while the DC Zone designation was in effect.

[1582] Sec. 1400B.

qualified DC Zone business.[1583] However, no gain attributable to periods before January 1, 1998, and after December 31, 2016, is qualified capital gain.

In addition to tax benefits provided in connection with the DC Zone, the Code provides for a nonrefundable tax credit for first-time homebuyers of a principal residence in the District of Columbia purchased before January 1, 2012.

Expanded tax-exempt financing for certain zone facilities

An enterprise zone business is permitted to borrow proceeds from the issuance of tax-exempt enterprise zone facility bonds (as defined in section 1394, without regard to the employee residency requirement) issued by the District of Columbia. To qualify, 95 percent (or more) of the net proceeds must be used to finance: (1) qualified zone property the principal user of which is an enterprise zone business, and (2) certain land functionally related and subordinate to such property. Accordingly, most of the proceeds have to be used to finance certain facilities within the DC Zone. The aggregate face amount of all outstanding qualified enterprise zone facility bonds per enterprise zone business may not exceed $15 million and may be issued only while the DC Zone designation is in effect, from January 1, 1998 through December 31, 2011.

The term enterprise zone business is the same as that used for purposes of the increased section 179 deduction limitation with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period, and (2) the business makes bona fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of (1) the issue date of the bond issue financing the qualified zone property, and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).

Second, a business that qualifies at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

Description of Proposal

The proposal repeals the DC Zone designation, which expired in 2011, and repeals all of the tax incentives available within the DC Zone except for the treatment of tax-exempt bonds for certain zone facilities issued before January 1, 2012, and the zero percent capital gains rate on DC Zone assets acquired before January 1, 2012. The proposal repeals the nonrefundable tax credit for first-time homebuyers of a principal residence in the District of Columbia, except for those principal residences purchased before January 1, 2012.

[1583] However, sole proprietorships and other taxpayers selling assets directly cannot claim the zero-percent rate on capital gain from the sale of any intangible property (*i.e.*, the integrally related test does not apply).

Effective Date

The proposal is effective on date of enactment.

3. Renewal Communities (sec. 3823 of the discussion draft and secs. 1400E-1400J of the Code)

Present Law

The 2000 Community Renewal Act[1584] authorized the designation of 40 "renewal communities" within which special tax incentives designed to attract business and investment to distressed urban and rural areas are available. The following tax incentives generally were available during the period beginning January 1, 2002, and ending December 31, 2009.[1585]

Renewal community employment credit

A 15-percent wage credit is available to employers for the first $10,000 of qualified wages paid to each employee (*i.e.*, a maximum credit of $1,500 with respect to each qualified employee) who (1) is a resident of the renewal community, and (2) performs substantially all employment services within the renewal community in a trade or business of the employer.[1586]

The wage credit applies to qualifying wages paid after December 31, 2001, and before January 1, 2010. Wages paid to a qualified employee who earns more than $10,000 are eligible for the wage credit (although only the first $10,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee, employed for at least 90 days, regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the renewal community may claim the

[1584] For legislative background of these provisions, see H. Rep. 106-1033, December 15, 2000, pp. 977-1000, and H. Rep. 106-1004, October 26, 2000, pp. 330-353, that accompanied H.R. 2614. H.R. 2614 was passed by the House of Representatives on October 26, 2000, but was not brought to a vote in the Senate.

Charged with auditing the renewal community program, the GAO included a detailed description of the renewal community program implementation in its 2004 report. U.S. General Accounting Office, *Community Development: Federal Revitalization Programs Are Being Implemented, but Data on the Use of Tax Benefits Are Limited*, GAO-04-306, March 2004. On July 7, 2004, the General Accounting Office was renamed the Government Accountability Office. The abbreviation GAO as used herein refers to the General Accounting Office for documents published before July 7, 2004, and to the Government Accountability Office for documents published on or after such date.

[1585] If a renewal community designation is terminated prior to December 31, 2009, the tax incentives cease to be available as of the termination date.

[1586] Sec. 1400H. This section treats a renewal community as an empowerment zone for purposes of section 1396 with respect to wages paid or incurred after December 31, 2001, subject to modifications of the applicable percentage amount (15 percent instead of 20 percent) and the qualified wage amount ($10,000 instead of $15,000).

wage credit, regardless of whether the employer meets the definition of a "renewal community business."[1587]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[1588] Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.[1589] In addition, the $10,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.[1590] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[1591]

Additional section 179 expensing

A renewal community business (as defined below in connection with the zero-percent capital gains rate) is allowed an additional $35,000 of section 179 expensing for qualified renewal property placed in service after December 31, 2001, and before January 1, 2010.[1592] The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified renewal property placed in service during the year by the taxpayer exceeds $500,000.[1593]

The term "qualified renewal property" is defined as depreciable tangible property (including buildings), provided that (1) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (2) the original use of the property in the renewal community commences with the taxpayer, and (3) substantially all of the use of the property is in the renewal community in the active conduct of a trade or business by the taxpayer.[1594] Special rules are provided in the case of property that is substantially renovated by the taxpayer.

[1587] Sec. 1400G. However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B) or certain farming activities. In addition, wages are not eligible for the wage credit if paid to (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

[1588] Sec. 280C(a).

[1589] Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).

[1590] Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).

[1591] Sec. 38(c)(2).

[1592] Sec. 1400J.

[1593] Sec. 1400J, 179(b)(2), 179(b)(7). For 2008 and 2009, the limit is $800,000.

[1594] Secs. 1400J(b), 1397D.

Commercial revitalization deduction

Each State is permitted to allocate up to $12 million of commercial revitalization expenditures to each renewal community located within the State for each calendar year after 2001 and before 2010. The appropriate State agency will make the allocations pursuant to a qualified allocation plan.[1595]

A commercial revitalization expenditure means the cost of a new building or the cost of substantially rehabilitating an existing building. The building must be used for commercial purposes and be located in a renewal community. In the case of the rehabilitation of an existing building, the cost of acquiring the building will be treated as a qualifying expenditure only to the extent that such costs do not exceed 30 percent of the other rehabilitation expenditures. The qualifying expenditures for any building cannot exceed $10 million.

A taxpayer can elect either to (a) deduct one-half of the commercial revitalization expenditures for the taxable year the building is placed in service or (b) amortize all the expenditures ratably over the 120-month period beginning with the month the building is placed in service.[1596] No depreciation is allowed for amounts deducted under this provision. The adjusted basis of the building is reduced by the amount of the commercial revitalization deduction, and the deduction is treated as a depreciation deduction in applying the depreciation recapture rules.

The commercial revitalization deduction is treated in the same manner as the low-income housing credit in applying the passive loss rules. Thus, up to $25,000 of deductions (together with the other deductions and credits not subject to the passive loss limitation by reason of section 469(i)) are allowed to an individual taxpayer regardless of the taxpayer's adjusted gross income. The commercial revitalization deduction is allowed in computing a taxpayer's alternative minimum taxable income.

Zero-percent capital gains rate

A zero-percent capital gains rate applies with respect to gain from the sale of a qualified community asset acquired after December 31, 2001, and before January 1, 2010, and held for more than five years.[1597] A qualified community asset includes: (1) qualified community stock (meaning original-issue stock purchased for cash in a renewal community business); (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in a renewal community business); and (3) qualified community business property (meaning tangible property originally used in a renewal community business by the taxpayer) that is purchased or substantially improved after December 31, 2001.

[1595] Sec. 1400I.

[1596] Sec. 1400I.

[1597] Sec. 1400F.

A renewal community business is defined as a corporation or partnership (or proprietorship) if for the taxable year (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business[1598] within a renewal community; (2) at least 50 percent of the total gross income is derived from the active conduct of a "qualified business" within a renewal community; (3) a substantial portion of the business's tangible property is used within a renewal community; (4) a substantial portion of the business's intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed by employees are performed within a renewal community; (6) at least 35 percent of the employees are residents of the renewal community; and (7) less than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business. Property will continue to be a qualified community asset if sold (or otherwise transferred) to a subsequent purchaser, provided that the property continues to represent an interest in (or tangible property used in) a renewal community business.

The termination of an area's status as a renewal community will not affect whether property is a qualified community asset, but any gain attributable to the period before January 1, 2002, or after December 31, 2014, is not eligible for the zero-percent rate.

Description of Proposal

The proposal repeals the renewal communities designation, which expired in 2009, and repeals all of the tax incentives available within designated renewal communities except for the treatment of qualified community assets acquired before 2010, qualified revitalization buildings placed in service before 2010, and qualified renewal property acquired before 2010.

Effective Date

The proposal is effective on date of enactment.

4. Short-term regional benefits (sec. 3824 of the discussion draft and secs. 1400L-1400T, 1400U-1, U-2 & U-3 of the Code)

Present Law

The Code contains tax benefits for the New York Liberty Zone, the area most affected by Hurricane Katrina, *i.e.*, the "Gulf Opportunity Zone" or "GO Zone," and the areas affected by Hurricanes Katrina, Rita and Wilma. These benefits generally expired before 2012 or earlier,

[1598] A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license. In addition, the leasing of real property that is located within the renewal community is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from renewal community businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of a renewal community.

unless otherwise noted. The Code also authorizes the issuance in 2009 and 2010 of certain types of bonds called recovery zone economic development bonds and recovery zone facility bonds.

New York Liberty Zone

The tax benefits available in the New York Liberty Zone include: (1) additional first-year depreciation for certain buildings, and for most other tangible property and computer software; (2) treating certain leasehold improvement property as 5-year property for Modified Accelerated Cost Recovery System ("MACRS") depreciation; (3) an increase in expensing for certain property; (4) expansion of the work opportunity tax credit for certain wages; (5) extending the replacement period for nonrecognition of gain for certain property involuntarily converted; (6) authorizing the issuance before January 1, 2014 of up to $8 billion of tax-exempt private activity bonds to finance the construction and repair of infrastructure; and (7) advance refunding of certain tax-exempt bonds.

Gulf Opportunity Zone

The tax benefits available in the Gulf Opportunity Zone generally include: (1) tax-exempt bond financing; (2) advance refunding of certain tax-exempt bonds; (3) increase in the low-income housing credit cap and other modifications; (4) additional first-year depreciation for certain property; (5) increase in expensing for certain property; (6) expensing for certain demolition and clean-up costs; (7) extension of expensing for environmental remediation costs; (8) increase in the rehabilitation tax credit with respect to certain buildings; (9) increased expensing for reforestation expenditures of small timber producers; (10) a five-year NOL carryback of certain timber losses; (11) a special rule for certain public utility casualty losses; (12) a five-year NOL carryback for certain amounts attributable to Gulf Opportunity Zone losses; (13) a tax credit for holders of certain bonds (Gulf tax credit bonds); (14) additional allocation of new markets tax credit for certain investments; (15) reliance on representations permitted regarding income eligibility for purposes of qualified residential rental project requirements; (16) favorable treatment of public utility disaster losses; (17) expansion of the Hope Scholarship and Lifetime Learning Credit for certain students; (18) housing relief for individuals affected by Hurricane Katrina; (19) special rules for mortgage revenue bonds; and (20) Treasury authority to grant bonus depreciation placed-in-service date relief.

Hurricanes Katrina, Rita, and Wilma

The tax benefits related to areas affected by Hurricanes Katrina, Rita, and Wilma generally include: (1) favorable rules for use of retirement funds; (2) an employee retention credit for employers; (3) temporary suspension of the percentage limitations on certain charitable contributions; (4) suspension of certain limitations on personal casualty losses; (5) Treasury authority to postpone certain deadlines to a certain date; (6) special look-back rules for determining the earned income credit and the refundable child credit; (7) Secretarial authority to make adjustments regarding taxpayer and dependency status; and (8) special rules for mortgage revenue bonds.

Recovery Zone Bonds

The Code permits issuers to issue recovery zone economic development bonds and recovery zone facility bonds in areas with significant poverty or distress. There is a national recovery zone economic development bond limitation of $10 billion and a national recovery zone facility bond limitation of $15 billion. These limitations are allocated among States in proportion to their respective 2008 declines in employment, subject to each State receiving a minimum allocation of nine-tenths of one percent of each national limitation. The amount allocated to a State is then reallocated among the State's counties and municipalities.

Recovery zone economic development bonds are taxable governmental bonds (so called build America bonds) that are irrevocably designated as recovery zone economic development bonds and for which 100 percent of the "available project proceeds" are used for "qualified economic development purposes." These bonds provide a payment to the issuer equal to 45 percent of the interest paid on the bond, and the holder is taxable on the interest paid.

Recovery zone facility bonds are tax-exempt private facility bonds designated by the issuer as recovery zone facility bonds and for which at least 95 percent of the proceeds are used for recovery zone property, which is broadly defined.

Description of Proposal

The proposal repeals the NY Zone desingation, and repeals all of the tax benefits available within the New York Liberty Zone except for: (1) the expansion of the work opportunity tax credit for wages paid or incurred before January 1, 2004; (2) the additional first-year depreciation allowance and increase in expensing allowed for property placed in service before January 1, 2010; (3) the treatment of qualified New York Liberty Zone leasehold improvement property placed in service before January 1, 2007 as 5-year property; (4) the authorization of the issuance before January 1, 2014 of up to $8 billion of tax-exempt private activity bonds to finance the construction and repair of infrastructure; (5) the advance refunding of certain tax-exempt bonds before January 1, 2006; and (6) the extension of the replacement period for nonrecognition of gain for certain property involuntarily converted as a result of the terrorist attacks of September 11, 2001.

The proposal repeals the Gulf Opportunity Zone designation, and repeals all of the tax benefits available within the Gulf Opportunity Zone and the benefits related to the areas affected by Hurricanes Katrina, Rita, and Wilma, except for: (1) the tax-exempt bond financing for obligations issued before January 1, 2012; (2) the advance refunding of certain tax-exempt bonds before January 1, 2011; (3) an additional first-year depreciation for certain property placed in service before January 1, 2012; (4) an increase in expensing for certain property placed in service before January 1, 2009; (5) the expensing for certain demolition and clean-up costs and environmental remediation costs paid or incurred before January 1, 2008; (6) an increase in the rehabilitation tax credit with respect to certain buildings for amounts paid or incurred before January 1, 2012; (7) a tax credit for holders of certain bonds (Gulf tax credit bonds) issued before January 1, 2007; (8) the tax-favored withdrawals from retirement plans for distributions before January 1, 2007; (9) allowing recontributions of withdrawals for home purchases for contributions before March 1, 2006; (10) allowing loans from qualified plans made before

January 1, 2007; (11) an employee retention credit for employers for wages paid or incurred before January 1, 2006; (12) the temporary suspension of the percentage limitations on certain charitable contributions for contributions paid before January 1, 2006; and (13) the special rules for mortgage revenue bonds for financing provided before January 1, 2011.

The proposal repeals the recovery zone bond provisions. However, the repeal does not apply to obligations issued before January 1, 2011.

Effective Date

The proposal is effective on the date of enactment.

TITLE IV – PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME

PRESENT LAW

Overview of the U.S. international tax system

Present law combines the worldwide taxation of all U.S. persons[1599] on all income, whether derived in the United States or abroad, with limited deferral for foreign income earned by foreign subsidiaries of U.S. companies, and provides territorial-based taxation of U.S.-source income of nonresident aliens and foreign entities. This combination is sometimes described as the U.S. hybrid system. Under this system, the application of the Code to outbound investment (the foreign activities of U.S. persons) differs somewhat from its rules applicable to inbound investment (foreign persons with investment in U.S. assets or activities).

As stated above, U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether derived in the United States or abroad.[1600] Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. However, certain U.S. anti-deferral regimes may cause the domestic parent corporation to be taxed currently in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[1601] and the passive foreign investment company rules.[1602] Taxation of income earned from foreign operations may differ depending upon the classification of the foreign entity conducting the foreign operations.

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes paid.[1603] As a consequence, even though resident individuals and domestic corporations are subject to U.S. tax on all their income, both U.S.- and foreign-source, source of income remains a critical factor to the extent that it determines the amount of credit available for foreign taxes paid. The foreign tax credit generally is available to offset, in whole

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[1599] Section 7701(a)(30) defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, estates, and certain trusts. Whether a noncitizen is a resident is determined under rules in section 7701(b).

[1600] A U.S. citizen or resident living abroad may be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs under section 911. For a description of this exclusion, see *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011, p. 52.

[1601] Secs. 951-964.

[1602] Secs. 1291-1298.

[1603] In lieu of the foreign tax credit, foreign income, war profits, and excess profits taxes are allowed as deductions under section 164(a)(3).

or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[1604] In addition to the statutory relief afforded by the credit, the U.S. network of bilateral income tax treaties provides a system for removing double taxation and ensuring reciprocal treatment of taxpayers from treaty countries.

Category-by-category rules determine whether income has a U.S. source or a foreign source. Additionally, present law provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not, however, affect the timing of the expense deduction. A domestic corporation generally is allowed a current deduction for its expenses (such as interest and administrative expenses) that support income that is derived through foreign subsidiaries and on which U.S. tax is deferred. Instead, the expense allocation rules apply to a domestic corporation principally for determining the corporation's foreign tax credit limitation.

Taxation of nonresident aliens and foreign corporations

Nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability and the mechanism by which it is taxed. The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income: U.S.-source income that is "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") or income that is "effectively connected with the conduct of a trade or business within the United States" ("ECI"). FDAP income generally is subject to a 30-percent gross-basis withholding tax, while ECI is generally subject to the same U.S. tax rules that apply to business income derived by U.S. persons. That is, deductions are permitted in determining taxable ECI, which is then taxed at the same rates applicable to U.S. persons. Much FDAP income and similar income is, however, exempt from withholding tax or is subject to a reduced rate of tax under the Code or a bilateral income tax treaty.[1605]

FDAP income includes U.S.-source portfolio interest, which means any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person.[1606] For obligations issued before March 19, 2012, portfolio interest also includes interest paid on an obligation that is not in registered form, provided that the obligation is shown to be targeted to foreign investors under the conditions sufficient to establish deductibility of the payment of such interest.[1607] Portfolio interest,

[1604] Secs. 901, 902, 960, 1291(g).

[1605] *E.g.*, the portfolio interest exception in section 871(h) (discussed below).

[1606] Sec. 871(h)(2).

[1607] Sec. 163(f)(2)(B). The exception to the registration requirements for foreign targeted securities was repealed in 2010, effective for obligations issued two years after enactment, thus narrowing the portfolio interest exemption for obligations issued after March 18, 2012. See Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).

however, does not include interest received by a 10-percent shareholder,[1608] certain contingent interest,[1609] interest received by a controlled foreign corporation from a related person,[1610] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[1611]

U.S. tax law includes rules intended to prevent reduction of the U.S. tax base, whether through excessive borrowing in the United States, migration of the tax residence of domestic corporations from the United States to foreign jurisdictions through corporate inversion transactions,[1612] or aggressive intercompany pricing practices, particularly with respect to intangible property.

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[1613] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as ECI and, therefore, as taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of ECI.[1614] In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as ECI ("FIRPTA income") is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[1615] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total ECI and deductions (if any) for the taxable year.

[1608] Sec. 871(h)(3).

[1609] Sec. 871(h)(4).

[1610] Sec. 881(c)(3)(C).

[1611] Sec. 881(c)(3)(A).

[1612] See sec. 7874. For a description of provisions designed to curtail inversion transactions, see Joint Committee on Taxation, *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011, p. 50.

[1613] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, 6652(f).

[1614] Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

[1615] Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that reduce the 35-percent withholding on distributions to 20-percent withholding during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.[1616] The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Certain U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Switzerland, and the United Kingdom.[1617] To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).[1618]

Entity classification

A business entity is generally eligible to choose how it is classified for Federal tax law purposes, under the "check-the-box" regulations adopted in 1997.[1619] Those regulations simplified the entity classification process for both taxpayers and the Internal Revenue Service ("IRS"), by making the entity classification of unincorporated entities explicitly elective in most instances.[1620] Whether an entity is eligible and the breadth of its choices depends upon whether it is a "*per se* corporation" and the number of beneficial owners.

[1616] Secs. 4371-4374.

[1617] Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.

[1618] In Rev. Rul. 2008-15, 2008-1 C.B. 633, the IRS provided guidance to the effect that the excise tax is imposed separately on each reinsurance policy covering a U.S. risk. Thus, if a U.S. insurer or reinsurer reinsures a U.S. risk with a foreign reinsurer, and that foreign reinsurer in turn reinsnres the risk with a second foreign reinsurer, the excise tax applies to both the premium to the first foreign reinsurer and the premium to the second foreign reinsurer. In addition, if the first foreign reinsurer is resident in a jurisdiction with a tax treaty containing an excise tax exemption, the revenue ruling provides that the excise tax still applies to both payments to the extent that the transaction violates an anti-conduit rule in the applicable tax treaty. Even if no violation of an anti-conduit rule occurs, under the revenue ruling, the excise tax still applies to the premiums paid to the second foreign reinsurer, unless the second foreign reinsurer is itself entitled to an excise tax exemption.

[1619] Treas. Reg. sec. 301.7701-1, *et seq.*

[1620] The check-the-box regulations replaced Treas. Reg. sec. 301.7701-2, as in effect prior to 1997, (the "Kintner regulations") under which the classification of unincorporated entities for Federal tax purposes was determined on the basis of four characteristics indicative of status as a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. An entity that possessed three or more of these characteristics was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership. Thus, to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these corporate characteristics. The advent and

Certain entities are treated as "*per se* corporations" for which an election is not permitted. Generally, these are domestic entities formed under a State corporation statute. A number of specific types of foreign business entities are identified in the regulations as *per se* corporations. These entities are generally corporations that are not closely held and the shares of which can be traded on a securities exchange.[1621]

An eligible entity with two or more members may elect, however, to be classified as a corporation or a partnership. If an eligible entity fails to make an election, default rules apply. A domestic entity with multiple members is treated as a partnership. A foreign entity with multiple members is treated as a partnership, if at least one member does not have limited liability, but is treated as a corporation if all members have limited liability.

The regulations also provide explicitly that a single-member unincorporated entity may elect either to be treated as a corporation or to be disregarded (treated as not separate from its owner). A disregarded entity owned by an individual is treated in the same manner as a sole proprietorship. In the case of an entity owned by a corporation or partnership, the disregarded entity is treated in the same manner as a branch or division. The default treatment for an eligible single-member domestic entity is as a disregarded entity. For an eligible single-member foreign entity, the default treatment is as a corporation, if the single owner has limited liability, and as a disregarded entity if the owner does not have limited liability.

The regulations extended elective classification to foreign, as well as domestic, entities on the basis that the complexities and resources devoted to classification of domestic unincorporated business entities were mirrored in the foreign context. As a result, it is possible for an entity that operates cross-border to elect into a hybrid status. "Hybrid entities" refers to entities that are treated as flow-through or disregarded entities for U.S. tax purposes but as corporations for foreign tax purposes; for "reverse hybrid entities," the opposite is true. The existence of hybrid and reverse hybrid entities can affect whether the taxpayer can use foreign tax credits attributable to deferred foreign-source income or income that is not taxable in the United States, as well as whether income is currently includible under subpart F.

Source of income rules

The rules for determining the source of certain types of income are specified in the Code and described briefly below. Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor, the status or nationality of the recipient, the location of the recipient's activities that generate the income, and the situs of the assets that

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proliferation of limited liability companies ("LLCs") under State laws allowed business owners to create customized entities that possessed a critical common feature—limited liability for investors—as well as other corporate characteristics the owners found desirable. As a consequence, classification was effectively elective for well-advised taxpayers.

[1621] For domestic entities, the State corporation statute must describe the entity as a corporation, joint-stock company, or in similar terms. The regulations also treat insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, and organizations that are taxable as corporations under other Code provisions as *per se* corporations.

generate the income. If a payor or recipient is an entity that is eligible to elect its classification for Federal tax purposes, its choice of whether to be recognized as legally separate from its owner in another jurisdiction can affect the determination of the source of the income and other tax attributes, if the hybrid entity is disregarded in one jurisdiction, but recognized in the other.[1622] To the extent that the source of income is not specified by statute, the Treasury Secretary may promulgate regulations that explain the appropriate treatment. However, many items of income are not explicitly addressed by either the Code or Treasury regulations. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.[1623]

Interest

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[1624] Special rules apply to treat as foreign-source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions.[1625] Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[1626]

Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.[1627] Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income.[1628]

[1622] See Treas. Reg. sec. 301-7701-1 through 301.7701-3.

[1623] See, *e.g.*, *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

[1624] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1).

[1625] Secs. 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations the source rule in section 861(a)(1)(B) does not apply to interest paid by the foreign branch of a domestic financial institution, resulting in treating the payment as a withholdable payment. Sec. 1473(1)(C).

[1626] Sec. 884(f)(1).

[1627] Secs. 861(a)(2), 862(a)(2).

[1628] Sec. 861(a)(2)(B).

Rents and royalties

Rental income is sourced by reference to the location or place of use of the leased property.[1629] The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible.

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid.[1630] This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

Income from sales of personal property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.[1631] For this purpose, special definitions of the terms "U.S. resident" and "nonresident" are provided. A nonresident is defined as any person who is not a U.S. resident,[1632] while the term "U.S. resident" comprises any juridical entity which is a U.S. person, all U.S. citizens, as well as any individual who is a U.S. resident without a tax home in a foreign country or a nonresident alien with a tax home in the United States.[1633] As a result, nonresident includes any foreign corporation.[1634]

Several special rules apply. For example, income from the sale of inventory property is generally sourced to the place of sale, which is determined by where title to the property passes.[1635] However, if the sale is by a nonresident and is attributable to an office or other fixed place of business in the United States, the sale is treated as U.S.-source without regard to the place of sale, unless it is sold for use, disposition, or consumption outside the United States and a foreign office materially participates in the sale.[1636] Income from the sale of inventory property that a taxpayer produces (in whole or in part) in the United States and sells outside the United

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[1629] Sec. 861(a)(4).

[1630] *Ibid.*

[1631] Sec. 865(a).

[1632] Sec. 865(g)(1)(B).

[1633] Sec. 865(g)(1)(A).

[1634] Sec. 865(g).

[1635] Secs. 865(b), 861(a)(6), 862(a)(6); Treas. Reg. sec. 1.861-7(c).

[1636] Sec. 865(e)(2).

States, or that a taxpayer produces (in whole or in part) outside the United States and sells in the United States is treated as partly U.S.-source and partly foreign-source.[1637]

In determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS applies the asset-use test and business activities test at the partnership level to determine whether there is a U.S. business and, if so, the extent to which income derived is effectively connected with that U.S. business. To the extent that there is unrealized gain attributable to partnership assets that are effectively connected with the U.S. business, the foreign person's gain or loss from the sale or exchange of a partnership interest is effectively connected gain or loss to the extent of the partner's distributive share of such unrealized gain or loss. Similarly, to the extent that the partner's distributive share of unrealized gain is attributable to a permanent establishment of the partnership under an applicable treaty provision, it may be subject to U.S. tax under a treaty.[1638]

Gain on the sale of depreciable property is divided between U.S.-source and foreign-source in the same ratio that the depreciation was previously deductible for U.S. tax purposes.[1639] Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible property.[1640]

Personal services income

Compensation for labor or personal services is generally sourced to the place-of-performance. Thus, compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain

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[1637] Sec. 863(b). A taxpayer may elect one of three methods for allocating and apportioning income as U.S.- or foreign-source: (1) 50-50 method under which 50 percent of the income from the sale of inventory property in such a situation is attributable to the production activities and 50 percent to the sales activities, with the income sourced based on the location of those activities; (2) IFP method under which, in certain circumstances, an independent factory price ("IFP") may be established by the taxpayer to determine income from production activities; (3) books and records method under which, with advance permission, the taxpayer may use books of account to detail the allocation of receipts and expenditures between production and sales activities. Treas. Reg. sec. 1.863-3(b), (c). If production activity occurs only within the United States, or only within foreign countries, then all income is sourced to where the production activity occurs; when production activities occur in both the United States and one or more foreign countries, the income attributable to production activities must be split between U.S. and foreign sources. Treas. Reg. sec. 1.863-3(c)(1). The sales activity is generally sourced based on where title to the property passes. Treas. Reg. secs. 1.863-3(c)(2), 1.861-7(c).

[1638] Rev. Rul. 91-32, 1991-1 C.B. 107.

[1639] Sec. 865(c).

[1640] Sec. 865(d).

de minimis criteria.[1641] Compensation for services performed both within and without the United States is allocated between U.S.- and foreign-source.[1642]

Insurance income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.[1643]

Transportation income

Generally, income from furnishing transportation that begins and ends in the United States is U.S.-source income.[1644] Fifty percent of other income attributable to transportation that begins or ends in the United States is treated as U.S.-source income.

Income from space or ocean activities or international communications

In the case of a foreign person, generally no income from a space or ocean activity is treated as U.S.-source income.[1645] The same holds true for international communications income unless the foreign person maintains an office or other fixed place of business in the United States, in which case the income attributable to such fixed place of business is treated as U.S.-source income.[1646]

Amounts received with respect to guarantees of indebtedness

Amounts received, directly or indirectly, from a noncorporate resident or from a domestic corporation for the provision of a guarantee of indebtedness of such person are income from U.S. sources.[1647] This includes payments that are made indirectly for the provision of a guarantee.

[1641] Sec. 861(a)(3). Gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship is generally treated as foreign-source income.

[1642] Treas. Reg. sec. 1.861-4(b).

[1643] Sec. 861(a)(7).

[1644] Sec. 863(c).

[1645] Sec. 863(d).

[1646] Sec. 863(e).

[1647] Sec. 861(a)(9). This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner*, 134 T.C. 122 (February 17, 2010), aff'd 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011). The Tax Court held that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were more closely analogous to compensation for services than to interest, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

For example, U.S.-source income under this rule includes a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for instance, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the additional interest payments made by the subsidiary are treated as indirect payments of the guarantee fee and, therefore, as U.S.-source.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person that is effectively connected with the conduct of a U.S. trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign-source income if they are not from sources within the United States under section 861(a)(9).

Subpart F

Generally

Subpart F,[1648] applicable to controlled foreign corporations ("CFC") and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[1649] Under the subpart F rules, the United States generally taxes the 10-percent U.S. shareholders of a CFC on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[1650] In effect, the United States treats the 10-percent U.S. shareholders of a CFC as having received a current distribution of the corporation's subpart F income.

With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[1651] insurance income,[1652] and certain income relating to international boycotts and other violations of public policy.[1653]

[1648] Secs. 951-964.

[1649] Secs. 951(b), 957, 958.

[1650] Sec. 951(a).

[1651] Sec. 954.

[1652] Sec. 953.

[1653] Sec. 952(a)(3)-(5).

Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.[1654]

Prior to 2005, subpart F income included foreign base company shipping income.[1655] Foreign base company shipping income generally included income derived from the use of an aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, the sale or other disposition of any such aircraft or vessel, and certain space or ocean activities. However, for taxable years beginning after 1975 and before 1987, subpart F income did not include foreign base company shipping income to the extent that such shipping income was reinvested during the taxable year in certain qualified shipping investments.[1656] To the extent that, in a subsequent year, a net decrease in qualified shipping investments occurred, however, the amount of previously excluded subpart F income equal to such decrease is itself considered subpart F income under section 955. Therefore, withdrawal of previously excluded subpart F income from qualified shipping investments triggers an equivalent increase in the subpart F income of the CFC.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.[1657]

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. In the case of insurance, temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life

[1654] Sec. 954.

[1655] Sec. 954(f) prior to its repeal by The American Jobs Creation Act of 2004, Pub. L. No. 108-357.

[1656] Former sec. 954(b)(2).

[1657] Prop. Treas. Reg. sec. 1.953-1(a).

insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

Special rules apply under subpart F with respect to related person insurance income.[1658] Enacted in 1986, these rules address the concern that "the related person insurance income of many offshore 'captive' insurance companies avoided current taxation under the subpart F rules of prior law because, for example, the company's U.S. ownership was relatively dispersed."[1659] For purposes of these rules, the U.S. ownership threshold for controlled foreign corporation status is reduced to 25 percent or more. Any U.S. person who owns or is considered to own any stock in a controlled foreign corporation, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation's related person insurance income. Related person insurance income is defined for this purpose to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (within the meaning of the provision) in the foreign corporation receiving the income or a person related to such a shareholder.

Investments in U.S. property

The 10-percent U.S. shareholders of a CFC also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's untaxed earnings invested in certain items of U.S. property.[1660] This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.[1661] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[1662] The inclusion rule for investment of earnings in U.S. property is intended to prevent taxpayers from avoiding U.S. tax on dividend repatriations by repatriating CFC earnings through non-dividend payments, such as loans to U.S. persons.

[1658] Sec. 953(c).

[1659] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (JCS-10-87), May 4, 1987, p. 968.

[1660] Secs. 951(a)(1)(B), 956.

[1661] Sec. 956(c)(1).

[1662] Sec. 956(c)(2).

Subpart F exceptions

A temporary provision enacted in 2006 (colloquially referred to as the "CFC look-through" rule) excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to non-subpart-F income of the payor.[1663] The exclusion originally applied for taxable years beginning after 2005 and before 2009 and has been extended most recently to apply for taxable years of the foreign corporation beginning before 2014.[1664]

Under a provision enacted in 1997 and originally applicable only for one taxable year,[1665] there is an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of a banking or financing business ("active financing income").[1666] Congress has extended the application of section 954(h) several times, most recently in 2013.[1667] The exception from subpart F for active financing income now applies to taxable years of foreign corporations starting before January 1, 2014 (and to taxable years of 10-percent U.S. shareholders with or within which those corporate taxable years end). With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU

[1663] Sec. 954(c)(6).

[1664] Sec. 954(c)(6)(C). Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 751(a).

[1665] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1175.

[1666] Sec. 954(h).

[1667] American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, sec. 322(b); Pub. L. No. 111-312, sec. 750(a), 2010; Pub. L. No. 110-343, div. C, sec. 303(b), 2008; Pub. L. No. 109-222, sec. 103(a)(2), 2006; Pub. L. No. 107-147, sec. 614, 2002; Pub. L. No. 106-170, sec. 503, 1999; Pub. L. No. 105-277, 1998.

in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

The American Jobs Creation Act of 2004 ("AJCA")[1668] expanded the scope of the active financing income exclusion from subpart F. Income is treated as active financing income (and was so treated before AJCA) only if, among other requirements, it is derived by a CFC or by a qualified business unit of that CFC. After the enactment of AJCA, certain activities conducted by persons related to the CFC or its qualified business unit are treated as conducted directly by the CFC or qualified business unit.[1669] An activity qualifies under this rule if the activity is performed by employees of the related person and if the related person is an eligible CFC, the home country of which is the same as the home country of the related CFC or qualified business unit; the activity is performed in the home country of the related person; and the related person receives arm's-length compensation that is treated as earned in the home country. Income from an activity qualifying under this rule is excepted from subpart F income so long as the other active financing requirements are satisfied.

Other exclusions from foreign personal holding company income include exceptions for dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized and for rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized.[1670] These exclusions do not apply to the extent the payments reduce the subpart F income of the payor. There is an exception from foreign base company income and insurance income for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).[1671]

Exclusion of previously taxed earnings and profits

A 10-percent U.S. shareholder of a CFC may exclude from its income actual distributions of earnings and profits from the CFC that were previously included in the 10-percent U.S. shareholder's income under subpart F.[1672] Any income inclusion (under section 956) resulting from investments in U.S. property may also be excluded from the 10-percent U.S. shareholder's income.[1673] Ordering rules provide that distributions from a CFC are treated as coming first out

[1668] Pub. L. No. 108-357.

[1669] AJCA sec. 416; Code sec. 954(h)(3)(E).

[1670] Sec. 954(c)(3).

[1671] Sec. 954(b)(4).

[1672] Sec. 959(a)(1).

[1673] Sec. 959(a)(2).

of earnings and profits of the CFC that have been previously taxed under subpart F, then out of other earnings and profits.[1674]

Basis adjustments

In general, a 10-percent U.S. shareholder of a CFC receives a basis increase with respect to its stock in the CFC equal to the amount of the CFC's earnings that are included in the 10-percent U.S. shareholder's income under subpart F.[1675] Similarly, a 10-percent U.S. shareholder of a CFC generally reduces its basis in the CFC's stock in an amount equal to any distributions that the 10-percent U.S. shareholder receives from the CFC that are excluded from its income as previously taxed under subpart F.[1676]

Passive foreign investment companies

The Tax Reform Act of 1986[1677] established an anti-deferral regime for passive foreign investment companies ("PFICs"). A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[1678] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to PFICs that are qualified electing funds, under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[1679] A second set of rules applies to PFICs that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[1680] A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[1681]

[1674] Sec. 959(c).

[1675] Sec. 961(a).

[1676] Sec. 961(b).

[1677] Pub. L. No. 99-514.

[1678] Sec. 1297.

[1679] Secs. 1293-1295.

[1680] Sec. 1291.

[1681] Sec. 1296.

Other anti-deferral rules

The subpart F and PFIC rules are not the only anti-deferral regimes. Other rules that impose current U.S. taxation on income earned through corporations include the accumulated earnings tax rules[1682] and the personal holding company rules.[1683] Until the enactment of AJCA, the Code included two other sets of anti-deferral rules, those applicable to foreign personal holding companies and those for foreign investment companies.[1684] Because the overlap among the various anti-deferral regimes was seen as creating complexity, often with no ultimate tax consequences, AJCA repealed the foreign personal holding company and foreign investment company rules.[1685]

Rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a PFIC with respect to a particular shareholder if the corporation is also a CFC and the shareholder is a 10-percent U.S. shareholder. Thus, subpart F is allowed to trump the PFIC rules.

Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed to claim credit for foreign income taxes they pay. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed as a dividend or is included in the domestic corporation's income under the anti-deferral rules.[1686]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[1687] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's

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[1682] Secs. 531-537.

[1683] Secs. 541-547. The accumulated earnings tax rules and the personal holding company rules apply in respect of both U.S.-source and foreign-source income.

[1684] Secs. 551-558, 1246-1247.

[1685] AJCA, sec. 413.

[1686] Secs. 901, 902, 960, 1295(f).

[1687] Secs. 901, 904.

foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[1688]

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each limitation category (described below) by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category, on the other. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[1689] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.[1690] In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.[1691]

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.[1692] These rules exclude foreign corporations from an affiliated group.[1693] AJCA modified the interest expense allocation rules for taxable years beginning after December 31, 2008.[1694] The effective date of the modified rules has been delayed to January 1, 2021.[1695] The new rules permit a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis (that is, as if all domestic and foreign affiliates are a single corporation). A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group. The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

[1688] Sec. 904(c).

[1689] Treas. Reg. sec. 1.861-8(b), Temp. Treas. Reg. sec. 1.861-8T(c).

[1690] Temp. Treas. Reg. sec. 1.861-9T, Treas. Reg. sec. 1.861-17.

[1691] Sec. 864(e)(1), (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

[1692] Secs. 864(e)(5), 1504.

[1693] Sec. 1504(b)(3).

[1694] AJCA sec. 401.

[1695] Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 551(a).

The foreign tax credit limitation is applied separately to passive category income and to general category income.[1696] Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. General category income includes all other income. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is highly taxed (that is, if the foreign tax rate is determined to exceed the highest rate of tax specified in Code section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made.[1697] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[1698]

In addition to the foreign tax credit limitation just described, a taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[1699]

Transfer pricing

A basic U.S. tax principle applicable in dividing profits from transactions between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in similar transactions with unrelated parties. The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign

[1696] Sec. 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Before AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations (also known as "10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). A number of other provisions of the Code, including several enacted in 2010 as part of Pub. L. No. 111-226, create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, *e.g.*, secs. 865(h), 901(j), 904(d)(6), 904(h)(10).

[1697] Sec. 904(d)(3). The subpart F rules applicable to CFCs and their 10-percent U.S. shareholders are described below.

[1698] Sec. 904(d)(4).

[1699] Sec. 909.

company through pricing that does not reflect an arm's-length result.[1700] Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing. The arm's-length standard is difficult to administer in situations in which no unrelated party market prices exist for transactions between related parties. When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in part by the same transfer pricing rules of section 482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances among related business entities[1701] when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate.[1702] The regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length. For income from intangible property, section 482 provides "in the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion in income of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[1703]

Other special rules

Dual consolidated loss rules

Under the rules applicable to corporations filing consolidated returns, a dual consolidated loss ("DCL") is any net operating loss of a domestic corporation if the corporation is subject to an income tax of a foreign country without regard to whether such income is from sources in or outside of such foreign country, or if the corporation is subject to such a tax on a residence basis (a "dual resident corporation").[1704] A DCL generally cannot be used to reduce the taxable income of any member of the corporation's affiliated group. Losses of a separate unit of a

[1700] For a detailed description of the U.S. transfer pricing rules, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 18-50.

[1701] The term "related" as used herein refers to relationships described in section 482, which refers to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

[1702] Section 1059A buttresses section 482 by limiting the extent to which costs used to determine custom valuation can also be used to determine basis in property imported from a related party. A taxpayer that imports property from a related party may not assign a value to the property for cost purposes that exceeds its customs value.

[1703] H.R. Rep. No. 99-426, p. 423.

[1704] Sec. 1503(d).

domestic corporation (a foreign branch or an interest in a hybrid entity owned by the corporation) are subject to this limitation in the same manner as if the unit were a wholly owned subsidiary of such corporation. An exemption is available under Treasury regulations in the case of DCLs for which a domestic use election (that is, an election to use the loss only for domestic, and not foreign, tax purposes) has been made.[1705] Recapture is required, however, upon the occurrence of certain triggering events, including the conversion of a separate unit to a foreign corporation and the transfer of 50 percent or more of the assets of a separate unit within a twelve-month period.[1706]

Temporary dividends-received deduction for repatriated foreign earnings

AJCA section 421 added to the Code section 965, a temporary provision intended to encourage U.S. multinational companies to repatriate foreign earnings. Under section 965, for one taxable year certain dividends received by a U.S. corporation from its CFCs were eligible for an 85-percent dividends-received deduction. At the taxpayer's election, this deduction was available for dividends received either during the taxpayer's first taxable year beginning on or after October 22, 2004, or during the taxpayer's last taxable year beginning before such date.

The temporary deduction was subject to a number of general limitations. First, it applied only to cash repatriations generally in excess of the taxpayer's average repatriation level calculated for a three-year base period preceding the year of the deduction. Second, the amount of dividends eligible for the deduction was generally limited to the amount of earnings shown as permanently invested outside the United States on the taxpayer's recent audited financial statements. Third, to qualify for the deduction, dividends were required to be invested in the United States according to a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.[1707]

No foreign tax credit (or deduction) was allowed for foreign taxes attributable to the deductible portion of any dividend.[1708] For this purpose, the taxpayer was permitted to specifically identify which dividends were treated as carrying the deduction and which dividends were not. In other words, the taxpayer was allowed to choose which of its dividends were treated as meeting the base-period repatriation level (and thus carry foreign tax credits, to the extent otherwise allowable), and which of its dividends were treated as part of the excess eligible for the deduction (and thus subject to proportional disallowance of any associated foreign tax

[1705] Treas. Reg. sec. 1.1503(d)-6(d).

[1706] See Treas. Reg. sec. 1.1503(d)-6(e)(1).

[1707] Section 965(b)(4). The plan was required to provide for the reinvestment of the repatriated dividends in the United States, including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for the purposes of job retention or creation.

[1708] Sec. 965(d)(1).

credits).[1709] Deductions were disallowed for expenses that were directly allocable to the deductible portion of any dividend.[1710]

Earnings stripping

A domestic corporation may reduce the U.S. tax on the income derived from its U.S. operations through the payment of deductible amounts such as interest, rents, royalties, premiums, and management service fees to foreign affiliates that are not subject to U.S. tax on the receipt of such payments.[1711] Generating excessively large U.S. tax deductions in this manner is known as "earnings stripping."

Although the term "earnings stripping" may be broadly applied to the generation of excessive deductions for interest, rents, royalties, premiums, management fees, and similar types of payments in the circumstances described above, more commonly it refers only to the generation of excessive interest deductions. In general, earnings stripping provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, *i.e.*, the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or reduced taxes on financing structures.

Taxpayers are limited in their ability to reduce the U.S. tax on the income derived from their U.S. operations through certain earnings stripping transactions involving interest payments. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for disqualified interest paid or accrued by the payor in a taxable year is generally disallowed to the extent of the payor's excess interest expense.[1712] Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;[1713] to unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"); or to a REIT by a taxable REIT subsidiary of that REIT. Excess interest expense is the amount by which the payor's net interest expense (that is, the excess of interest paid or accrued over interest income) exceeds 50 percent

[1709] Accordingly, taxpayers generally were expected to pay regular dividends out of high-taxed CFC earnings (thereby generating deemed-paid credits available to offset foreign-source income) and section 965 dividends out of low-taxed CFC earnings (thereby availing themselves of the 85-percent deduction).

[1710] Sec. 965(d)(2).

[1711] In general, for U.S.-controlled corporations, this type of tax planning is greatly limited by the anti-deferral rules of subpart F.

[1712] Sec. 163(j).

[1713] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

of its adjusted taxable income (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (that is, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

Domestic international sales corporations

A domestic international sales corporation ("DISC") is a domestic corporation that satisfies the following conditions: 95 percent of its gross receipts must be qualified export receipts; 95 percent of the sum of the adjusted bases of all its assets must be attributable to the sum of the adjusted bases of qualified export assets;[1714] the corporation must have no more than one class of stock, and the par or stated value of the outstanding stock must be at least $2,500 on each day of the taxable year; and an election must be in effect to be taxed as a DISC.[1715] In general, a DISC is not subject to corporate-level tax and offers limited deferral of tax liability to its shareholders.[1716] DISC income attributable to a maximum of $10 million annually of qualified export receipts is generally exempt from corporate and shareholder level income tax. Shareholders must pay interest to account for the benefit of deferring the tax liability on undistributed DISC income related to this $10 million maximum annual amount.[1717] Shareholders of a DISC are deemed to receive a dividend out of current earnings and profits of qualified export receipts in excess of $10 million.[1718] Gain on the sale of DISC stock is treated as a dividend to the extent of accumulated DISC income.[1719] The shareholders of a corporation which is not a DISC, but was a DISC in a previous taxable year, and which has previously taxed income or accumulated DISC income, are also required to pay interest on the deferral benefit, and gain on the sale or exchange of stock in such corporation is treated as a dividend.

[1714] If a corporation fails to satisfy either or both of the 95-percent tests, it is deemed to satisfy such tests if it makes a pro rata distribution of its gross receipts which are not qualified export receipts and the fair market value of its assets which are not qualified export assets. Sec. 992(c).

[1715] Secs. 992(a) and (b).

[1716] Sec. 991.

[1717] The rate is the average of 1-year constant maturity Treasury yields. The deferral benefit is the excess of the amount of tax the shareholder would be liable if deferred DISC income were included as ordinary income over the actual tax liability of such shareholder. Sec. 995(f).

[1718] The amount of the deemed distribution is the sum of several items, including qualified export receipts in excess of $10 million. See sec. 955(b).

[1719] Sec. 995(c).

A. Establishment of Exemption System

1. Deduction for dividends received by domestic corporations from certain foreign corporations (sec. 4001 of the discussion draft and new sec. 245A of the Code)

Description of Proposal

In general

The proposal establishes a participation exemption system for foreign income.[1720] This exemption is effectuated by means of a 95-percent deduction for the foreign-source portion of dividends received from certain foreign corporations ("specified 10-percent owned foreign corporations") by domestic corporations that are United States shareholders of those foreign corporations within the meaning of section 951(b).[1721] As under the exemption systems of some other countries, five percent of an otherwise deductible dividend from a foreign corporation remains taxable. This taxation is intended to be a substitute for the disallowance of deductions for expenses incurred to generate exempt foreign income.

A specified 10-percent owned foreign corporation is any foreign corporation if any domestic corporation owns directly, or indirectly through a chain of ownership described under section 958(a), 10 percent or more of the voting stock of that foreign corporation.

Foreign-source portion of a dividend

The participation exemption system is intended to be available only for foreign income, not for U.S-source income. Some specified 10-percent owned foreign corporations, however, may have U.S.-source income. Consequently, the 95-percent dividends-received deduction is available only for the foreign-source portion of a dividend.

The foreign-source portion of a dividend from a specified 10-percent owned foreign corporation for which the 95-percent deduction is allowed represents the portion of the dividend that relates to the foreign corporation's post-1986 undistributed foreign earnings.[1722] The foreign-source portion of any dividend is, therefore, the amount that bears the same ratio to the dividend as the foreign corporation's post-1986 undistributed foreign earnings bears to the corporation's total post-1986 undistributed earnings. This rule complements the present law section 245 rule allowing a deduction for the U.S.-source portion of a dividend received from a

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[1720] The term "participation exemption," commonly used in describing similar systems in other countries, refers to the exemption granted to a domestic corporation for earnings of a foreign corporation by virtue of the present corporation's participation in the ownership of the subsidiary.

[1721] Under section 951(b) a corporation is a United States shareholder of a foreign corporation if it owns (within the meaning of section 958(a)) or is considered as owning by applying the rules of section 958(b) 10 percent or more of the voting stock of the foreign corporation.

[1722] Undistributed foreign earnings include both foreign income on which a U.S. taxpayer may be taxed under subpart F and other foreign income on which no U.S. taxpayer is taxed before receipt of the dividend.

qualified 10-percent owned foreign corporation. The U.S.-source portion of any dividend for which a deduction is allowed under section 245 is the amount that bears the same ratio to the dividend as the dividend-paying corporation's post-1986 undistributed U.S. earnings bears to the corporation's total post-1986 undistributed earnings. For this purpose, a corporation's post-1986 undistributed U.S. earnings are, in general, undistributed earnings attributable to (a) the corporation's income that is effectively connected with the conduct of a trade or business within the United States, or (b) any dividend received (directly or through a wholly owned foreign corporation) from an 80-percent-owned (by vote or value) domestic corporation.[1723]

Under the proposal, a CFC's post-1986 undistributed foreign earnings are, in general terms, the portion of post-1986 undistributed earnings that is not attributable to post-1986 undistributed U.S. earnings.

The term post-1986 undistributed earnings means the amount of the earnings and profits of the specified 10-percent owned foreign corporation (computed in accordance with sections 964(a) and 986) accumulated in taxable years beginning after December 31, 1986 as of the close of the taxable year of the foreign corporation in which the dividend is distributed and without diminution by reason of dividends distributed during that year.

Rules similar to the rules just described apply when a dividend is paid out of earnings of a specified 10-percent owned foreign corporation accumulated in taxable years beginning before January 1, 1987. As a consequence, the participation exemption system is available for both post-1986 and pre-1987 foreign earnings. An ordering rule provides that dividends are treated as paid out of post-1986 undistributed earnings to the extent of those earnings.

As a result of the coordination with the present law section 245 dividends received deduction for dividends received from certain 10-percent owned foreign corporations, the proposal provides the 95-percent dividends-received deduction for a dividend received by a United States shareholder from a specified 10-percent owned foreign corporation only to the extent the dividend is not deductible under present law section 245. More broadly, present law section 245 is intended to prevent a second imposition of U.S. corporate tax when a domestic corporation receives a dividend from a foreign corporation attributable to the foreign corporation's U.S.-source effectively connected income, whereas the proposal is intended to provide an exemption from U.S. corporate tax when a domestic corporation receives a dividend from an eligible foreign corporation attributable to the corporation's foreign-source income.

Foreign tax credit disallowance; foreign tax credit limitation

No foreign tax credit is allowed for any taxes (including withholding taxes) paid or accrued with respect to any dividend for which the 95-percent dividends-received deduction is allowed. A deduction for any foreign tax paid or accrued in respect of a deductible dividend also is denied. This foreign tax credit disallowance and deduction denial apply to foreign tax with

[1723] Section 3650 of the discussion draft, described previously, modifies the definition of a domestic corporation for purposes of the definition of post-1986 undistributed U.S. earnings so that dividends derived from RICs and REITs are ineligible for the section 245 dividends received deduction.

respect to the entire amount of any deductible dividend even though a deduction is available for only 95 percent of the dividend. By contrast, a foreign tax credit is allowed for foreign tax imposed on income included under subpart F and for foreign tax paid directly by a domestic corporation on foreign-source income (on, for example, income from foreign sales). Likewise, a foreign tax credit generally is available for foreign withholding tax imposed on payments such as royalties and interest. A foreign tax credit is not, however, available for foreign withholding tax imposed on dividends for which the 95-percent deduction is permitted. The proposal's foreign tax credit rules are described in more detail below.

For purposes of computing its section 904(a) foreign tax credit limitation, a domestic corporation that is a United States shareholder of a specified 10-percent owned foreign corporation must compute its foreign-source taxable income by disregarding the foreign-source portion of any dividend received from that foreign corporation and any deductions properly allocable to that foreign-source portion.

Six-month holding period requirement

A domestic corporation is allowed the 95-percent deduction for a dividend it receives on stock of a specified 10-percent owned foreign corporation only if the domestic corporation satisfies a six-month holding period requirement in respect of the stock on which the dividend is paid. No deduction is allowed in respect of any dividend on any share of stock that is held by the domestic corporation for 180 days or less during the 361-day period beginning on the date that is 180 days before the date on which the share becomes ex-dividend with respect to the dividend. A deduction also is not permitted in respect of 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.

These holding period requirements parallel the section 246(c)(1) requirements for the dividends-received deductions available under present law sections 243, 244, and 245. The proposal also incorporates some, but not all, of the other present law section 246(c) holding-period-related rules (including, for example, the section 246(c)(4) rule under which holding periods are reduced in a manner provided in Treasury regulations for any period during which the taxpayer has diminished its risk of loss in respect of stock on which a dividend is paid).

The 180-out-of-361-days test described above is satisfied only if the specified 10-percent owned foreign corporation is a specified 10-percent owned foreign corporation at all times during the period and the domestic corporation is a United States shareholder of the foreign corporation at all times during the period.

Foreign branches

The proposal does not change the general rules related to the taxation of foreign branches of domestic corporations. Section 4002 of the discussion draft, however (described below), provides new income recognition rules when a domestic corporation transfers a foreign branch to its specified 10-percent owned foreign corporation and coordinates those new rules with the present law branch loss recapture rules.

Conforming amendments and other changes

The proposal includes a number of changes that coordinate the new dividends-received deduction rules with existing Code provisions or that conform existing Code provisions to the new dividends-received deduction rules. Certain changes are described below.

Like the present law dividends-received deduction rules of sections 243, 244, and 245, the proposal's 95-percent dividends-received deduction is not available for any dividend from a corporation that is exempt from taxation under section 501 or 521.

In conformity with the present law dividends-received deduction rules, deductible dividends under the proposal and the stock on which deductible dividends are paid are treated as 95-percent tax-exempt income and 95-percent tax-exempt assets, respectively, for purposes of allocating and apportioning deductible expenses.

Present law section 1059 generally requires that a corporation that receives an extraordinary dividend in respect of stock that the corporation has not held for more than two years before the dividend announcement date must reduce its basis in the stock by the amount of the dividends-received deduction available under section 243, 244, or 245. The proposal extends this rule to stock on which a dividend eligible for the 95-percent dividends-received deduction is paid.

Effective Date

The proposal applies to taxable years of foreign corporations beginning after December 31, 2014 and to taxable years of United States shareholders in which or with which those taxable years of foreign corporations end.

2. Limitation on losses with respect to specified 10-percent owned foreign corporations (sec. 4002 of the discussion draft, and secs. 367(a)(3)(C) and 961 and new sec. 91 of the Code)

Description of Proposal

Reduction in basis of certain foreign stock

Under the proposal, solely for the purpose of determining a loss, a domestic corporate shareholder's adjusted basis in the stock of a specified 10-percent owned foreign corporation (as defined in new section 245A and explained above) is reduced by an amount equal to the portion of any dividend received with respect to such stock from such foreign corporation that was not taxed by reason of a dividends received deduction allowable under section 245A in any taxable year of such domestic corporation.

Inclusion of transferred loss amount in certain assets transfers

Under the proposal, if a domestic corporation transfers substantially all of the assets of a foreign branch (within the meaning of section 367(a)(3)(C)) to a foreign corporation which, after such transfer, is a specified 10-percent owned foreign corporation with respect to which such domestic corporation is a United States shareholder, such domestic corporation includes in gross income an amount equal to the transferred loss amount, subject to certain limitations.

For any taxable year of such domestic corporation, the amount included in gross income is limited to the aggregate amount of dividends received deductions allowable under new section 245A to such domestic corporation during such taxable year (taking into account all specified 10-percent owned foreign corporations with respect to which such domestic corporation is a United States shareholder). Transferred loss amounts not included in gross income by reason of such limitation are carried forward and included in gross income in subsequent years, subject to the application of such limitation in such subsequent taxable year.

The transferred loss amount is the excess of (1) losses incurred by the foreign branch after December 31, 2014, for which a deduction was allowed to the domestic corporation, over (2) the sum of taxable income earned by the foreign branch and gain recognized by reason of an overall foreign loss recapture arising out of disposition of assets on account of the underlying transfer. For the purposes of (2), only taxable income of the foreign branch in taxable years after the loss is incurred through the close of the taxable year of the transfer is included.

For transfers not covered by section 367(a)(3)(C), the transferred loss amount is reduced by the amount of gain recognized by the domestic corporation on the transfer (other than gains recognized by reason of overall foreign loss recapture). For transfers covered by section 367(a)(3)(C), the transferred loss amount is reduced by the amount of gain recognized by reason of such subparagraph.

Amounts included in gross income by reason of the proposal or by reason of section 367(a)(3)(C) are treated as derived from sources within the United States.

The proposal provides authority for the Secretary to prescribe regulations or other guidance for proper adjustments to the adjusted basis of the specified 10-percent owned foreign corporation to which the transfer is made, and to the adjusted basis of the property transferred, to reflect amounts included in gross income under the proposal.

Effective Date

The proposal relating to reduction of basis in certain foreign stock for the purposes of determining a loss is effective for dividends received in taxable years beginning after December 31, 2014.

The proposal relating to transfer of loss amounts from foreign branches to certain foreign corporations is effective for transfers after December 31, 2014.

3. Treatment of deferred foreign income upon transition to participation exemption system of taxation (sec. 4003 of the discussion draft and secs. 965 and 9503 of the Code)

Description of Proposal

In general

The proposal generally requires that, for the last taxable year beginning before the participation exemption takes effect, any 10-percent U.S. shareholder of a CFC or other 10-percent owned foreign corporation must include in income its pro rata share of the undistributed, non-previously-taxed post-1986 foreign earnings of the corporation. Up to 90 percent of the amount so included in income is deductible by the U.S. shareholder, depending on whether the deferred earnings are in cash or other assets. The deduction results in a reduced rate of tax with respect to income from the required inclusion of pre-effective date earnings. A corresponding portion of the credit for foreign taxes is disallowed, thus limiting the credit to the taxable portion of the included income. In determining the increase in a 10-percent U.S. shareholder's U.S. tax liability as a result of the mandatory inclusion, the Code is applied as in effect before enactment of the discussion draft. For example, the corporate tax rate remains unchanged and the separate foreign tax credit limitation rules of present law section 904 apply. The increased tax liability generally may be paid over an eight-year period. An amount equivalent to the taxes collected under this proposal is appropriated to the Highway Trust Fund.

Subpart F

The mechanism for the mandatory inclusion of pre-effective date foreign earnings is subpart F. The proposal provides that in the last taxable year of a specified foreign corporation that ends before January 1, 2015, which is that foreign corporation's last taxable year before the participation exemption system begins, the subpart F income of the foreign corporation is increased by the accumulated deferred foreign income of the corporation determined as of the close of that taxable year. In contrast to the participation exemption deduction available only to domestic corporations that are U.S. shareholders under subpart F, the transition rule applies to all U.S. shareholders[1724] of a specified foreign corporation, which includes any foreign corporation in which a U.S. person owns ten percent of the voting stock. Consistent with the general operation of subpart F, each 10-percent U.S. shareholder of a specified foreign corporation must include in income its pro rata share of the foreign corporation's subpart F income attributable to its accumulated deferred foreign income.[1725]

A 10-percent U.S. shareholder of a specified foreign corporation is allowed a deduction in an amount determined by reference to the portion of deferred earnings and profits that are held

[1724] Sec. 951(b), which defines United States shareholder as any U.S. person that owns 10 percent or more of the voting classes of stock of a foreign corporation.

[1725] For purposes of taking into account its subpart F income under this rule, a noncontrolled 10/50 corporation is treated as a CFC.

in cash or liquid assets. The noncash portion is eligible for a deduction of 90 percent; the U.S. shareholder aggregate foreign cash position is eligible for a deduction of 75 percent.

Accumulated deferred foreign income

A specified foreign corporation's accumulated deferred foreign income that must be taken into account as subpart F income is the portion of the foreign corporation's post-1986 undistributed earnings that is not attributable to (1) income that is effectively connected with the conduct of a trade or business in the United States and subject to U.S. income tax, (2) subpart F income (determined without regard to the mandatory inclusion rule) of a CFC that is included in the gross income of a 10-percent U.S. shareholder of the CFC and with respect to which the CFC has not made distributions that are excludable from gross income under section 959, (3) or, for PFICs, an amount that would be treated as an excess distribution or attributable to an unreversed inclusion. Undistributed earnings are the earnings and profits of the foreign corporation (computed in accordance with sections 964(a) and 986) as of the close of the corporation's last taxable year that ends before January 1, 2015.

The income inclusion required of a U.S. shareholder under this transition rule is reduced by the portion of aggregate foreign earnings and profits deficit allocated to that person by reason of that person's interest in one or more E&P deficit foreign corporations. An E&P deficit foreign corporation is defined as any specified foreign corporation owned by the U.S. shareholder as of February 26, 2014 and which also has a deficit in post-1986 earnings and profits as of that date. The U.S. shareholder aggregates its pro rata share in the foreign E&P deficits of each such company and allocates it among the deferred foreign income corporations in which the shareholder is a U.S. shareholder. The aggregate foreign E & P deficit allocable to a specified foreign corporation is in same ratio as the U.S. shareholder's pro rata share of post-1986 deferred income in that corporation bears to the U.S. shareholder's pro rata share of accumulated post-1986 deferred foreign income from all deferred income companies of such shareholder.

To illustrate, assume that a U.S. corporation is a U.S. shareholder with respect to each of four specified foreign corporations, two of which are E&P deficit foreign corporations, and that the foreign companies have the following accumulated post-1986 deferred foreign income or foreign E&P deficits as of February 26, 2014:

Table 8.–Example

Specified Foreign Corp.	Percentage Owned	Foreign profit/deficit	Pro Rata Share
A	60	(1,000)	(600)
B	10	(200)	(20)
C	70	2,000	1,400
D	100	1,000	1,000

The aggregate foreign E & P deficit of the U. S. shareholder is (620), and the aggregate share of accumulated post-1986 deferred foreign income is 2400. Thus, the portion allocable to Corporation C is $362, that is, $620 x 1400/2400. The remainder of the aggregate foreign E&P deficit is allocable to Corporation D.

Specific regulatory authority is granted to permit reductions of accumulated deferred earnings and profits where appropriate to effect the intent of the drafters that U.S. persons not incur tax with respect to earnings and profits of a controlled foreign corporation allocable to stock owned by persons other than United States shareholders as deferred foreign income.

Foreign tax credit

Like present law section 965, the proposal disallows a foreign tax credit for the portion of foreign taxes paid with respect to the pre-effective-date undistributed CFC earnings inclusion. The proposal also denies a deduction for any foreign tax for which a credit is disallowed. A 10-percent U.S. shareholder's income is not increased under section 78 by the amount of tax for which a foreign tax credit is not allowed.

The required inclusion of deferred foreign income under this provision is disregarded for purposes of determining the amount of income from foreign sources that a U.S. shareholder has for purposes of the recapture rules applicable to overall foreign losses.

Installment payments

A 10-percent U.S. shareholder may elect to pay the net tax liability resulting from the mandatory inclusion of pre-effective-date undistributed CFC earnings in eight installments, in the following amounts: installments one through five in an amount equal to eight percent of the net tax liability; a sixth installment of 15 percent of the net tax liability; the seventh is 20 percent and the eighth, 25 percent. The net tax liability that may be paid in installments is the excess of the 10-percent U.S. shareholder's net income tax for the taxable year in which the pre-effective-date undistributed CFC earnings are included in income over the taxpayer's net income tax for that year determined without regard to the inclusion. Net income tax means net income tax as defined for purposes of the general business credit, but reduced by the amount of that credit.

An election to pay tax in installments must be made by the due date for the tax return for the taxable year in which the pre-effective-date undistributed CFC earnings are included in income. The Treasury Secretary has authority to prescribe the manner of making the election. The first installment must be paid on the due date (determined without regard to extensions) for the tax return for the taxable year of the income inclusion. Succeeding installments must be paid annually no later than the due dates (without extensions) for the income tax return of each succeeding year. If a deficiency is later determined with respect to the net tax liability, the additional tax due may be prorated among all installment payments in most circumstances. The portions of the deficiency prorated to an installment for which the due date is past must be paid upon notice and demand. The portion prorated to any remaining installment is payable with the timely payment of that installment payment, unless the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax, in which case the entire deficiency is payable upon notice and demand.

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 this proposal, 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.

The proposal also includes an acceleration rule. If (1) there is a failure to pay timely any required installment, (2) there is a liquidation or sale of substantially all of the 10-percent U.S. shareholder's assets (including in a bankruptcy case), (3) the 10-percent 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 title 11 or similar case, the day before the petition is filed).

Special rule for S corporations

A special rule permits deferral of the transition net tax liability for shareholders of a 10-percent U.S. shareholder that is a flow-through entity known as an S corporation.[1726] Any shareholder of the S corporation may elect to defer his portion of the net tax liability at transition to the participation exemption system until the shareholder's taxable year in which a triggering event occurs. If an election to defer tax is made, the S corporation and the electing shareholder are jointly and severally liable for any net tax liability and related interest or penalties. The election to defer the tax is due not later than the due date for the return of the S corporation for its last taxable year that begins before January 1, 2015.

Three types of events may trigger an end to deferral of the net tax liability. The first type of triggering event is a change in the status of the corporation as an S corporation. The second category includes liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, including reorganization in bankruptcy. The third type of triggering event is 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. Partial transfers trigger the end of deferral only with respect to the portion of tax properly allocable to the portion of stock sold.

If a shareholder of an S corporation has elected deferral under the special rule for S corporation shareholders and a triggering event occurs, that shareholder may be eligible to elect to pay the net tax liability in installments, subject to rules similar to those generally applicable absent deferral. Whether or not a shareholder may elect to pay in installments depends upon the type of event that triggered the end of deferral. If the triggering event is liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar

[1726] Section 1361 defines an S corporation as a domestic small business corporation that has an election in effect for status as an S corporation, with fewer than 100 shareholders, none of whom are nonresident aliens, and all of whom are individuals, estates, trusts or certain exempt organizations.

event, installment payments are not available. Instead, the entire net tax liability is due upon notice and demand. The installment election is due with the timely return for the year in which the triggering event occurs. The first installment payment is required by the due date of the same return, determined without regard to extensions of time to file.

If an election to defer payment of the net tax liability is in effect for a shareholder, the period within which the IRS may collect such liability does not begin before the date of an event that triggers the end of the deferral.

Highway Trust Fund

The proposal requires that income tax payments relating to the net tax liability for deemed repatriation of pre-effective date foreign earnings will be transferred to the Highway Trust Fund. The Highway Trust Fund, established in 1956, is divided into two accounts, a Highway Account and a Mass Transit Account, each of which is the funding source for specific programs.[1727] The Highway Trust Fund is currently funded by taxes on motor fuels (gasoline, kerosene, diesel fuel, and certain alternative fuels), a tax on heavy vehicle tires, a retail sales tax on certain trucks, trailers and tractors, and an annual use tax for heavy highway vehicles. Of the receipts received in the Treasury as a result of the deemed repatriation provision (and not otherwise appropriated), an amount equivalent to twenty percent will be transferred to the Mass Transit Account, the balance transferred to the Highway Account.

Effective Date

The proposal is effective for the last taxable year of a deferred foreign corporation that begins before January 1, 2015, and with respect to U.S. shareholders, for the taxable years in which or with which such taxable years of the specified foreign corporations end.

4. Look-thru rule for related controlled foreign corporations made permanent (sec. 4004 of the discussion draft and sec. 954(c)(6) of the Code)

Description of Proposal

The proposal makes the exclusion from foreign personal holding company income for certain dividends, interest, rents, and royalties received from a related controlled foreign corporation permanent.

Effective Date

The proposal applies to taxable years of foreign corporations beginning after December 31, 2013 and to taxable years of United States shareholders in which or with which those taxable years of foreign corporations end.

[1727] Sec. 9503(e)(1).

B. Modifications Related to Foreign Tax Credit System

1. Repeal of section 902 indirect foreign tax credits; determination of section 960 credit on current year basis (sec. 4101 of the discussion draft and secs. 902 and 960 of the Code)

Description of Proposal

The proposal repeals the deemed-paid credit with respect to dividends received by a domestic corporation which owns 10-percent or more of the voting stock of a foreign corporation.

A deemed-paid credit is provided with respect to any income inclusion under subpart F. The deemed-paid credit is limited to the amount of foreign income taxes properly attributable to the subpart F inclusion. Foreign income taxes under the proposal include income, war profits, or excess profits taxes paid or accrued by the CFC to any foreign country or possession of the United States. The proposal eliminates the need for computing and tracking cumulative tax pools.

Additionally, the proposal provides rules applicable to foreign taxes attributable to distributions from previously taxed earnings and profits, including distributions made through tiered-CFCs.

The Secretary is granted authority under the proposal to provide regulations as necessary and appropriate to carry out the purposes of this proposal. It is anticipated that the Secretary would provide regulations with rules for allocating taxes similar to rules in place for purposes of determining the allocation of taxes to specific foreign tax credit baskets.[1728] Under such 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 a certain type of income from its tax base, no deemed-paid credit results from the inclusion of such income as subpart F. Tax imposed on income that is not included in subpart F income, is not considered attributable to subpart F income.

In addition to the rules described in this section, the proposal makes several conforming amendments to various other sections of the Code reflecting the repeal of section 902 and the modification of section 960. These conforming amendments include amending the section 78 gross-up provision to apply solely to taxes deemed paid under the amended section 960.

Effective Date

The proposal applies to taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

[1728] See Treas. Reg. sec. 1.904-6(a).

2. Foreign tax credit limitation applied by allocating only directly allocable deductions to foreign source income (sec. 4102 of the discussion draft and sec. 904 of the Code)

Description of Proposal

The proposal provides that for purposes of computing the foreign tax credit limitation, only directly allocable deductions are subtracted from gross foreign-source income to compute foreign-source taxable income. Taxpayers are not required under the proposal to allocate other deductions against foreign-source income for purposes of determining the foreign tax credit limitation.

For purposes of applying this proposal, directly allocable deductions are deductions that are directly incurred as a result of the activities that produce the related foreign-source income. Directly allocable deductions could include items such as salaries of sales personnel, supplies, and shipping expenses directly related to the production of foreign-source income. Deductions such as stewardship expenses, general and administrative expenses, and interest expenses are not considered directly allocable deductions for purposes of the proposal.

Effective Date

This proposal is applicable to taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

3. Passive category income expanded to include other mobile income (sec. 4103 of the discussion draft and sec. 904 of the Code)

Description of Proposal

The proposal generally retains the separate category rules (*i.e.*, general category and passive category) for determining the foreign tax credit limitation. The passive category is renamed mobile category income and is expanded to include a shareholder's foreign base company sales income and foreign base company intangible income. Additionally, the special rules for treating financial services income as general category income are eliminated.

Several conforming amendments are made to various sections of the Code.

Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

This proposal applies to taxes carried from any taxable year beginning before January 1, 2015 to any taxable year beginning on or after such date.

Treasury regulations may provide for the allocation of any carryback of taxes with respect to income from a taxable year beginning on or after January 1, 2015 to a taxable year beginning before such date for purposes of allocating income among separate foreign tax credit limitation categories in effect for the taxable year to which such taxes are carried.

4. Source of income from sales of inventory determined solely on basis of production activities (sec. 4104 of the discussion draft and sec. 863(b) of the Code)

Description of Proposal

Under this proposal, income derived from the sale of inventory produced partly in, and partly outside, the United States is allocated and apportioned on the basis of the location of production activities in accordance with the regulations applicable to section 863(b). For example, income derived from the sale of inventory property to a foreign jurisdiction is sourced wholly within the United States if the property was produced entirely in the United States, even if title passage occurred elsewhere. Likewise, income derived from inventory property sold in the United States, but produced entirely in another country, is sourced in that country even if title passage occurs in the United States. Had the inventory property been produced partly in, and partly outside, the United States in this example, however, the income derived from its sale is sourced partly in the United States.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

C. Rules Related to Passive and Mobile Income

1. Subpart F income to only include low-taxed foreign income (sec. 4201 of the discussion draft and secs. 953 and 954 of the Code)

Description of Proposal

The proposal modifies the rule excluding items of income subject to high foreign taxes from foreign base company income and from insurance income. Under the proposal, foreign base company income and insurance income do not include items of income received by a controlled foreign corporation which are subject to an effective tax rate imposed by a foreign country which is greater than or equal to the maximum U.S. corporate rate specified in section 11.

The proposal creates special rules for certain categories of foreign base company income. Under the proposal, foreign base company income does not include items of foreign base company sales income which are subject to an effective tax rate of tax imposed by a foreign country which is greater than or equal to 50-percent of the maximum U.S. corporate rate specified in section 11.

Further, foreign base company income does not include the foreign percentage (as determined under new section 250(c) with respect to the controlled foreign corporation) of foreign base company intangible income if such foreign base company intangible income is subject to an effective tax rate imposed by a foreign country which is greater than the applicable percentage. For the purpose of the tax rate test, the applicable percentage for any taxable year beginning in 2015 is 45 percent, 2016 is 48 percent, 2017 is 52 percent, 2018 is 56 percent and 2019 and thereafter is 60 percent.[1729] All foreign personal holding company intangible income is treated as a single item of income for purposes of the tax rate test.

Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

2. Foreign base company sales income (sec. 4202 of the discussion draft and secs. 954 and 960 of the Code)

Description of Proposal

The proposal permits an exclusion of 50 percent of all foreign base company sales income ("FBCSI"). The taxes paid by the controlled foreign corporation with respect to such income remain creditable as deemed paid taxes, notwithstanding the exclusion of income.

[1729] The applicable percentage corresponds to the phase-down of the corporate income tax rate under section 3001 of the discussion draft.

Furthermore, FBCSI of a controlled foreign corporation is excluded in full if the foreign corporation is eligible for benefits as a qualified resident under a comprehensive income tax treaty with the United States. The phrase "comprehensive income tax treaty" refers to any bilateral treaty for the elimination of double income taxation. By limiting the provision to companies that are eligible as qualified resident for all benefits of such a treaty, the scope of the provision is intended to be limited to those companies that satisfy the robust limitation on benefits provisions of income tax treaties. Such rules are intended to prevent the inappropriate claims of treaty benefits by third-country residents, and are generally standard provisions in treaties that have entered into force since January 1, 1990.

Effective Date

The exception described above applies to taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders in which or with which those taxable years of foreign corporations end.

3. Inflation adjustment of *de minimis* exception for foreign base company income (sec. 4203 of the discussion draft and sec. 954(b) of the Code)

Description of Proposal

In the case of any taxable year beginning after 2015, the proposal indexes for inflation the $1,000,000 *de minimis* amount for foreign base company income, with all increases rounded to the nearest multiple of $50,000.

Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders within which or with which such taxable years of foreign corporations end.

4. Active financing exception extended with limitation for low-taxed income (sec. 4204 of the discussion draft and secs. 953, 954, and 960 of the Code)

Description of Proposal

The proposal modifies and extends for five years (for taxable years beginning before January 1, 2019) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Under the proposal, foreign personal holding company income does not include any item of qualified banking or financing income of an eligible controlled foreign corporation (as determined under 954(h)), or qualified insurance income of a qualifying insurance company (as determined under 954(i)), which is subject to an effective foreign income tax rate of at least 50 percent of the maximum U.S. corporate rate under section 11.

The proposal also excludes from foreign personal holding income fifty percent of any item of qualified banking or financing income of an eligible controlled foreign corporation, or qualified insurance income of a qualifying insurance company, which is subject to an effective foreign income tax rate of less than 50 percent of the maximum U.S. corporate rate under section 11.

Under the proposal, with respect to such items of income subject to the 50-percent exclusion from foreign personal holding company income, the determination of taxes deemed paid by a United States shareholder under section 960(a) is made as if no 50-percent exclusion were allowed. In other words, a United States shareholder is deemed to pay the pro rata share of the full amount of tax paid by the controlled foreign corporation on such item of income.

Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2013, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

5. Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment (sec. 4205 of the discussion draft and sec. 955 of the Code)

Description of Proposal

The proposal repeals section 955.

Effective Date

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2013, and to taxable years of U.S. shareholders within which or with which such taxable years of foreign corporations end.

6. Foreign intangible income subject to taxation at reduced rate; intangible income treated as subpart F income (sec. 4211 of the discussion draft and sec. 954 of the Code)

Description of Proposal

In general

The proposal addresses erosion of the U.S. tax base through shifting intangible income by creating a new category of subpart F income for intangible income derived by CFCs and providing a phased deduction for a domestic corporation for income from its foreign exploitation of intangibles. As a result, the proposal both increases the U.S. taxation of income derived from intangibles owned or licensed by a CFC and decreases the U.S. tax on the income of a U.S. corporation from its use of intangibles in foreign markets. When fully phased in, the deduction from the gross income of the domestic corporation results in a reduced tax rate of 15 percent for income from the foreign exploitation of intangible property.

Foreign base company intangible income

The proposal adds a new category of subpart F income, foreign base company intangible income. Foreign base company intangible income is the excess of the corporation's adjusted gross income over 10 percent of the corporation's qualified business asset investment. This amount is reduced by the applicable percentage of the corporation's foreign personal holding company income, foreign base company sales income, foreign base company services income, and foreign base company oil related income. The applicable percentage is the excess of the corporation's adjusted gross income over 10 percent of the corporation's qualified business asset investment divided by the total adjusted gross income of the corporation. Adjusted gross income means the gross income of the corporation reduced by commodities gross income.

A corporation's qualified business asset investment is the aggregate of the corporation's adjusted bases in specified tangible property. A corporation's aggregate basis in specified tangible property is determined as of the close of any taxable year after any adjustments made for the taxable year. Specified tangible property is any tangible property unless the property is used in the production of commodities gross income. The specified tangible property is property used in a trade or business of the corporation, and is of a type with respect to which a deduction is allowable under section 168. The basis of any property is determined in accordance with the new rules provided elsewhere in the discussion draft, and without regard to any provisions enacted after the enactment of these rules. The proposal includes authority for the Secretary to issue guidance appropriate to prevent the avoidance of the application of the tangible property rules, including guidance providing for the treatment of property if the property is transferred or held temporarily or if avoiding the purpose of the proposal is a factor in the transfer or holding of property.

To illustrate, suppose a CFC in the business of manufacturing and selling widgets has an aggregate basis in specified tangible property of $300, and adjusted gross income of $50 which includes $10 of foreign personal holding company income. The amount of the CFC's adjusted gross income in excess of 10 percent of its basis in property is $20 [$50 - $30]. The applicable percentage of 40 percent [$20 / $50] multiplied by the $10 of foreign personal holding company income is $4. The CFC's foreign base company intangible income is $16.

Foreign base company intangible income is only subpart F income under the proposal to the extent that the income is subject to a foreign effective tax rate lower than the effective U.S. tax rate imposed after taking into account the deduction for foreign intangible income discussed below.

Commodities gross income

Commodities gross income is excluded from the computation of foreign base company intangible income. A CFC's commodities gross income is the gross income derived from the sale, disposition, production or extraction of any commodity. Additionally, specified tangible property does not include property used in the production of commodities gross income. If a property is used for the production of both commodities gross income and other income, the property is treated under the proposal as specified tangible property in the same proportion as the adjusted gross income produced with respect to the property bears to the total gross income produced with respect to the property.

For purposes of the proposal, a commodity is any commodity described in section 475(e)(2)(A).

Deduction for foreign intangible income

The proposal allows a domestic corporation a deduction equal to the applicable percentage of the lesser of (1) the sum of the domestic corporation's foreign percentage of its net intangible income and the domestic corporation's share of a CFC's foreign base company intangible income multiplied by the CFC's foreign percentage, and (2) the taxable income of the domestic corporation.

The applicable percentage phases in over time in accordance with the phase-in of the lower domestic corporate tax rate. The applicable percentage is 55 percent for 2015, 52 percent for 2016, 48 percent for 2017, 44 percent for 2018, and 40 percent for 2019 and thereafter.

The domestic corporation's intangible income is computed in the same manner as the foreign base company intangible income of a CFC. Intangible income of the domestic corporation is equal to the adjusted gross income in excess of 10 percent of the corporation's qualified business asset investment. Adjusted gross income and qualified business asset investment are defined the same for the domestic corporation as they are for the CFC. Net intangible income is the excess of the intangible income over deductions property allocable to that income.

Only foreign intangible income is eligible for the deduction. Foreign intangible income is computed by multiplying the foreign percentage by the domestic corporation's net intangible income and multiplying the CFC's foreign percentage by the domestic corporation's share of the CFC's foreign base company intangible income.

A corporation's foreign percentage is the ratio of the foreign-derived adjusted gross income over the corporation's total adjusted gross income for the taxable year. Under the proposal, foreign-derived adjusted gross income is gross income derived in connection with property which is sold for use, consumption, or disposition outside the United States, or services provided with respect to persons or property located outside the United States. The location of title passage is not determinative of where property is sold for use, consumption, or disposition. For example, the gross income from a foreign military sale where title is transferred first to the U.S. government for on-sale to a foreign purchaser for use, consumption, or disposition outside the United States qualifies as foreign-derived adjusted gross income.

Property is not treated as sold for use, consumption, or disposition outside the United States if the taxpayer knew, or had reason to know, that the property would ultimately be sold for use, consumption, or disposition in the United States. Property sold to a related party will not be treated as sold for use, consumption, or disposition outside the United States unless the property is ultimately sold by a related party for use, consumption, or disposition outside the United States, or if the property is resold to an unrelated party outside the United States and no related party knew or had reason to know that the property would ultimately be sold for use, consumption, or disposition in the United States. Similar rules apply with respect to services. A related party for these purposes means any member of an affiliated group defined in section 1504(a) determined by using "more than 50 percent" in place of "at least 80 percent" and by including insurance companies and foreign corporations. Any person (other than a corporation) is treated as a member of the group if the person is controlled by members of the group, or controls any member of the group. Control for these purposes is determined under the rules of section 954(d)(3).

Effective Date

The proposal is generally effective for foreign corporations for taxable years beginning after December 31, 2014, and for the U.S. shareholder of such foreign corporation, for the taxable years within which or with which, such taxable years of the foreign corporations end.

The deduction provided by this proposal is applicable for taxable years of a domestic corporation beginning after December 31, 2014.

7. Denial of deduction for interest expense of U.S. shareholders which are members of worldwide affiliated groups with excess domestic indebtedness (sec. 4212 of the discussion draft and sec. 163 of the Code)

Description of Proposal

The proposal addresses base erosion that results from excessive and disproportionate borrowing in the United States by limiting the deductibility of net interest expense[1730] of a U.S. corporation that is a U.S. shareholder with respect to any CFC if both the CFC and U.S. corporation are part of a worldwide affiliated group. A portion of otherwise deductible interest is disallowed if the U.S. group fails to meet both a relative leverage test and a percentage of adjusted taxable income test. The lesser of the two amounts determined under these tests is the amount by which deductible interest is reduced. The proposal does not apply to a wholly domestic group.

A worldwide affiliated group is one or more chains of corporations, connected through stock ownership with a common parent that would qualify as an affiliated group under section 1504, with two differences. First, the ownership threshold of section 1504(a)(2) is applied using 50 percent rather than 80 percent. Second, the restriction on inclusion of a foreign corporation under section 1504(b)(3) is disregarded for purposes of identifying the worldwide affiliated group.

In the relative leverage test, all U.S. members of the worldwide affiliated group are treated as one member in order to determine whether the group has excess domestic indebtedness as a result of a debt-to-equity differential. Excess domestic indebtedness is the amount by which the total indebtedness of the U.S. members exceeds 110 percent of the debt those members

[1730] Net interest for these purposes is defined in section 163(j)(6)(B) as the excess of interest paid or accrued over the interest includible in gross income for the taxable year.

would hold if their aggregate debt-to-equity ratio were proportionate to the ratio of debt-to-equity in the worldwide group. The percentage of aggregate domestic debt represented by excess domestic indebtedness is the debt-to-equity differential by which net interest expense is multiplied to determine the amount of interest that would be disallowed under the relative leverage test. Intragroup debt and equity interests are disregarded for purposes of this computation.

The percentage of adjusted taxable income test computes the amount by which the net interest expense of a U.S. shareholder exceeds 40 percent of adjusted taxable income. The proposal requires that the U.S. shareholder first compute adjusted taxable income as defined in section 163(j)(6)(A), that is, taxable income increased by deductible losses, interest, depreciation and amortization, qualified production expenses and as prescribed under regulations. The net interest expense is the amount of interest paid or accrued in the taxable year in excess of the amount of interest includible in gross income for the same taxable year, as defined in section 163(j)(6)(B).

Several changes to section 163(j) conform its operation to the new subsection. Interest disallowed under either this rule or under section 163(j) may be carried forward to subsequent taxable years. The amount by which corporate net interest expense may exceed the adjusted taxable income of the corporation (plus any excess limitation carryforward from years beginning before January 1, 2015) is reduced to 40 percent from 50 percent. Excess limitation for years beginning after January 1, 2015 is not available to be carried forward. Finally, the amount of interest disallowed under section 163(j) is reduced to the extent that a disallowance of deduction is required by this proposal.

The Secretary is provided regulatory authority to provide anti-avoidance rules and the treatment of partnership indebtedness, allocation of partnership debt, interest, or distributive shares.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

TITLE V – TAX EXEMPT ENTITIES

A. Unrelated Business Income Tax

PRESENT LAW

Tax exemption for certain organizations

Section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in section 401(a).

Section 115 excludes from gross income certain income of entities that perform an essential government function. The exemption applies to: (1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia; or (2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

Unrelated business income tax, in general

An exempt organization generally may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (*e.g.*, program service revenue); investment income; and trade or business income that is not related to exempt activities. The Federal income tax exemption generally extends to the first three categories, and does not extend to an organization's unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.[1731]

The unrelated business income tax ("UBIT") generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.[1732] An organization that is subject to UBIT and that has $1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing exempt status. A section 501(c)(3) (charitable) organization, however, may not

[1731] This is the case for social clubs (sec. 501(c)(7)), voluntary employees' beneficiary associations (sec. 501(c)(9)), and organizations and trusts described in sections 501(c)(17) and 501(c)(20). Sec. 512(a)(3).

[1732] Secs. 511-514.

operate an unrelated trade or business as a substantial part of its activities.[1733] Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

Organizations subject to tax on unrelated business income

Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to the unrelated business income tax generally include: (1) organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts);[1734] (2) qualified pension, profit-sharing, and stock bonus plans described in section 401(a);[1735] and (3) certain State colleges and universities.[1736]

Exclusions from Unrelated Business Taxable Income

In general

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents,[1737] unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.[1738] Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and State fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

Research income

Certain income derived from research activities of exempt organizations is excluded from unrelated business taxable income. For example, income derived from research performed for the United States, a State, and certain agencies and subdivisions is excluded.[1739] Income from

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[1733] Treas. Reg. sec. 1.501(c)(3)-1(e).

[1734] Sec. 511(a)(2)(A).

[1735] Sec. 511(a)(2)(A).

[1736] Sec. 511(a)(2)(B).

[1737] Secs. 511-514.

[1738] Sec. 512(b)(13).

[1739] Sec. 512(b)(7).

research performed by a college, university or hospital for any person also is excluded.[1740] Finally, if an organization is operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public, all income derived by research performed by such organization for any person, not just income derived from research available to the general public, is excluded.[1741]

Gain or loss from disposition of real property acquired from financial institutions in conservatorship or receivership

Section 512(b)(16) provides an exclusion from unrelated business taxable income for income from sales of property held for sale in the ordinary course of a trade or business by excluding gains and losses from the sale, exchange, or other disposition of certain real property and mortgages acquired from financial institutions that are in conservatorship or receivership. The exclusion is limited to properties designated by the taxpayer within nine months of acquisition as property held for sale, except that not more than one-half of property acquired in a single transaction may be so designated. The disposition generally must occur within 30 months of the date of acquisition.

Specific deduction against unrelated business taxable income

In computing unrelated business taxable income, an exempt organization may take a specific deduction of $1,000. This specific deduction may not be used to create a net operating loss that will be carried back or forward to another year.[1742]

In the case of a diocese, province or religious order, or a convention or association of churches, a specific deduction is allowed with respect to each parish, individual church, district, or other local unit. The specific deduction is equal to the lower of $1,000 or the gross income derived from any unrelated trade or business regularly carried on by the local unit.[1743]

Deduction against unrelated business taxable income for charitable contributions

In computing unrelated business taxable income, an exempt organization may deduct certain charitable contributions made to other organizations (generally, contributions that satisfy the requirements of section 170), whether or not directly connected with the carrying on of the trade or business. For most organizations subject to that tax on unrelated business income – *i.e.*, those described in section 511(a) – the charitable contribution deduction is limited to 10 percent of the unrelated business taxable income, computed without regard to the deduction of charitable contributions.[1744] A separate rule applies in determining the charitable contribution deduction

[1740] Sec. 512(b)(8).

[1741] Sec. 512(b)(9).

[1742] Sec. 512(b)(12).

[1743] *Ibid.*

[1744] Sec. 512(b)(10).

for charitable trusts described in section 511(b).[1745] For such trusts, the charitable contribution percentage limitations under section 170(b)(1)(A) and 170(b)(1)(B) generally apply in determining the trust's charitable contribution deduction, but with the percentage limits being determined with respect to the trust's unrelated business taxable income instead of its adjusted gross income.[1746]

Qualified sponsorship payments

Under section 513(i), the activity of soliciting or receiving qualified sponsorship payments by a tax-exempt organization is not an unrelated trade or business. As a result, such payments are exempt from UBIT.

"Qualified sponsorship payments" are defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the organization's activities.[1747] Such a use or acknowledgment does not include advertising of such person's products or services – meaning qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use such products or services.[1748] Thus, for example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event conducted by the organization, such payment will not be subject to UBIT. In contrast, if the organization provides advertising of a sponsor's products, the payment made to the organization by the sponsor in order to receive such advertising will be subject to UBIT (provided that the other requirements for UBIT liability are satisfied).

The term "qualified sponsorship payment" does not include any payments where the amount of such payment is contingent, by contract or otherwise, upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree of public exposure to an activity.[1749] The term also excludes payments that entitle the payor to the use or acknowledgment of the payor's trade or business name or logo (or product lines) in tax-exempt organization periodicals.[1750] Such payments are outside the qualified sponsorship payment provision's safe-harbor exclusion, and, therefore, are governed by generally applicable rules that determine whether the payment is subject to UBIT. Thus, for example, payments that entitle the

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[1745] For purposes of the trust's charitable contribution deduction, a distribution by the trust is treated as a gift or contribution. Sec. 512(b)(11).

[1746] Sec. 512(b)(11).

[1747] Sec. 513(i)(2)(A).

[1748] Sec. 513(i)(2)(A).

[1749] Sec. 513(i)(2)(B)(i).

[1750] Sec. 513(i)(2)(B)(ii).

payor to a depiction of the payor's name or logo in a tax-exempt organization periodical may or may not be subject to UBIT depending on the application of rules regarding periodical advertising and nontaxable donor recognition. For this purpose, the term "periodical" means regularly scheduled and printed material published by (or on behalf of) the payee organization that is not related to and primarily distributed in connection with a specific event conducted by the payee organization. In addition, the safe-harbor exclusion for qualified sponsorship payments does not apply to payments made in connection with "qualified convention or trade show activities," as defined in section 513(d)(3).[1751]

To the extent that a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, such portion of the payment is treated as a separate payment.[1752]

Operation of multiple unrelated trades or businesses

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated trade or business.[1753] Under regulations, in determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions.[1754] As a result, an organization may use a loss from one unrelated trade or business to offset gain from another, thereby reducing total unrelated business taxable income.

1. Clarification of unrelated business income tax treatment of entities exempt from tax under section 501(a) (sec. 5001 of the discussion draft and sec. 511 of the Code)

Description of Proposal

The proposal clarifies that an organization does not fail to be subject to tax on its unrelated business income as an organization exempt from tax under section 501(a) solely because the organization also is exempt, or excludes amounts from gross income, by reason of another provision of the Code. For example, if an organization is described in section 401(a) (and thus is exempt from tax under section 501(a)) and its income also is described in section 115 (relating to the exclusion from gross income of certain income derived from the exercise of an essential governmental function), its governmental status under section 115 does not cause it to be exempt from tax on its unrelated business income.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

[1751] Sec. 513(i)(2)(B)(ii).

[1752] Sec. 513(i)(3).

[1753] Sec. 512(a).

[1754] Treas. Reg. sec. 1.512(a)-1(a).

2. Name and logo royalties treated as unrelated business taxable income (sec. 5002 of the discussion draft and secs. 512 and 513 of the Code)

Description of Proposal

The proposal modifies the UBIT treatment of the licensing of an organization's name or logo generally to subject royalty income derived from such a license to UBIT. Specifically, the proposal amends section 513 (regarding unrelated trades or businesses) to provide that any sale or licensing by an organization of any name or logo of the organization (including any trademark or copyright related to a name or logo) is treated as an unrelated trade or business that is regularly carried on by the organization. In addition, the proposal amends section 512 (regarding unrelated business taxable income) to provide that income derived from any such licensing of a name or logo of the organization is included in the organization's gross unrelated business taxable income, notwithstanding the provisions of section 512 that otherwise exclude certain types of passive income (including royalties) from unrelated business taxable income.[1755]

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

3. Unrelated business taxable income separately computed for each trade or business (sec. 5003 of the discussion draft and sec. 512 of the Code)

Description of Proposal

For an organization with more than one unrelated trade or business, the proposal requires that unrelated business taxable income first be computed separately with respect to each trade or business and without regard to the specific deduction generally allowed under section 512(b)(12). The organization's unrelated business taxable income for a taxable year is the sum of the amounts (not less than zero) computed for each separate unrelated trade or business, less the specific deduction allowed under section 512(b)(12). A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose.

The result of the proposal is that a loss from one trade or business for a taxable year may not be used to offset gain from a different unrelated trade or business for the same taxable year. The proposal generally does not, however, prevent an organization from using a loss from one taxable year to offset gain from the same unrelated trade or business activity in another taxable year, where appropriate.

Effective Date

The proposal generally is effective for taxable years beginning after December 31, 2014.

[1755] Specifically, the proposal references sections 512(b)(1), (2), (3) and (5).

Special transition rules apply for net operating loss carryforwards and carrybacks. In the case of a net operating loss arising in a taxable year beginning before January 1, 2015, and carried over to a year beginning on or after such date, the new rule that allows a net operating loss deduction only with respect to the trade or business from which the loss arose shall not apply. In the case of a net operating loss arising in a taxable year beginning after December 31, 2014, and carried back to a taxable year beginning on or before such date, the net operating loss deduction is allowed only with respect to the trade or business from which the loss arose.

4. Exclusion of research income from unrelated business taxable income limited to publicly available research (sec. 5004 of the discussion draft and sec. 512(b)(9) of the Code)

Description of Proposal

The proposal modifies the exclusion of income from research performed by an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public (section 512(b)(9)). Under the proposal, the organization may exclude from unrelated business taxable income under section 512(b)(9) only income from such fundamental research the results of which are freely available to the general public.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

5. Parity of charitable contribution limitation between trusts and corporations for purposes of computing unrelated business taxable income (sec. 5005 of the discussion draft and sec. 512(b)(11) of the Code)

Description of Proposal

The proposal modifies the charitable deduction percentage limit that applies under section 512(b)(11) in determining the charitable contribution deduction a charitable trust described in section 511(b) may take in computing its unrelated business taxable income to align with the limit that applies to a corporation. Under the proposal, the trust's charitable contribution deduction is limited to 10 percent of its unrelated business taxable income computed without regard to the deduction for charitable contributions. The percentage limits of sections 170(b)(1)(A) and 170(b)(1)(B) no longer apply.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

6. Increase in specific deduction against unrelated business taxable income (sec. 5006 of the discussion draft and sec. 512(b)(12) of the Code)

Description of Proposal

The proposal increases the specific deduction described in section 512(b)(12) from $1,000 to $10,000 (or, in the case of a diocese, province or religious order, or a convention or association of churches, the lower of $10,000 or the gross income derived from any unrelated trade or business regularly carried on by each parish, individual church, district or other local unit).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

7. Repeal of exclusion from unrelated business taxable income of gain or loss from the disposition of distressed property (sec. 5007 of the discussion draft and sec. 512(b)(16) of the Code)

Description of Proposal

The proposal repeals the exclusion from unrelated business taxable income of gain or loss from the disposition of real property acquired from financial institutions in conservatorship or receivership (section 512(b)(16)).

Effective Date

The proposal is effective for property acquired after December 31, 2014.

8. Modify rules concerning qualified sponsorship payments (sec. 5008 of the discussion draft and sec. 513(i) of the Code)

Description of Proposal

The proposal modifies the definition of "qualified sponsorship payment" to exclude from the permitted substantial return benefit the use or acknowledgment of the sponsor's product lines. In other words, if in exchange for a payment from a sponsor the exempt organization uses or acknowledges the sponsor's product lines, the payment is not a qualified sponsorship payment. The proposal makes a conforming change (regarding the use or acknowledgment of product lines) to the exclusion from the qualified sponsorship payment safe-harbor for periodicals.

The proposal includes a special rule for an event with respect to which an organization receives an aggregate amount of sponsorship payments greater than $25,000. A payment with respect to such an event is not a qualified sponsorship payment unless any use or acknowledgment of the sponsor's name or logo only appears with, and in substantially the same manner as, the names of a significant portion of the other donors to the organization with respect to such event. A significant portion of the donors to the organization with respect to an event is determined by taking into account both the total number of donors to the event and the amounts contributed to the event by such donors, but in no event shall fewer than two other donors be treated as a significant portion of other donors.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

B. Penalties

1. Increase in information return penalties (sec. 5101 of the discussion draft and sec. 6652(c) of the Code)

Present Law

In general

The Code imposes penalties in the event an exempt organization fails to make certain required disclosures or file required information returns.[1756] The penalties are not imposed if it is shown that a failure was due to reasonable cause.[1757] In certain situations, a penalty may also be imposed against certain persons who fail to make such a filing. Solely for this purpose, the term "person" means an officer, director, trustee, employee, or other individual who is under a duty to perform the act in respect to which the failure occurs.[1758]

Failure to file an exempt organization or political organization annual information return (secs. 6652(c)(1)(A) and (B))

In the event of a failure by an exempt organization or political organization to file a return required under section 6033(a)(1) or 6012(a)(6), respectively, or a failure to include any of the information required to be shown on such a return or to show the correct information, section 6652(c)(1)(A) imposes a penalty on the exempt organization of $20 for each day during which the failure continues. The maximum penalty with respect to any one return is limited to the lesser of $10,000 or five percent of the gross receipts of the organization for the year. For organizations with gross receipts exceeding $1 million for the year, the daily penalty amount is increased from $20 to $100, and the maximum penalty is $50,000.

In the event an organization is subject to a penalty under section 6652(c)(1)(A) (described in the preceding paragraph), the Secretary may make a written demand on the organization specifying a reasonable future date by which the return shall be filed or the information furnished. If any person fails to comply with such a demand on or before the date specified in the demand, section 6652(c)(1)(B) imposes a penalty of $10 for each day after the expiration of the time specified in the demand during which the failure continues. The maximum penalty that may be imposed on all persons with respect to any one return is limited to $5,000.

Failure to make annual returns available for public inspection (sec. 6652(c)(1)(C))

Section 6104(d) generally requires certain organizations exempt from tax to make available for public inspection their three most recent annual information returns (Forms 990) and application for tax exemption. Section 527(j) requires certain political organizations to make

[1756] Sec. 6652.

[1757] Sec. 6652(c)(4).

[1758] Sec. 6652(c)(5)(C).

disclosures of expenditures and contributions. In the event of a failure to comply with section 6104(d) with respect to an annual information return or the disclosure requirements of section 527(j), section 6652(c)(1)(C) imposes on any person failing to meet the requirements a penalty of $20 for each day during which the failure continues. The maximum penalty on all persons for failures with respect to any one return or report is limited to $10,000.

Failure to make application for exemption or notice of status available for public inspection (sec. 6652(c)(1)(D))

In the event of a failure to comply with 6104(d) with respect to any exempt status application materials or notice materials (as defined in section 6104(d)), section 6652(c)(1)(D) imposes on any person failing to meet the requirements a penalty of $20 for each day during which the failure continues.

Charitable trust returns; exempt organizations liquidating, dissolving, or terminating (sec. 6652(c)(2))

In the case of a failure to file a return required under section 6034(b) (relating to certain trusts other than split-interest trusts) or 6043(b) (relating to terminations, etc. of exempt organizations), section 6652(c)(2)(A) imposes a penalty on the organization or trust failing to file equal to $10 per day for each day during which the failure continues (up to a maximum of $5,000 per return).

In the event a penalty is imposed on the organization or trust under section 6652(c)(2)(A), the Secretary may make a written demand on the organization or trust specifying a reasonable future date by which a filing shall be made. If any person fails to comply with such a demand on or before the date specified in the demand, section 6652(c)(2)(B) imposes a penalty of $10 for each day after the expiration of the time specified in the demand during with the failure continues. The maximum penalty that may be imposed on all persons with respect to any one return is limited to $5,000.

In the case of a failure to file a return under section 6034(a) by a charitable split-interest trust, section 6652(c)(2)(C) provides that the penalties generally applicable to the failure to file an exempt organization return (under section 6652(c)(2)(A)) will apply, except that, in general (1) the five-percent limitation shall not apply, and (2) the increase in the penalty from $20 to $100 (and the maximum penalty from $10,000 to $50,000) shall apply to trusts with gross income in excess of $250,000. In addition to any penalty on the trust, if the person required to file the return knowingly fails to file it, the above penalty also is imposed on the person, who is personally liable for the penalty.

Failure to file a reportable transaction disclosure (sec. 6652(c)(3))

Section 6033(a)(2) generally requires an exempt organization to file a disclosure if it is a party to any prohibited tax shelter transaction within the meaning of section 4965(e). In the case of a failure to file such a disclosure, section 6652(c)(3)(A) imposes a penalty on the organization (or, in some cases, on an entity manager) of $100 for each day during which the failure continues (up to a maximum of $50,000 per return).

In the event a penalty is imposed under section 6652(c)(3)(A), the Secretary may make a written demand on an entity or manager specifying a reasonable future date by which a filing shall be made. If any entity or manager fails to comply with such a demand on or before the date specified in the demand, section 6652(c)(3)(B) imposes a penalty of $100 for each day after the expiration of the time specified in the demand during with the failure continues. The maximum penalty that may be imposed on all entities and managers with respect to any one disclosure is limited to $10,000.

Description of Proposal

As described below, the proposal doubles each of the daily penalty amounts described above.

Failure to file an exempt organization or political organization annual information return (secs. 6652(c)(1)(A) and (B))

The proposal increases the daily penalties under section 6652(c)(1)(A) from $20 to $40 and from $100 to $200. The daily penalty on managers under section 6652(c)(1)(B) is increased from $10 to $20.

Failure to make annual returns available for public inspection (sec. 6652(c)(1)(C))

The proposal increases the daily penalty under section 6652(c)(1)(C) from $20 to $40.

Failure to make application for exemption or notice of status available for public inspection (sec. 6652(c)(1)(D))

The proposal increases the daily penalty under section 6652(c)(1)(D) from $20 to $40.

Charitable trust returns; exempt organizations liquidating, dissolving, or terminating (sec. 6652(c)(2))

The proposal increases the daily penalties under sections 6652(c)(2)(A), (B), and (C)(ii) from $10 to $20 and from $100 to $200.

Failure to file a reportable transaction disclosure (sec. 6652(c)(3))

The proposal increases the daily penalties under sections 6652(c)(3)(A) and (B) from $100 to $200.

Effective Date

The proposal is effective for information returns required to be filed on or after January 1, 2015.

2. Manager-level accuracy-related penalty on underpayment of unrelated business income tax (sec. 5102 of the discussion draft and secs. 6662 and 6662A of the Code)

Present Law

General accuracy-related penalty (sec. 6662)

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or $10,000 if greater) or (b) $10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[1759] Except in the case of tax shelters,[1760] the amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. The Secretary may prescribe a list of positions that the Secretary believes do not meet the requirements for substantial authority under this provision.

The section 6662 penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[1761] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on [a professional] tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[1762]

With certain exceptions, section 6662 does not apply to any portion of an underpayment that is attributable to a reportable transaction understatement on which a penalty is imposed under section 6662A (discussed below).[1763]

[1759] Sec. 6662.

[1760] A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

[1761] Sec. 6664(c).

[1762] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B). See also Treas. Reg. sec. 1.6664-4(c).

[1763] Sec. 6662(b) (flush language).

Accuracy-related penalty on understatements with respect to reportable transactions (sec. 6662A)

A separate accuracy-related penalty under section 6662A applies to "listed transactions" and to other "reportable transactions" with a significant tax avoidance purpose. The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[1764] A reportable transaction is defined as one that the Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.[1765] There are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions and transactions of interest.[1766] Transactions falling under the first and last categories of reportable transactions are transactions that are described in publications issued by the Treasury Department and identified as one of these types of transaction. A listed transaction is defined as a reportable transaction that is the same as, or substantially similar[1767] to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.[1768]

Description of Proposal

In the case of a substantial understatement of income tax under section 6662 that is attributable to the unrelated business income tax of an organization imposed under section 511, the proposal imposes a new penalty on any manager of such organization. The tax equals five percent of the underpayment attributable to such understatement. For this purpose, the term "manager" includes any officer, director, trustee, employee, or other individual who is under a duty to perform an act in respect of which the underpayment occurs. If more than one person is liable for the manager-level penalty with respect to an understatement, all such persons are jointly and severally liable with respect to such understatement. The maximum amount of manager-level penalty that may be imposed with respect to an understatement is $20,000.

In the case of any portion of a reportable understatement of unrelated business income tax of an organization imposed under section 511 to which the accuracy-related penalty under

[1764] Treas. Reg. sec. 1.6011-4.

[1765] Sec. 6707A(c)(1).

[1766] Treas. Reg. sec. 1.6011-4(b)(2)-(6).

[1767] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1.6011-4(c)(4).

[1768] Sec. 6707A(c)(2).

section 6662A (relating to reportable transactions) applies, the proposal imposes a new penalty on any manager of such organization. The penalty equals 10 percent of the portion of the underpayment to which the reportable transaction understatement relates. For this purpose, the term "manager" includes any officer, director, trustee, employee, or other individual who is under a duty to perform an act in respect of which the underpayment occurs. If more than one person is liable for the manager-level penalty with respect to a reportable transaction understatement, all such persons are jointly and severally liable with respect to such understatement. The maximum amount of manager-level penalty that may be imposed with respect to a reportable transaction understatement is $40,000.

The proposal includes a conforming change regarding the coordination of penalties under sections 6662 and 6662A (*i.e.*, the rule under which section 6662 generally does not apply to any portion of an underpayment which is attributable to a reportable transaction understatement on which a penalty is imposed under present law). The conforming change is intended to clarify that this coordination rule of present law also applies to the new manager penalties added by the proposal.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

C. Excise Taxes

1. Modification of taxes on excess benefit transactions (intermediate sanctions) (sec. 5201 of the discussion draft and sec. 4958 of the Code)

Present Law

Excess benefit transactions ("intermediate sanctions")

The Code imposes excise taxes on excess benefit transactions between disqualified persons and charitable organizations (other than private foundations) or social welfare organizations (as described in section 501(c)(4)).[1769] The excess benefit transaction tax commonly is referred to as "intermediate sanctions."[1770] An excess benefit transaction generally is a transaction in which an economic benefit is provided, directly or indirectly, by a charitable or social welfare organization to or for the use of a disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. The excise tax is imposed on any such excess.

Disqualified persons

Disqualified persons generally include: (1) persons who were, at any time during the five-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the organization (including officers and directors); (2) a member of the family of such a person; and (3) certain 35-percent or more controlled entities.[1771]

Special rules apply with respect to charities that are sponsoring organizations of donor advised funds. For such organizations, the term "disqualified person" also includes: (1) donors and certain other persons appointed by a donor to provide advice with respect to the fund (donor advisors); (2) investment advisors; and (3) members of the family and certain 35-percent or more controlled entities of a person described in (1) or (2).[1772] An investment advisor is a person (other than an employee of the sponsoring organization) compensated by the organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the organization.[1773]

[1769] Sec. 4958.

[1770] The excess benefit transaction rules were enacted in 1996 to provide a sanction short of revocation of tax exemption, an "intermediate" sanction, for abusive self-dealing transactions (*i.e.*, private inurement) between an organization insider and the organization. Prior to enactment of the excess benefit transaction rules, there was no sanction in the Code on organization insiders or disqualified persons for engaging in self-dealing transactions with respect to a public charity.

[1771] Sec. 4958(f)(1).

[1772] Secs. 4958(f)(1)(E) and (F).

[1773] Sec. 4958(f)(8).

Rebuttable presumption of reasonableness

Under the intermediate sanctions regulations, in certain cases an exempt organization may avail itself of a rebuttable presumption with respect to compensation arrangements and property transfers. Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if: (1) the arrangement or terms of transfer are approved in advance by an authorized body of the organization (as defined below) composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transfer; (2) the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and (3) the authorized body adequately documented the basis for its determination concurrently with making that determination.[1774] If these requirements are satisfied, the IRS may overcome the presumption of reasonableness if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body.[1775]

An authorized body is defined as: (1) the governing body of the organization; (2) a committee of the governing body, which may be composed of any individuals permitted under State law to serve on such a committee, to the extent that the committee is permitted by State law to act on behalf of the governing body; or (3) to the extent permitted by State law, other parties authorized by the governing body of the organization to act on its behalf by following procedures specified by the governing body in approving compensation arrangements or property transfers.[1776]

In general, an authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether the arrangement is reasonable in its entirety or the transfer is at fair market value.[1777] In the case of compensation, relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person. In the case of property, relevant information includes, but is not limited to, current independent appraisals of the value of all property to be transferred, and offers received as part of an open and competitive bidding process. For organizations with annual gross receipts (including contributions) of less than $1 million, the authorized body is considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. There is no inference with respect to whether circumstances

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[1774] Treas. Reg. sec. 53.4958-6(a). See also H. Rep. No. 506, 104th Congress, 2d Sess. 1996, pp. 53, 56-7.

[1775] Treas. Reg. sec. 53.4958-6(b).

[1776] Treas. Reg. sec. 53.4958-6(c)(1)(i).

[1777] Treas. Reg. sec. 53.4958-6(c)(2)(i).

falling outside this safe harbor will meet the requirement with respect to the collection of appropriate data.[1778]

In general, for a decision to be documented adequately, the written or electronic records of the authorized body must note: (1) the terms of the transaction that was approved and the date it was approved; (2) the members of the authorized body who were present during debate on the transaction that was approved and those who voted on it; (3) the comparability data obtained and relied upon by the authorized body and how the data was obtained; and (4) any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.[1779]

Amount of the excise tax

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization's managers, but is not imposed on the exempt organization.

An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed $20,000 with respect to any excess benefit transaction) is imposed on an organization manager who knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.[1780] If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.[1781]

Standard for knowing violations

A manager participates in a transaction knowingly only if the manager: (1) has actual knowledge of sufficient facts indicating that, based solely upon those facts, such transaction would be an excess benefit transaction; (2) is aware that such a transaction under these circumstances may violate the provisions of Federal tax law governing excess benefit transactions; and (3) negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a

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[1778] Treas. Reg. sec. 53.4958-6(c)(2)(ii).

[1779] Treas. Reg. sec. 53.4958-6(c)(3).

[1780] Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[1781] Sec. 4958(d)(1).

transaction.[1782] The burden of proof in a Tax Court proceeding as to whether an organization manager (or foundation manager) acted knowingly is on the Secretary.[1783]

Knowing does not mean having a reason to know.[1784] However, evidence tending to show that an organization manager has reason to know of a particular fact or particular rule is relevant in determining whether the manager had actual knowledge of such a fact or rule. Thus, for example, evidence tending to show that a manager has reason to know of sufficient facts indicating that, based solely upon such facts, a transaction would be an excess benefit transaction is relevant in determining whether the manager has actual knowledge of such facts.[1785]

Participation by an organization manager is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. Participation by an organization manager is not willful if the manager does not know that the transaction in which the manager is participating is an excess benefit transaction.[1786] An organization manager's participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.[1787]

Special rules

An organization manager's reliance on professional advice generally means that the manager has not knowingly participated in an excess benefit transaction. Under Treasury regulations, an organization manager's participation in a transaction ordinarily is not considered knowing, even though the transaction subsequently is held to be an excess benefit transaction, to the extent that, after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned written opinion of that professional with respect to elements of the transaction within the professional's expertise. A written opinion is considered as reasoned even though it reaches a conclusion that is subsequently determined to be incorrect so long as the opinion addresses itself to the facts and the applicable standards. A written opinion is not considered to be reasoned if it does nothing more than recite the facts and express a conclusion. The absence of a written opinion of an appropriate professional with respect to a transaction does not, by itself, give rise to any inference that an organization manager participated in the transaction knowingly.

[1782] Treas. Reg. sec. 53.4958-1(d)(4)(i).

[1783] Sec. 7454(b).

[1784] Treas. Reg. sec. 53.4958-1(d)(4)(ii).

[1785] *Ibid.*

[1786] Treas. Reg. sec. 53.4958-1(d)(5).

[1787] Treas. Reg. sec. 53.4958-1(d)(6).

Appropriate professionals on whose written opinion an organization manager may rely, are: (1) legal counsel, including in-house counsel; (2) certified public accountants or accounting firms with expertise regarding the relevant tax law matters; and (3) independent valuation experts who hold themselves out to the public as appraisers or compensation consultants, perform the relevant valuations on a regular basis, are qualified to make valuations of the type of property or services involved, and include in the written opinion a certification that the three preceding requirements are met.[1788]

An organization manager's participation in a transaction ordinarily is not considered knowing even though the transaction subsequently is held to be an excess benefit transaction, if an appropriate authorized body that approved the transaction meets the requirements of the rebuttable presumption of reasonableness with respect to the transaction.[1789]

Description of Proposal

Entity-level tax in the event of an excess benefit transaction

Under the proposal, if an initial tax is imposed on a disqualified person under the intermediate sanctions rules,[1790] the organization is subject to an excise tax equal to 10 percent of the excess benefit. No tax on the organization is imposed if the organization: (1) establishes that the minimum standards of due diligence (described below) were met with respect to the transaction; or (2) establishes to the satisfaction of the Secretary that other reasonable procedures were used to ensure that no excess benefit was provided.

Eliminate rebuttable presumption and establish due diligence procedures

The proposal eliminates the rebuttable presumption of reasonableness contained in the intermediate sanctions regulations. Under the proposal, the procedures that presently provide an organization with a presumption of reasonableness (*i.e.*, advance approval by an authorized body, reliance upon data as to comparability, and adequate and concurrent documentation) generally will establish instead that an organization has performed the minimum standards of due diligence with respect to an arrangement or transfer involving a disqualified person. Satisfaction of these minimum standards will not result in a presumption of reasonableness with respect to the transaction.

Eliminate certain special rules for knowing behavior by organization managers

The proposal eliminates the special rule that provides that an organization manager's participation ordinarily is not "knowing" for purposes of the intermediate sanctions excise taxes if the manager relied on professional advice. Although the proposal eliminates the special rule,

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[1788] Treas. Reg. sec. 53.4958-1(d)(4)(iii).

[1789] Treas. Reg. sec. 53.4958-1(d)(4)(iv).

[1790] Sec. 4958(a)(1).

whether an organization manager relies on professional advice is a relevant consideration in determining the manager knowingly participated in an excess benefit transaction.

The proposal also eliminates the special regulatory rule that provides that an organization manager ordinarily does not act knowingly for purposes of the excess benefit transaction excise tax if the organization has met the requirements of the rebuttable presumption procedure.

Treat investment advisors and athletic coaches as disqualified persons

The proposal modifies the definition of a disqualified person for purposes of the intermediate sanctions rules. First, a person who performs services as an athletic coach for the organization is treated as a disqualified person with respect to the organization. Second, the proposal (1) expands to all organizations that are subject to the intermediate sanctions rules the present-law rule that treats investment advisors to donor advised funds as disqualified persons, and (2) modifies the definition of investment advisor for this purpose. For all applicable tax-exempt organizations (including sponsoring organizations of donor advised funds), the term investment advisor means, with respect to an organization, any person compensated by the organization, and who is primarily responsible, for managing the investment of, or providing investment advice with respect to, assets of the organization.[1791] For a sponsoring organization of a donor advised fund, the term investment advisor also includes any person who is an investment advisor with respect to a sponsoring organization under present law, *i.e.*, a person (other than an employee of the organization) compensated by such organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the sponsoring organization.

Application of intermediate sanctions rules to section 501(c)(5) and section 501(c)(6) organizations

The proposal extends application of the section 4958 intermediate sanctions rules to tax-exempt organizations described in sections 501(c)(5) (labor and certain other organizations) and 501(c)(6) (business leagues and certain other organizations).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

[1791] Under the proposal, the existing rules that treat as disqualified persons certain family members and 35-percent controlled entities of investment advisors to sponsoring organizations of donor advised funds will apply more broadly to investment advisors that are disqualified persons with respect to any organization subject to the intermediate sanctions rules.

2. Modification of taxes on self-dealing (sec. 5202 of the discussion draft and sec. 4941 of the Code)

Present Law

Self-dealing involving private foundations, in general

Excise taxes are imposed on acts of self-dealing between a disqualified person (as defined in section 4946) and a private foundation.[1792] In general, self-dealing transactions are any direct or indirect: (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person, including transfers of property subject to a mortgage or lien that the private foundation assumes or that was put on the property by the disqualified person within 10 years of the transfer; (2) lending of money or other extension of credit between a private foundation and a disqualified person, except for no-interest loans by a disqualified person, the proceeds of which are used exclusively for charitable purposes; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person, unless the goods, services, or facilities are (i) functionally related to the foundation's exempt purposes and are provided to or by the foundation on the same basis as provided by the foundation or disqualified person to the general public, (ii) reasonable and necessary to performing exempt purposes and not excessive, or (iii) provided by disqualified person without charge; (4) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation, unless the use or benefit is de minimis; and (5) certain payments of money or property to a government official. Leases provided by a disqualified person without charge to a private foundation, even if the foundation pays for maintenance, are permitted.

An initial tax of 10 percent of the amount involved with respect to an act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. If such a tax is imposed, a five-percent tax of the amount involved is imposed on a foundation manager who participated in the act of self-dealing knowing it was such an act (and such participation was not willful and was due to reasonable cause) up to $20,000 per act. Such initial taxes may not be abated.[1793] Such initial taxes are imposed for each year in the taxable period, which begins on the date the act of self-dealing occurs and ends on the earliest of the date of mailing of a notice of deficiency for the tax, the date on which the tax is assessed, or the date on which correction of the act of self-dealing is completed. A government official (as defined in section 4946(c)) is subject to such initial tax only if the official participates in the act of self-dealing knowing it is such an act. If the act of self-dealing is not corrected, a tax of 200 percent of the amount involved is imposed on the disqualified person and a tax of 50 percent of the amount involved (up to $20,000 per act) is imposed on a foundation manager who

[1792] Sec. 4941. In general, a private foundation is a section 501(c)(3) organization (generally, a charitable organization) that does not meet the requirements of section 509(a) for being treated more favorably as a public charity.

[1793] Sec. 4962(b).

refused to agree to correcting the act of self-dealing. Such additional taxes are subject to abatement.[1794]

Standard for knowing violations

A foundation manager participates in a transaction knowingly only if the manager: (1) has actual knowledge of sufficient facts indicating that, based solely upon those facts, such transaction would be an act of self-dealing; (2) is aware that such an act under these circumstances may violate the provisions of Federal tax law governing self-dealing; and (3) negligently fails to make reasonable attempts to ascertain whether the transaction is an act of self-dealing, or the manager is in fact aware that it is such an act.[1795] The burden of proof in a Tax Court proceeding as to whether a foundation manager acted knowingly is on the Secretary.[1796]

Knowing does not mean having a reason to know.[1797] However, evidence tending to show that a person has reason to know of a particular fact or rule is relevant in determining whether he had actual knowledge of such a fact or rule. Thus, for example, evidence tending to show that a person has reason to know of sufficient facts indicating that, based solely upon such facts, a transaction would be an act of self-dealing is relevant in determining whether the person has actual knowledge of such facts.[1798]

Participation by a foundation manager is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. Participation by a foundation manager is not willful if the manager does not know that the transaction in which the manager is participating is an act of self-dealing.[1799] A foundation manager's participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.[1800]

Special rules

A foundation manager's reliance on advice of legal counsel generally means that the manager has not knowingly participated in an act of self-dealing. Under Treasury regulations, a

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[1794] Sec. 4961.

[1795] Treas. Reg. sec. 53.4941(a)-1(b)(3).

[1796] Sec. 7454(b).

[1797] Treas. Reg. sec. 53.4941(a)-1(b)(3).

[1798] *Ibid.*

[1799] Treas. Reg. sec. 53.4941(a)-1(b)(4).

[1800] Treas. Reg. sec. 53.4941(a)-1(b)(5).

foundation manager's participation in a transaction ordinarily is not considered knowing, even though the transaction subsequently is held to be an act of self-dealing, to the extent that, after full disclosure of the factual situation to legal counsel (including in-house counsel), the manager relies on a reasoned written legal opinion that an act is not an act of self-dealing. A written opinion is considered as reasoned even though it reaches a conclusion that is subsequently determined to be incorrect so long as the opinion addresses itself to the facts and the applicable law. A written opinion is not considered to be reasoned if it does nothing more than recite the facts and express a conclusion. The absence of advice of counsel with respect to a transaction does not, by itself, give rise to any inference that a foundation manager participated in the transaction knowingly.[1801]

Description of Proposal

Entity level tax on private foundations

Under the proposal, if an initial tax is imposed on a disqualified person under the self-dealing rules[1802] the organization is subject to an excise tax equal to 2.5 percent (10 percent in the case of a payment of compensation) of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period.

Eliminate special rule for knowing behavior by foundation managers

The proposal eliminates the special rule that provides that a foundation manager's participation ordinarily is not "knowing" for purposes of the self-dealing excise taxes if the manager relied on advice of counsel. Although the proposal eliminates the special rule, whether a foundation manager relies on advice of counsel is a relevant consideration in determining whether the manager knowingly participated in an act of self-dealing.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

3. Excise tax on failure to distribute within five years a contribution to a donor advised fund (sec. 5203 of the discussion draft and new sec. 4968 of the Code)

Present Law

Overview

Some charitable organizations (including community foundations) establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Such accounts are

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[1801] Treas. Reg. sec. 53.4941(a)-1(b)(6).

[1802] Sec. 4941(a)(1).

commonly referred to as "donor advised funds." Donors who make contributions to charities for maintenance in a donor advised fund generally claim a charitable contribution deduction at the time of the contribution.[1803] Although sponsoring charities frequently permit donors (or other persons appointed by donors) to provide nonbinding recommendations concerning the distribution or investment of assets in a donor advised fund, sponsoring charities generally must have legal ownership and control of such assets following the contribution. If the sponsoring charity does not have such control (or permits a donor to exercise control over amounts contributed), the donor's contributions may not qualify for a charitable deduction, and, in the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor.

Statutory definition of a donor advised fund

The Code defines a "donor advised fund" as a fund or account that is: (1) separately identified by reference to contributions of a donor or donors; (2) owned and controlled by a sponsoring organization; and (3) with respect to which a donor (or any person appointed or designated by such donor (a "donor advisor")) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the separately identified fund or account by reason of the donor's status as a donor. All three prongs of the definition must be met in order for a fund or account to be treated as a donor advised fund.[1804]

A "sponsoring organization" is an organization that: (1) is described in section 170(c)[1805] (other than a governmental entity described in section 170(c)(1), and without regard to any

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[1803] Contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income tax purposes if the sponsoring organization is a veterans' organization described in section 170(c)(3), a fraternal society described in section 170(c)(4), or a cemetery company described in section 170(c)(5); for gift tax purposes if the sponsoring organization is a fraternal society described in section 2522(a)(3) or a veterans' organization described in section 2522(a)(4); or for estate tax purposes if the sponsoring organization is a fraternal society described in section 2055(a)(3) or a veterans' organization described in section 2055(a)(4). In addition, contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income, gift, or estate tax purposes if the sponsoring organization is a Type III supporting organization (other than a functionally integrated Type III supporting organization). In addition to satisfying generally applicable substantiation requirements under section 170(f), a donor must obtain, with respect to each charitable contribution to a sponsoring organization to be maintained in a donor advised fund, a contemporaneous written acknowledgment from the sponsoring organization providing that the sponsoring organization has exclusive legal control over the assets contributed.

[1804] See sec. 4966(d)(2)(A). A donor advised fund does not include a fund or account that makes distributions only to a single identified organization or governmental entity. A donor advised fund also does not include certain funds or accounts with respect to which a donor or donor advisor provides advice as to which individuals receive grants for travel, study, or other similar purposes. In addition, the Secretary may exempt a fund or account from treatment as a donor advised fund if such fund or account is advised by a committee not directly or indirectly controlled by a donor, donor advisor, or persons related to a donor or donor advisor. The Secretary also may exempt a fund or account from treatment as a donor advised fund if such fund or account benefits a single identified charitable purpose. Secs. 4966(d)(2)(B) and (C).

[1805] Section 170(c) describes organizations to which charitable contributions that are deductible for income tax purposes can be made.

requirement that the organization be organized in the United States[1806]); (2) is not a private foundation (as defined in section 509(a)); and (3) maintains one or more donor advised funds.[1807]

Excess business holdings

The excess business holdings rules of section 4943 are applied to donor advised funds.[1808] In applying such rules, the term disqualified person means, with respect to a donor advised fund, a donor, donor advisor, a member of the family of a donor or donor advisor, or a 35 percent controlled entity of any such person.[1809]

Excess benefit transactions, taxable distributions, and more than incidental benefit

Excess benefit transactions

Under section 4958, an excise tax is imposed in the event of an excess benefit transaction between a disqualified person (generally, an organization insider) and an applicable tax-exempt organization. An excess benefit transaction generally is a transaction in which an economic benefit is provided by an organization to or for the use of a disqualified person if the value of the economic benefit provided exceeds the value of consideration received in exchange for the benefit.[1810] Applicable tax-exempt organizations include section 501(c)(3) public charities and organizations described in section 501(c)(4) (generally, social welfare organizations) or 501(c)(29) (qualified nonprofit health insurance issuers).[1811]

Section 4958 includes special excess benefit transaction rules for donor advised funds. Any grant, loan, compensation, or other similar payment from a donor advised fund to a person that with respect to such fund is a donor, donor advisor, or a person related[1812] to a donor or donor advisor automatically is treated as an excess benefit transaction under section 4958, with the entire amount paid to any such person treated as the amount of the excess benefit.[1813] Any amount repaid as a result of correcting an excess benefit transaction shall not be held in any donor advised fund.

[1806] See sec. 170(c)(2)(A).

[1807] Sec. 4966(d)(1).

[1808] Sec. 4943(e).

[1809] Sec. 4943(e)(2).

[1810] Sec. 4958(c).

[1811] Sec. 4958(e).

[1812] For this purpose, a person is treated as related to another person if such person bears a relationship to such other person similar to the relationships described in sections 4958(f)(1)(B) and 4958(f)(1)(C).

[1813] Sec. 4958(c)(2).

In general, donors and donor advisors with respect to a donor advised fund (as well as persons related to a donor or donor advisor) are treated as disqualified persons under section 4958 with respect to transactions with such donor advised fund (though not necessarily with respect to transactions with the sponsoring organization more generally).[1814] An investment advisor (as well as persons related to the investment advisor) also is treated as a disqualified person under section 4958 with respect to the sponsoring organization.[1815] The term "investment advisor" means, with respect to any sponsoring organization, any person (other than an employee of the sponsoring organization) who is compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds (including pools of assets all or part of which are attributed to donor advised funds) owned by the sponsoring organization.[1816]

Taxable distributions

Certain distributions from a donor advised fund are subject to tax.[1817] A "taxable distribution" is any distribution from a donor advised fund to: (1) any natural person; or (2) to any other person for any purpose other than one specified in section 170(c)(2)(B) (generally, a charitable purpose) or, if for a charitable purpose, the sponsoring organization does not exercise expenditure responsibility with respect to the distribution in accordance with section 4945(h).[1818] The expenditure responsibility rules generally require that an organization exert all reasonable efforts and establish adequate procedures to see that the distribution is spent solely for the purposes for which it was made, to obtain full and complete reports from the distributee on how the funds are spent, and to make full and detailed reports with respect to such expenditures to the Secretary. A taxable distribution does not in any case include a distribution to (1) an organization described in section 170(b)(1)(A) (other than to a disqualified supporting organization); (2) the sponsoring organization of such donor advised fund; or (3) to another donor advised fund.[1819]

In the event of a taxable distribution, an excise tax equal to 20 percent of the amount of the distribution is imposed against the sponsoring organization. In addition, an excise tax equal to five percent of the amount of the distribution is imposed against any manager of the sponsoring organization (defined in a manner similar to the term "foundation manager" under section 4945) who knowingly approved the distribution, not to exceed $10,000 with respect to

[1814] Sec. 4958(f)(1)(E).

[1815] Sec. 4958(f)(1)(F).

[1816] Sec. 4958(f)(8).

[1817] Sec. 4966.

[1818] Sec. 4966(c)(1).

[1819] Sec. 4966(c)(2).

any one taxable distribution. The taxes on taxable distributions are subject to abatement under generally applicable rules.[1820]

More than incidental benefit

If a donor, a donor advisor, or a person related to a donor or donor advisor of a donor advised fund provides advice as to a distribution that results in any such person receiving, directly or indirectly, a more than incidental benefit, an excise tax equal to 125 percent of the amount of such benefit is imposed against the person who advised as to the distribution, and against the recipient of the benefit. Persons subject to the tax are jointly and severally liable for the tax. In addition, if a manager of the sponsoring organization (defined in a manner similar to the term "foundation manager" under section 4945) agreed to the making of the distribution, knowing that the distribution would confer a more than incidental benefit on a donor, a donor advisor, or a person related to a donor or donor advisor, the manager is subject to an excise tax equal to 10 percent of the amount of such benefit, not to exceed $10,000. The taxes on more than incidental benefit are subject to abatement under generally applicable rules.[1821]

Reporting and disclosure

Each sponsoring organization must disclose on its information return: (1) the total number of donor advised funds it owns; (2) the aggregate value of assets held in those funds at the end of the organization's taxable year; and (3) the aggregate contributions to and grants made from those funds during the year.[1822] In addition, when seeking recognition of its tax-exempt status, a sponsoring organization must disclose whether it intends to maintain donor advised funds.[1823]

Description of Proposal

The proposal generally requires that contributions to donor advised funds be distributed for charitable purposes within a specified time period and imposes an excise tax in the event of a failure to make timely distributions. Specifically, in the case of a contribution that is held in a donor advised fund, the proposal imposes a tax equal to 20 percent of so much of the contribution as has not been distributed by the sponsoring organization in an eligible distribution before the beginning of the sixth (or any succeeding) taxable year beginning after the taxable year during which such contribution is made.[1824]

[1820] Secs. 4966(a) and (b).

[1821] See generally sec. 4967.

[1822] Sec. 6033(k).

[1823] Sec. 508(f).

[1824] For example, if such a contribution remains undistributed as of the beginning of the seventh taxable year following the year in which the contributions is made, a tax will be imposed for both the sixth and seventh taxable years following the contribution year.

An eligible distribution is a distribution to an organization described in section 170(b)(1)(A) (generally, to a public charity), other than a supporting organization described in section 509(a)(3) or another donor advised fund described in section 4966(d)(2). Distributions are treated as made from contributions (and any earnings attributable thereto) on a first-in, first-out basis.

The tax imposed by the proposal must be paid by the sponsoring organization.

Effective Date

The proposal generally is effective for contributions made after December 31, 2014. In the case of a contribution made before January 1, 2015, any portion of which (including any earnings attributable thereto) is held in a donor advised fund as of such date, such portion is treated as having been contributed on such date.

4. Simplification of excise tax on private foundation investment income (sec. 5204 of the discussion draft and sec. 4940 of the Code)

Present Law

Excise tax on the net investment income of private foundations

Under section 4940(a), private foundations that are recognized as exempt from Federal income tax under section 501(a) (other than exempt operating foundations) are subject to a two-percent excise tax on their net investment income. Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[1825] equal or exceed the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.[1826] In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements in section 4942.

Private foundations that are not exempt from tax under section 501(a), such as certain charitable trusts, are subject to an excise tax under section 4940(b). The tax is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the tax on unrelated business income that would

[1825] Sec. 4942(g).

[1826] Sec. 4940(e).

have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

Private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.[1827]

Exempt operating foundations

Exempt operating foundations are exempt from the tax on the net investment income of private foundations.[1828] Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation (as defined in section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons.[1829]

Description of Proposal

The proposal replaces the two rates of excise tax on tax-exempt private foundations with a single rate of tax of one percent. Thus, under the proposal, a tax-exempt private foundation generally is subject to an excise tax of one percent on its net investment income. A taxable private foundation is subject to an excise tax equal to the excess (if any) of the sum of the one-percent net investment income excise tax and the amount of the tax on unrelated business income (both calculated as if the foundation were tax-exempt), over the income tax imposed on the foundation. The proposal repeals the special reduced excise tax rate for private foundations that exceed their historical level of qualifying distributions.

The proposal also repeals the exception for exempt operating foundations from the tax on the net investment income of private foundations.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

[1827] Sec. 4942(d)(2).

[1828] Sec. 4940(d)(1).

[1829] Sec. 4940(d)(2).

5. Repeal of exception for private operating foundation failure to distribute income (sec. 5205 of the discussion draft and sec. 4942 of the Code)

Present Law

Public charities and private foundations

An organization qualifying for tax-exempt status under section 501(c)(3) is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.[1830] Certain organizations are classified as public charities *per se*, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations, certain organizations providing assistance to colleges and universities, and governmental units.[1831] Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.[1832] Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public *plus* revenue arising from activities related to its exempt purposes (*e.g.*, fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.[1833] A supporting organization, *i.e.*, an organization that provides support to another section 501(c)(3) entity that is not a private foundation and meets certain other requirements of the Code, also is classified as a public charity.[1834]

[1830] The Code does not expressly define the term "public charity," but rather provides exceptions to those entities that are treated as private foundations.

[1831] Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

[1832] Treas. Reg. sec. 1.170A-9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a "facts and circumstances" test. Treas. Reg. sec. 1.170A-9(f)(3).

[1833] To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization's exempt purposes. Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

[1834] Sec. 509(a)(3). Supporting organizations are further classified as Type I, II, or III depending on the relationship they have with the organizations they support. Supporting organizations must support public charities listed in one of the other categories (*i.e.*, *per se* public charities, broadly supported public charities, or revenue generating public charities), and they are not permitted to support other supporting organizations or testing for public safety organizations.

A section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (*e.g.*, an individual, a family, or a corporation).

The deduction for charitable contributions to private foundations is in some instances less generous than the deduction for charitable contributions to public charities. In addition, private foundations are subject to a number of operational rules and restrictions that do not apply to public charities.[1835]

Tax on failure to distribute income by private nonoperating foundations

Private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions.[1836] In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[1837] Failure to pay out the minimum required amount results in an initial excise tax on the foundation of 30 percent of the undistributed amount. An additional tax of 100 percent of the undistributed amount applies if an initial tax is imposed and the required distributions have not been made by the end of the applicable taxable period.[1838] A foundation may include as a qualifying distribution the salaries, occupancy expenses, travel costs, and other reasonable and necessary administrative expenses that the foundation incurs in operating a grant program. A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set aside for exempt purposes.[1839]

Organizations organized and operated exclusively for testing for public safety also are classified as public charities. Sec. 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under section 170.

[1835] Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases). Sec. 4940. Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are prohibited from engaging in self-dealing transactions (sec. 4941), are required to make a minimum amount of charitable distributions each year, (sec. 4942), are limited in the extent to which they may control a business (sec. 4943), may not make speculative investments (sec. 4944), and may not make certain expenditures (sec. 4945). Violations of these rules result in excise taxes on the foundation and, in some cases, may result in excise taxes on the managers of the foundation.

[1836] Sec. 4942.

[1837] Sec. 4942(g)(1)(A).

[1838] Sec. 4942(a) and (b). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[1839] Sec. 4942(g)(1)(B) and 4942(g)(2). In general, an organization is permitted to adjust the distributable amount in those cases where distributions during the five preceding years have exceeded the payout requirements. Sec. 4942(i).

Private operating foundations

The tax on failure to distribute income does not apply to the undistributed income of a private foundation for any taxable year for which it is an operating foundation.[1840] Private operating foundations generally operate their own charitable programs directly, rather than serving primarily as a grantmaking entity.

Private operating foundations must satisfy several tests designed to distinguish them from nonoperating (grantmaking) foundations. First, an operating foundation generally must make qualifying distributions for the direct conduct of activities that are related to its exempt purpose (as opposed to making such distributions in the form of grants to other charities) equal to 85 percent of the lesser of its adjusted net income or its minimum investment return, each as defined under section 4942.[1841] In addition, an operating foundation must satisfy one of the following three alternative tests: (1) an asset test, under which substantially more than half of the organization's assets (generally, 65 percent) are devoted to the direct conduct of exempt activities or to functionally related businesses; (2) an endowment test, under which the organization normally makes qualifying distributions for the direct conduct of activities related to its exempt purpose in an amount not less than two-thirds of its minimum investment return; or (3) a support test, under which the organization must meet certain measures to show that it receives public support.[1842]

Description of Proposal

The proposal repeals the exception for private operating foundations from the excise tax on a private foundation's failure to distribute income under section 4942, thereby extending the excise tax to private operating foundations.[1843]

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

[1840] Sec. 4942(a)(1).

[1841] Sec. 4942(j)(3)(A); Treas. Reg. sec. 53.4942(b)-1(c).

[1842] Sec. 4942(j)(3)(B).

[1843] The proposal does not modify the rules for deducting charitable contributions to private operating foundations. As a conforming amendment to the Code, the proposal moves the definition of an operating foundation from section 4942 to section 170(b)(1).

6. Excise tax based on investment income of private colleges and universities (sec. 5206 of the discussion draft and new sec. 4969 of the Code)

Present Law

Public charities and private foundations

An organization qualifying for tax-exempt status under section 501(c)(3) is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.[1844] Certain organizations are classified as public charities *per se*, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations, certain organizations providing assistance to colleges and universities, and governmental units.[1845] Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.[1846] Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public *plus* revenue arising from activities related to its exempt purposes (*e.g.*, fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.[1847] A supporting organization, *i.e.*, an organization that provides support to another section 501(c)(3) entity that is not a private foundation and meets the requirements of the Code, also is classified as a public charity.[1848]

[1844] The Code does not expressly define the term "public charity," but rather provides exceptions to those entities that are treated as private foundations.

[1845] Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

[1846] Treas. Reg. sec. 1.170A-9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a "facts and circumstances" test. Treas. Reg. sec. 1.170A-9(f)(3).

[1847] To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization's exempt purposes. Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

[1848] Sec. 509(a)(3). Supporting organizations are further classified as Type I, II, or III depending on the relationship they have with the organizations they support. Supporting organizations must support public charities listed in one of the other categories (*i.e.*, *per se* public charities, broadly supported public charities, or revenue generating public charities), and they are not permitted to support other supporting organizations or testing for public safety organizations.

Organizations organized and operated exclusively for testing for public safety also are classified as public charities. Sec. 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under section 170.

A section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (*e.g.*, an individual, a family, or a corporation).

The deduction for charitable contributions to private foundations is in some instances less generous than the deduction for charitable contributions to public charities. In addition, private foundations are subject to a number of operational rules and restrictions that do not apply to public charities.[1849]

Excise tax on investment income of private foundations

Under section 4940(a), private foundations that are recognized as exempt from Federal income tax under section 501(a) (other than exempt operating foundations)[1850] are subject to a two-percent excise tax on their net investment income. Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[1851] equal or exceed the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.[1852] In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements in section 4942.[1853]

[1849] Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases). Sec. 4940. Private foundations also are subject to more restrictions on their activities than are pnblic charities. For example, private foundations are prohibited from engaging in self-dealing transactions (sec. 4941), are required to make a minimum amount of charitable distributions each year, (sec. 4942), are limited in the extent to which they may control a business (sec. 4943), may not make speculative investments (sec. 4944), and may not make certain expenditures (sec. 4945). Violations of these rules resnlt in excise taxes on the foundation and, in some cases, may result in excise taxes on the managers of the foundation.

[1850] Exempt operating foundations are exempt from the section 4940 tax. Sec. 4940(d)(1). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation (as defined in section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons. Sec. 4940(d)(2).

[1851] Sec. 4942(g).

[1852] Sec. 4940(e).

[1853] Under a separate proposal, the private foundation excise tax would be simplified by replacing the two-tier rate structure with a single-rate tax set at one percent.

Private foundations that are not exempt from tax under section 501(a), such as certain charitable trusts, are subject to an excise tax under section 4940(b). The tax is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the tax on unrelated business income that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

Private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.[1854]

Private colleges and universities

Private colleges and universities generally are treated as public charities rather than private foundations[1855] and thus are not subject to the private foundation excise tax on net investment income.

Description of Proposal

The proposal imposes an excise tax on an applicable educational institution for each taxable year equal to one percent of the net investment income of the institution for the taxable year. Net investment income is determined using rules similar to the rules of section 4940(c) (relating to the net investment income of a private foundation).

For purposes of the proposal, an applicable educational institution is an institution: (1) that is an eligible education institution as described in section 25A of the Code (as amended by a separate proposal)[1856]; (2) that is not described in the first section of section 511(a)(2)(B) of the Code (generally describing State colleges and universities); and (3) the aggregate fair market value of the assets of which at the end of the preceding taxable year (other than those assets which are used, or held for use, directly in carrying out the institution's exempt purpose) is at least $100,000 per student. For this purpose, 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.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

[1854] Sec. 4942(d)(2).

[1855] Secs. 509(a)(1) and 170(b)(1)(A)(ii).

[1856] Section 25A, as amended by a separate proposal, defines an eligible educational institution as an institution (1) which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. sec. 1088), as in effect on August 5, 1977, and (2) which is eligible to participate in a program under title IV of such Act.

D. Requirements for Organizations Exempt From Tax

1. Repeal of tax-exempt status for professional sports leagues (sec. 5301 of the discussion draft and sec. 501(c)(6) of the Code)

Present Law

Tax exemption for section 501(c)(6) organizations

Section 501(c)(6) provides tax exempt status for business leagues and certain other organizations not organized for profit, no part of the net earnings of which inures to the benefit of any private shareholder or individual. A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit.[1857] Such an organization may not have as its primary activity performing "particular services" for members.[1858] Contributions to these types of organizations are not deductible as charitable contributions; however, they may be deductible as trade or business expenses if ordinary and necessary in the conduct of the taxpayer's business. Many organizations known as "trade associations" may qualify for exempt status under this provision.

Professional sports leagues

Since 1966, section 501(c)(6) has included language exempting from tax "professional football leagues (whether or not administering a pension fund for football players)." The Internal Revenue Service has interpreted this language as applying not only to professional football leagues, but to all professional sports leagues.[1859]

Description of Proposal

The proposal strikes from section 501(c)(6) the phrase "professional football leagues (whether or not administering a pension fund for football players)." In addition, the proposal amends section 501(c)(6) to provide affirmatively that section 501(c)(6) "shall not apply to any professional sports league (whether or not administering a pension fund for players)."

[1857] Treas. Reg. sec. 1.501(c)(6)-1.

[1858] Treas. Reg. sec. 1.501(c)(6)-1.

[1859] See General Counsel Memorandum 38179, November 29, 1979 ("We continue to believe that professional sports leagues, including football leagues, do not qualify for exemption if the ordinary standards of section 501(c)(6) are applied. However, while the answer is far from clear, we have concluded upon reflection that the specific exemption of football leagues in 1966 can be viewed as providing support for recognition of exemption of all professional sports leagues as a unique category of organizations under section 501(c)(6). Since other professional sports leagues are indistinguishable in any meaningful way from football leagues, we think it is fair to conclude that by formally blessing the exemption it knew football leagues had historically enjoyed, Congress implicitly recognized a unique historical category of exemption under section 501(c)(6). The specific enumeration of football leagues can be viewed as merely exemplary of the category thus recognized, and as necessitated only by the problem of insuring that football's pension and merger arrangement would not endanger its exemption").

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

2. Repeal of exemption from tax for certain insurance companies and CO-OP health insurance issuers (sec. 5302 of the discussion draft and sec. 501 of the Code)

Present Law

Section 501(c)(15) exempts from tax: (1) stock property and casualty insurance companies with gross receipts that do not exceed $600,000, more than 50 percent of which consist of premiums; and (2) mutual property and casualty insurance companies with gross receipts that do not exceed $150,000, more than 35 percent of which consist of premiums.

Qualified nonprofit health insurance issuers (within the meaning of section 1322 of the Patient Protection and Affordable Care Act) that have received a loan or grant under the CO-OP program under such section are exempt from tax under section 501(c)(29) of the Code.

Description of Proposal

The provision strikes sections 501(c)(15) and 501(c)(29). Organizations in existence prior to the effective date are provided transition relief as follows. Organizations are given a fresh start with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. No adjustment is made under section 481 on account of an accounting method change. The basis of assets of such organizations is equal, for purposes of determining gain or loss, to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after the effective date.

Effective Date

The provision applies to taxable years beginning after December 31, 2014.

3. In-State requirement for certain tax-exempt workmen's compensation insurance organizations (sec. 5303 of the discussion draft and sec. 501(c)(27) of the Code)

Present Law

Workers' compensation reinsurance organizations

Section 501(c)(27)(A) provides tax-exempt status to any membership organization that is established by a State before June 1, 1996, exclusively to reimburse its members for workers' compensation insurance losses, and that satisfies certain other conditions. A State must require that the membership of the organization consist of all persons who issue insurance covering workers' compensation losses in such State, and all persons and governmental entities who self-insure against such losses. In addition, the organization must operate as a nonprofit organization by returning surplus income to members or to workers' compensation policyholders on a periodic basis and by reducing initial premiums in anticipation of investment income.

State workmen's compensation act companies

Section 501(c)(27)(B) provides tax-exempt status for any organization that is created by State law, and organized and operated exclusively to provide workmen's compensation insurance and related coverage that is incidental to workmen's compensation insurance, and that meets certain additional requirements. The workmen's compensation insurance must be required by State law, or be insurance with respect to which State law provides significant disincentives if it is not purchased by an employer (such as loss of exclusive remedy or forfeiture of affirmative defenses such as contributory negligence). The organization must provide workmen's compensation to any employer in the State (for employees in the State or temporarily assigned out-of-State) seeking such insurance and meeting other reasonable requirements. The State must either extend its full faith and credit to the initial debt of the organization or provide the initial operating capital of such organization. For this purpose, the initial operating capital can be provided by providing the proceeds of bonds issued by a State authority; the bonds may be repaid through exercise of the State's taxing authority, for example. For periods after the date of enactment (August 5, 1997), either the assets of the organization must revert to the State upon dissolution, or State law must not permit the dissolution of the organization absent an act of the State legislature. Should dissolution of the organization become permissible under applicable State law, then the requirement that the assets of the organization revert to the State upon dissolution applies. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

Description of Proposal

The proposal amends section 501(c)(27)(B) to limit tax-exempt status under that subparagraph to organizations that offer no insurance other than workmen's compensation insurance offered to any employer in the State (for employees in the State or temporarily assigned out-of-State).

Effective Date

The proposal is effective for policies issued, and renewals, after December 31, 2014.

4. Repeal of Type II and Type III supporting organizations (sec. 5304 of the discussion draft and sec. 509(a)(3) of the Code)

Present Law

Requirements for section 501(c)(3) tax-exempt status

Charitable organizations, *i.e.*, organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.[1860] In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) its net earnings may not inure to the benefit of any person in a position to influence the activities of the organization; (2) it must operate to provide a public benefit, not a private benefit;[1861] (3) it may not be operated primarily to conduct an unrelated trade or business;[1862] (4) it may not engage in substantial legislative lobbying; and (5) it may not participate or intervene in any political campaign.

Classification of section 501(c)(3) organizations

In general

Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[1863] Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (*i.e.*, churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (*e.g.*, an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.[1864] Public charities also have certain advantages over private foundations regarding the deductibility of contributions.

[1860] Treas. Reg. sec. 1.501(c)(3)-1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

[1861] Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

[1862] Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

[1863] Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

[1864] Secs. 4940 - 4945.

Supporting organizations (section 509(a)(3))

The Code provides that certain "supporting organizations" (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.[1865] To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more "publicly supported organizations"[1866] (the "organizational and operational tests");[1867] (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the "relationship test");[1868] and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the "lack of outside control test").[1869]

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as "Type I" supporting organizations); (2) supervised or controlled in connection with a publicly supported organization ("Type II" supporting organizations); or (3) operated in connection with a publicly supported organization ("Type III" supporting organizations).[1870]

Type I supporting organizations

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.[1871] The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by

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[1865] Sec. 509(a)(3).

[1866] In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

[1867] Sec. 509(a)(3)(A).

[1868] Sec. 509(a)(3)(B).

[1869] Sec. 509(a)(3)(C).

[1870] Treas. Reg. sec. 1.509(a)-4(f)(2).

[1871] Treas. Reg. sec. 1.509(a)-4(g)(1)(i).

the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.[1872]

Type II supporting organizations

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.[1873] An organization generally is not considered to be "supervised or controlled in connection with" a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.[1874]

Type III supporting organizations

Type III supporting organizations are "operated in connection with" one or more publicly supported organizations. To satisfy the "operated in connection with" relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization satisfies a notification requirement, a "responsiveness test," and an "integral part test."[1875] An organization is not operated in connection with one or more supported organizations if it supports any supported organization organized outside of the United States.[1876]

To satisfy the notification requirement for a taxable year, a Type III supporting organization must provide the following documents to each of its supported organizations: (1) a written notice to a principal officer of the supported organization describing the type and amount of all support the supporting organization provided during the supporting organization's preceding taxable year; (2) a copy of the supporting organization's most recently filed Form 990 (or other annual information return); and (3) a copy of the supporting organization's current governing documents, unless such documents have been previously provided and not

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[1872] *Ibid.*

[1873] Treas. Reg. sec. 1.509(a)- 4(h)(1).

[1874] Treas. Reg. sec. 1.509(a)-4(h)(2).

[1875] Treas. Reg. sec. 1.509(a)-4(i)(1).

[1876] Treas. Reg. sec. 1.509(a)-4(i)(10).

subsequently amended.[1877] The notification documents for a taxable year must be provided by the last day of the fifth calendar month following the close of the taxable year.[1878]

In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations.[1879] A supporting organization generally satisfies the test by demonstrating that: (1)(a) one or more of its officers, directors, or trustees are elected or appointed by the officers, directors, trustees, or membership of the supported organization; (b) one or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of, or hold other important offices in, the supporting organization; or (c) the officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the publicly supported organizations;[1880] and (2) by reason of such arrangement, the officers, directors, or trustees of the supported organization have a significant voice in the investment policies of the supporting organization, the timing and manner of making grants, the selection of grant recipients by the supporting organization, and otherwise directing the use of the income or assets of the supporting organization.[1881]

For purposes of the integral part test, Type III supporting organizations are further classified as "functionally integrated" or "non-functionally integrated."

Functionally integrated Type III supporting organizations.–To satisfy the integral part test as a functionally integrated Type III supporting organization, an organization must establish that: (1)(a) substantially all of its activities directly further the exempt purposes of one or more supported organizations by performing the functions of, or carrying out the purposes of, such organizations; and (b) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves;[1882] (2) it is the parent of each of its supported organizations;[1883] or (3) it supports a governmental organization.[1884]

[1877] Treas. Reg. sec. 1.509(a)-4(i)(2)(i).

[1878] Treas. Reg. sec. 1.509(a)-4(i)(2)(iii).

[1879] Treas. Reg. sec. 1.509(a)-4(i)(3)(i).

[1880] Treas. Reg. sec. 1.509(a)-4(i)(3)(ii).

[1881] Treas. Reg. sec. 1.509(a)-4(i)(3)(iii). For an organization that was supporting or benefiting one or more publicly supported organizations before November 20, 1970, additional facts and circumstances, such as an historic and continuing relationship between organizations, also may be taken into consideration to establish compliance with either of the responsiveness tests. Treas. Reg. sec. 1.509(a)-4(i)(3)(v).

[1882] Treas. Reg. secs. 1.509(a)-4(i)(4)(i)(A) & -4(i)(4)(ii).

[1883] Treas. Reg. secs. 1.509(a)-4(i)(4)(i)(B) & -4(i)(4)(iii).

[1884] Treas. Reg. sec. 1.509(a)-4(i)(4)(i)(C). Regulations describing this means of satisfying the integral support test have been reserved. Treas. Reg. sec. 1.509(a)-4(i)(4)(iv).

Non-functionally integrated Type III supporting organizations.–To satisfy the integral part test as a non-functionally integrated Type III supporting organization, an organization generally must satisfy a distribution requirement and an attentiveness requirement.[1885] An organization satisfies the distribution requirement for a taxable year if it distributes to or for the use of one or more supported organizations an amount equal to or greater than the supporting organization's distributable amount for the taxable year.[1886] The distributable amount generally is the greater of 85 percent of the supporting organization's adjusted net income or 3.5 percent of the organization's non-exempt use assets for the immediately preceding tax year.[1887] An organization satisfies the attentiveness requirement if: (1) it distributes to its supported organization at least 10 percent of the supported organization's total support; (2) the amount of support received from the supporting organization is necessary to avoid the interruption of the carrying on of a particular function or activity of the supported organization; or (3) based on facts and circumstances, the amount of support received from the supporting organization is a sufficient part of a supported organization's total support to ensure attentiveness.[1888]

Description of Proposal

The proposal limits supporting organization status to organizations that are operated, supervised, or controlled by one or more publicly supported organizations (present law Type I supporting organizations). An organization may no longer satisfy the relationship test by being supervised or controlled in connection with one or more publicly supported organizations (Type II supporting organizations) or by being operated in connection with one or more publicly supported organizations (Type III supporting organizations).

Effective Date

The proposal generally is effective on the date of enactment. For Type II and Type III supporting organizations recognized as of the date of enactment as exempt from tax under section 501(a) as an organization described in section 501(c)(3), the proposal is effective for taxable years beginning after December 31, 2015.

[1885] Treas. Reg. sec. 1.509(a)-4(i)(5)(i)(A). Special rules exist for certain pre-November 20, 1970 trusts. See Treas. Reg. secs. 1.509(a)-4(i)(5)(i)(B) & -4(i)(9).

[1886] Treas. Reg. sec. 1.509(a)-4(i)(5)(ii).

[1887] Treas. Reg. secs. 1.509(a)-4T(i)(5)(ii)(B) & (C).

[1888] Treas. Reg. sec. 1.509(a)-4(i)(5)(iii)(B).

TITLE VI – TAX ADMINISTRATION AND COMPLIANCE

A. IRS Investigation-Related Reforms

1. Require section 501(c)(4) organizations to provide notice of formation (sec. 6001 of the discussion draft and new sec. 506 of the Code)

Present Law

Section 501(c)(4) organizations

Section 501(c)(4) provides tax exemption for civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, and no part of the net earnings of which inures to the benefit of any private shareholder or individual. An organization is operated exclusively for the promotion of social welfare if it is engaged primarily in promoting in some way the common good and general welfare of the people of a community.[1889] The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office; however, social welfare organizations are permitted to engage in political activity so long as the organization remains engaged primarily in activities that promote social welfare. The lobbying activities of a social welfare organization generally are not limited. An organization is not operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations that are operated for profit.

Application for tax exemption

Section 501(c)(3) organizations

Section 501(c)(3) organizations (with certain exceptions) are required to seek formal recognition of tax-exempt status by filing an application with the IRS (Form 1023).[1890] In response to the application, the IRS issues a determination letter or ruling either recognizing the applicant as tax-exempt or not. Certain organizations are not required to apply for recognition of tax-exempt status in order to qualify as tax-exempt under section 501(c)(3) but may do so. These organizations include churches, certain church-related organizations, organizations (other than private foundations) the gross receipts of which in each taxable year are normally not more than $5,000, and organizations (other than private foundations) subordinate to another tax-exempt organization that are covered by a group exemption letter.

A favorable determination by the IRS on an application for recognition of tax-exempt status will be retroactive to the date that the section 501(c)(3) organization was created if it files

[1889] Treas. Reg. sec. 1.501(c)(4)-1(a)(2).

[1890] See sec. 508(a).

a completed Form 1023 within 15 months of the end of the month in which it was formed.[1891] If the organization does not file Form 1023 or files a late application, it will not be treated as tax-exempt under section 501(c)(3) for any period prior to the filing of an application for recognition of tax exemption.[1892] Contributions to section 501(c)(3) organizations that are subject to the requirement that the organization apply for recognition of tax-exempt status generally are not deductible from income, gift, or estate tax until the organization receives a determination letter from the IRS.[1893]

Information required on Form 1023 includes, but is not limited to: (1) a detailed statement of actual and proposed activities; (2) compensation and financial information regarding officers, directors, trustees, employees, and independent contractors; (3) a statement of revenues and expenses for the current year and the three preceding years (or for the years of the organization's existence, if less than four years); (4) a balance sheet for the current year; (5) a description of anticipated receipts and contemplated expenditures; (6) a copy of the articles of incorporation, trust document, or other organizational or enabling document; (7) organization bylaws (if any); and (8) information about previously filed Federal income tax and exempt organization returns, if applicable.

A favorable determination letter issued by the IRS will state that the application for recognition of tax exemption and supporting documents establish that the organization submitting the application meets the requirements of section 501(c)(3) and will classify (as either an adverse or definitive ruling) the organization as either a public charity or a private foundation.

Organizations that are classified as public charities (or as private operating foundations) and not as private nonoperating foundations may cease to satisfy the conditions that entitled the organization to such status. The IRS makes an initial determination of public charity or private foundation status (either a definitive ruling, or an advance ruling generally effective for five years and then reviewed again by the IRS) that is subsequently monitored by the IRS through annual return filings. The IRS periodically announces in the Internal Revenue Bulletin a list of organizations that have failed to establish, or have been unable to maintain, their status as public charities or as private operating foundations, and that become private nonoperating foundations.

If the IRS denies an organization's application for recognition of exemption under section 501(c)(3), the organization may seek a declaratory judgment regarding its tax status.[1894] Prior to

[1891] Pursuant to Treas. Reg. sec. 301.9100-2(a)(2)(iv), organizations are allowed an automatic 12-month extension as long as the application for recognition of tax exemption is filed within the extended, *i.e.*, 27-month, period. The IRS also may grant an extension beyond the 27-month period if the organization is able to establish that it acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. Treas. Reg. secs. 301.9100-1 and 301.9100-3.

[1892] Treas. Reg. sec. 1.508-1(a)(1).

[1893] Sec. 508(d)(2)(B). Contributions made prior to receipt of a favorable determination letter may be deductible prior to the organization's receipt of such favorable determination letter if the organization has timely filed its application to be recognized as tax-exempt. Treas. Reg. secs. 1.508-1(a) and 1.508-2(b)(1)(i)(b).

[1894] Sec. 7428.

utilizing the declaratory judgment procedure, the organization must have exhausted all administrative remedies available to it within the IRS.

Other section 501(c) organizations

Most section 501(c) organizations – including organizations described within sections 501(c)(4) (social welfare organizations, etc.), 501(c)(5) (labor organizations, etc.), or 501(c)(6) (business leagues, etc.) – are not required to provide notice to the Secretary that they are requesting recognition of exempt status. Rather, organizations are exempt under these provisions if they satisfy the requirements applicable to such organizations. However, in order to obtain certain benefits such as public recognition of tax-exempt status, exemption from certain State taxes, and nonprofit mailing privileges, such organizations voluntarily may request a formal recognition of exempt status by filing a Form 1024.

If such an organization voluntarily requests a determination letter by filing Form 1024 within 27 months of the end of the month in which it was formed, its determination of exempt status, once provided, generally will be effective as of the organization's date of formation.[1895] If, however, the organization files Form 1024 after the 27-month deadline has passed, its exempt status will be formally recognized only as of the date the organization filed Form 1024.

The declaratory judgment process available to organizations seeking exemption under section 501(c)(3) is not available to organizations seeking exemption under other subsections of the Code, including sections 501(c)(4), 501(c)(5), and 501(c)(6).

Revocation (and suspension) of exempt status

An organization that has received a favorable tax-exemption determination from the IRS generally may continue to rely on the determination as long as "there are no substantial changes in the organization's character, purposes, or methods of operation."[1896] A ruling or determination letter concluding that an organization is exempt from tax may, however, be revoked or modified: (1) by notice from the IRS to the organization to which the ruling or determination letter was originally issued; (2) by enactment of legislation or ratification of a tax treaty; (3) by a decision of the United States Supreme Court; (4) by issuance of temporary or final Regulations by the Treasury Department; (5) by issuance of a revenue ruling, a revenue procedure, or other statement in the Internal Revenue Bulletin; or (6) automatically, in the event the organization fails to file a required annual return or notice for three consecutive years.[1897] A revocation or modification of a determination letter or ruling may be retroactive if, for example, there has been a change in the applicable law, the organization omitted or misstated a material

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[1895] Rev. Proc. 2013-9, 2013-2 I.R.B. 255. Prior to the issuance of Revenue Procedure 2013-9 in early 2013, an organization that filed an application for exemption on Form 2014 generally could obtain a determination that it was exempt as of its date of formation, regardless of when it filed Form 1024.

[1896] Treas. Reg. sec. 1.501(a)-1(a)(2).

[1897] Rev. Proc. 2013-9, 2013-2 I.R.B. 255.

fact, or the organization has operated in a manner materially different from that originally represented.[1898]

The IRS generally issues a letter revoking recognition of an organization's tax-exempt status only after: (1) conducting an examination of the organization; (2) issuing a letter to the organization proposing revocation; and (3) allowing the organization to exhaust the administrative appeal rights that follow the issuance of the proposed revocation letter. In the case of a section 501(c)(3) organization, the revocation letter immediately is subject to judicial review under the declaratory judgment procedures of section 7428. To sustain a revocation of tax-exempt status under section 7428, the IRS must demonstrate that the organization no longer is entitled to exemption.

Upon revocation of tax-exemption or change in the classification of an organization (*e.g.*, from public charity to private foundation status), the IRS publishes an announcement of such revocation or change in the Internal Revenue Bulletin. Contributions made to organizations by donors who are unaware of the revocation or change in status ordinarily will be deductible if made on or before the date of publication of the announcement.

The IRS may suspend the tax-exempt status of an organization for any period during which an organization is designated or identified by U.S. authorities as a terrorist organization or supporter of terrorism.[1899] Such an organization also is ineligible to apply for tax exemption. The period of suspension runs from the date the organization is first designated or identified to the date when all designations or identifications with respect to the organization have been rescinded pursuant to the law or Executive Order under which the designation or identification was made. During the period of suspension, no deduction is allowed for any contribution to a terrorist organization.

<u>Description of Proposal</u>

Under the proposal, an organization described in section 501(c)(4) must provide to the Secretary notice of its formation and intent to operate as such an organization, in such manner as the Secretary may prescribe. The notice, together with a reasonable user fee in an amount to be established by the Secretary, must be provided no later than 60 days following the organization's establishment and must include the following information: (1) the name, address, and taxpayer identification number of the organization; (2) the date on which, and the State under the laws of which, the organization was organized; and (3) a statement of the purpose of the organization. The Secretary may extend the 60-day deadline for reasonable cause. Within 60 days of receipt of a notice of an organization's formation and intent to operate as an organization described in section 501(c)(4), the Secretary shall issue to the organization an acknowledgment of the notice. The notice and receipt are subject to the disclosure requirements of section 6104.

[1898] *Ibid.*

[1899] Sec. 501(p) (enacted by Pub. L. No. 108-121, sec. 108(a), effective for designations made before, on, or after November 11, 2003).

The proposal amends section 6652(c) (which provides for penalties in the event of certain failures to file an exempt organization return or disclosure) to impose penalties for failure to file the notice required under the proposal. An organization that fails to file a notice within 60 days of its formation (or, if an extension is granted for reasonable cause, by the deadline established by the Secretary) is subject to a penalty equal to $20 for each day during which the failure occurs, up to a maximum of $5,000. In the event such a penalty is imposed, the Secretary may make a written demand on the organization specifying a date by which the notice must be provided. If any person fails to comply with such a demand on or before the date specified in the demand, a penalty of $20 is imposed for each day the failure continues, up to a maximum of $5,000.

With its first annual information return (Form 990, Form 990-EZ, or Form 990-N) filed after providing the notice described above, a section 501(c)(4) organization must provide such information as the Secretary may require, and in the form prescribed by the Secretary, to support its qualification as an organization described in section 501(c)(4). The Secretary is not required to issue a determination letter following the organization's filing of the expanded first annual information return.

A section 501(c)(4) organization that desires additional certainty regarding its qualification as an organization described in section 501(c)(4) may file a request for a determination, together with the required user fee, with the Secretary. Such a request is in addition to, not in lieu of, filing the required notice described above. It is intended that such a request for a determination be submitted on a new form (separate from Form 1024, which may continue to be used by certain other organizations) that clearly states that filing such a request is optional. The request for a determination is treated as an application subject to public inspection and disclosure under sections 6104(a) and (d).

Effective Date

The proposal generally is effective for organizations organized after December 31, 2014.

Organizations organized prior to January 1, 2015, that have not filed an application for exemption (Form 1024) or annual information return on or before the date of enactment must provide the notice required under the provision within 180 days of the date of enactment.

2. Declaratory judgment procedure for organizations exempt from tax under section 501(c)(4) (sec. 6002 of the discussion draft and sec. 7428 of the Code)

Present Law

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it must file an application for recognition of exemption with the IRS and receive a favorable determination of its status.[1900] For most section 501(c)(3) organizations, eligibility to receive tax-deductible contributions similarly is dependent upon its receipt of a

[1900] Sec. 508(a).

favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases where an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS generally may revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

Present law authorizes an organization to seek a declaratory judgment regarding its tax-exempt status as a remedy if the IRS denies its application for recognition of exemption under section 501(c)(3), fails to act on such an application, or informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status.[1901] The right to seek a declaratory judgment arises in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes; (2) the initial classification or continuing classification of an organization as a private foundation; (3) the initial classification or continuing classification of an organization as a private operating foundation; or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3).[1902] A "determination" in this context generally means a final decision by the IRS affecting the tax qualification of a charitable organization. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.[1903]

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS.[1904] For the first 270 days after a request for a determination is made and before the IRS informs the organization of its decision, an organization is deemed not to have exhausted its administrative remedies. If no determination is made during the 270-day period, the organization may initiate an action for declaratory judgment after the period has elapsed. If, however, the IRS makes an adverse determination during the 270-day period, an organization may immediately seek declaratory relief. The 270-day period does not begin with respect to applications for recognition of tax-exempt status until the date a substantially completed application is submitted.

Under present law, a non-charity (*i.e.*, an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. In general, such an organization must petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or pay any tax owed and file a refund action in Federal district court or the U.S. Court of Federal Claims.

[1901] Sec. 7428.

[1902] Sec. 7428(a)(1).

[1903] Sec. 7428(a)(2).

[1904] Sec. 7428(b)(2).

Description of Proposal

The proposal extends the section 7428 declaratory judgment procedure to the initial determination or continuing classification of an organization as tax-exempt under section 501(a) as an organization described in section 501(c)(4) (*i.e.*, social welfare and certain other organizations).

Effective Date

The proposal is effective for pleadings filed after the date of enactment.

3. Modify reporting requirements for contributions to social welfare organizations (sec. 6003 of the discussion draft and sec. 6033 of the Code)

Present Law

In general, organizations exempt from taxation under section 501(a) – including social welfare and other organizations exempt under section 501(c)(4) – are required to file an annual return (Form 990 series), stating specifically the items of gross income, receipts, disbursements, and such other information as the Secretary may prescribe.[1905] An organization that is required to file an information return, but that has gross receipts of less than $200,000 during its taxable year, and total assets of less than $500,000 at the end of its taxable year, may file Form 990-EZ. Section 501(c)(3) private foundations are required to file Form 990-PF rather than Form 990. An organization that has not received a determination of its tax-exempt status, but that claims tax-exempt status under section 501(a), is subject to the same annual reporting requirements and exceptions as organizations that have received a tax-exemption determination.

On the applicable annual information return, organizations are required to report their gross income, information on their finances, functional expenses, compensation, activities, and other information required by the IRS in order to review the organization's activities and operations during the previous taxable year and to review whether the organization continues to meet the statutory requirements for exemption. Examples of the information required by Form 990 include: (1) a statement of program accomplishments; (2) a description of the relationship of the organization's activities to the accomplishment of the organization's exempt purposes; (3) a description of payments to individuals, including compensation to officers and directors, highly paid employees and contractors, grants, and certain insider transactions and loans; and (4) disclosure of certain activities, such as expenses of conferences and conventions, political expenditures, compliance with public inspection requirements, and lobbying activities.

Form 990-PF requires, among other things, reporting of: the foundation's gross income for the year; expenses attributable to such income; disbursements for exempt purposes; total contributions and gifts received and the names of all substantial contributors; names, addresses, and compensation of officers and directors; an itemized statement of securities and other assets held at the close of the year; an itemized statement of all grants made or approved; and

[1905] Sec. 6033(a).

information about whether the organization has complied with the restrictions applicable to private foundations (secs. 4941 through 4945).

An organization that files Form 990, Form 990-EZ, or Form 990-PF and receives during the year $5,000 or more (in money or property) from any one contributor generally must report such contributions on Schedule B ("Schedule of Contributors").[1906] The Schedule B is open to public inspection for an organization that files Form 990-PF (private foundations) or a section 527 political organization that files Form 990 or Form 990-EZ. For all other Form 990 and Form 990-EZ filers, the names and addresses of contributors are not required to be made available for public inspection. All other information, including the amount of contributions, the description of noncash contributions, and any other information, is required to be made available for public inspection unless it clearly identifies the contributor. As a matter of practice, the IRS does not include schedule B on the CD sets or any other form of media made available to the public. Instead, on a case-by-case basis, when an individual makes a request for a specific organization's Schedule B, the IRS reviews and redacts the schedule in an effort to avoid divulging information that would identify any contributor.

The requirement that an exempt organization file an annual information return (Form 990 or Form 990-EZ) does not apply to certain exempt organizations, including organizations (other than private foundations) the gross receipts of which in each taxable year normally are not more than $50,000. Pursuant to the Pension Protection Act of 2006, organizations that are excused from filing an information return by reason of normally having gross receipts below such amount must furnish to the Secretary an annual notice (Form 990-N), in electronic form, containing certain basic information about the organization.[1907]

Other organizations exempt from the annual information return requirement include: churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; certain State institutions whose income is excluded from gross income under section 115; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; and certain other organizations, including some that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.[1908]

Description of Proposal

The proposal limits the contributor information that must be reported by an organization described in section 501(c)(4) on its annual information return. In the case of such an organization, information relating to a contribution or gift may only be required to be submitted

[1906] Certain section 501(c)(3) organizations that meet a 33-1/2 percent public support test of the regulations under sections 509(a)(1) and 170(b)(1)(A)(vi) generally must report contributions totaling $5,000 or more from a single contributor only to the extent such contributions exceed two percent of the organization's total contributions. Additional special reporting rules apply to organizations described in sections 501(c)(7), (8), or (10).

[1907] Sec. 6033(i).

[1908] Sec. 6033(a)(2)(A); Treas. Reg. secs. 1.6033-2(a)(2)(i) and (g)(1).

on the organization's annual information return to the extent the contribution or gift is in excess of $5,000 and is made by an officer or director of the organization (or a person having powers or responsibilities similar to those of an officer or director) or by a covered employee. For this purpose, covered employee means a person who was (1) one of the five highest compensated employees of the organization for the taxable year, or (2) was a covered employee of the organization (or any predecessor organization) for any preceding taxable year beginning after December 31, 2013.

Effective Date

The proposal is effective for returns for taxable years beginning after December 31, 2013.

4. Mandatory e-filing by exempt organizations (sec. 6004 of the discussion draft and sec. 6033 of the Code)

Present Law

In general

The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998")[1909] states a Congressional policy to promote the paperless filing of Federal tax returns. Section 2001(a) of RRA 1998 set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007.[1910] Section 2001(b) of RRA 1998 requires the IRS to establish a 10-year strategic plan to eliminate barriers to electronic filing.

Present law requires the Secretary to issue regulations regarding electronic filing and specifies certain limitations on the rules that may be included in such regulations.[1911] The statute requires that Federal income tax returns prepared by specified tax return preparers be filed electronically,[1912] and that all partnerships with more than 100 partners be required to file electronically. For taxpayers other than partnerships, the statute prohibits any requirement that persons who file fewer than 250 returns during a calendar year file electronically. With respect to individuals, estates, and trusts, the Secretary may permit, but generally cannot require, electronic filing of income tax returns. In crafting any of these required regulations, the Secretary must take into account the ability of taxpayers to comply at reasonable cost.

1909 Pub. L. No. 105-206.

1910 The Electronic Tax Administration Advisory Committee, the body charged with oversight of IRS progress in reaching that goal reported that e-filing by individuals exceeded 80 percent in the 2013 filing season, but projected an overall rate of 72.8 percent based on all Federal returns. See Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, June 2013, IRS Pub. 3415, page 6.

1911 Sec. 6011(e).

1912 Section 6011(e)(3)(B) defines a "specified tax return preparer" as any return preparer who reasonably expects to file more than 10 individual income tax returns during a calendar year.

The regulations require corporations that have assets of $10 million or more and file at least 250 returns during a calendar year to file electronically their Form 1120/1120S income tax returns and Form 990 information returns for tax years ending on or after December 31, 2006. In determining whether the 250 return threshold is met, income tax, information, excise tax, and employment tax returns filed within one calendar year are counted.

Tax-exempt organizations

Most tax-exempt organizations are required to file annual information returns in the Form 990 series. Since 2007, the smallest organizations – generally, those with gross receipts of less than $50,000 – may provide an abbreviated notice on Form 990-N, sometimes referred to as an "e-postcard." Which form to file depends on the annual receipts, value of assets, and types of activities of the exempt entity. The Forms 990, 990-EZ, and 990-PF are released to the public on DVDs.

In general, only the largest and smallest tax-exempt organizations are required to electronically file their annual information returns. First, as indicated above, tax-exempt corporations that have assets of $10 million or more and that file at least 250 returns during a calendar year must electronically file their Form 990 information returns. Private foundations and charitable trusts, regardless of asset size, that file at least 250 returns during a calendar year are required to file electronically their Form 990-PF information returns.[1913] Finally, organizations that file Form 990-N (the e-postcard) also must electronically file.[1914]

Description of Proposal

The proposal extends the requirement to e-file to all tax-exempt organizations required to file statements or returns in the Form 990 series. The proposal also requires that the IRS make the information provided on the forms available to the public in a machine-readable format as soon as practicable. It is intended that the information be provided to the public in a format that permits one to extract and perform computations on the data but not alter or manipulate the statements or returns from which the data is to be extracted.

Effective Date

The proposal generally is effective for taxable years beginning after date of enactment. Transition relief is provided for certain organizations. First, for certain small organizations or other organizations for which the Secretary determines that application of the e-filing requirement would constitute an undue hardship in the absence of additional transitional time, the requirement to file electronically must be implemented not later than taxable years beginning two years following the date of enactment. For this purpose, small organization means any

[1913] Taxpayers can request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden on the taxpayer.

[1914] See Form 990-N, "Electronic Notice for Tax-exempt Organizations not Required to File a Form 990 or 990-EZ."

organization: (1) the gross receipts of which for the taxable year are less than $200,000; and (2) the aggregate gross assets of which at the end of the taxable year are less than $500,000. In addition, the proposal grants IRS the discretion to delay the effective date not later than taxable years beginning two years after the date of enactment for the filing of form 990-T (reports of unrelated business taxable income or the payment of proxy tax under section 6033(e)).

5. Duty to ensure that IRS employees are familiar with and act in accordance with certain taxpayer rights (sec. 6005 of the discussion draft and sec. 7803 of the Code)

Present Law

The Code provides that the Commissioner has such duties and powers as prescribed by the Secretary. Unless otherwise specified by the Secretary, such duties and powers include the power to administer, manage, conduct, direct, and supervise the execution and application of the internal revenue laws or related statutes and tax conventions to which the United States is a party, and to recommend to the President a candidate for Chief Counsel (and recommend the removal of the Chief Counsel). If the Secretary determines not to delegate such specified duties to the Commissioner, such determination will not take effect until 30 days after the Secretary notifies the House Committees on Ways and Means, Government Reform and Oversight, and Appropriations, and the Senate Committees on Finance, Governmental Affairs, and Appropriations. The Commissioner is to consult with the Oversight Board on all matters within the Board's authority (other than the recommendation of candidates for Commissioner and the recommendation to remove the Commissioner).

Unless otherwise specified by the Secretary, the Commissioner is authorized to employ such persons as the Commissioner deems proper for the administration and enforcement of the internal revenue laws and is required to issue all necessary directions, instructions, orders, and rules applicable to such persons. Unless otherwise provided by the Secretary, the Commissioner will determine and designate the posts of duty.

Description of Proposal

The proposal adds to the Commissioner's duties the requirement to ensure that employees of the IRS are familiar with and act in accord with taxpayer rights as afforded by other provisions of the Internal Revenue Code, including (i) the right to be informed, (ii) the right to be assisted, (iii) the right to be heard, (iv) the right to pay not more than the correct amount of tax, (v) the right to appeal, (vi) the right to certainty, (vii) the right to privacy, (viii) the right to confidentiality, (ix) the right to representation, and (x) the right to a fair and just tax system.

Effective Date

The proposal is effective on the date of enactment.

6. Termination of employment of Internal Revenue Service employees for taking official actions for political purposes (sec. 6006 of the discussion draft)

Present Law

The IRS Restructuring and Reform Act of 1998 (the "Act")[1915] requires the IRS to terminate an employee for certain proven violations committed by the employee in connection with the performance of official duties. The violations include: (1) willful failure to obtain the required approval signatures on documents authorizing the seizure of a taxpayer's home, personal belongings, or business assets; (2) providing a false statement under oath material to a matter involving a taxpayer; (3) with respect to a taxpayer, taxpayer representative, or other IRS employee, the violation of any right under the U.S. Constitution, or any civil right established under titles VI or VII of the Civil Rights Act of 1964, title IX of the Educational Amendments of 1972, the Age Discrimination in Employment Act of 1967, the Age Discrimination Act of 1975, sections 501 or 504 of the Rehabilitation Act of 1973 and title I of the Americans with Disabilities Act of 1990; (4) falsifying or destroying documents to conceal mistakes made by any employee with respect to a matter involving a taxpayer or a taxpayer representative; (5) assault or battery on a taxpayer or other IRS employee, but only if there is a criminal conviction or a final judgment by a court in a civil case, with respect to the assault or battery; (6) violations of the Internal Revenue Code, Treasury Regulations, or policies of the IRS (including the Internal Revenue Manual) for the purpose of retaliating or harassing a taxpayer or other IRS employee; (7) willful misuse of section 6103 for the purpose of concealing data from a Congressional inquiry; (8) willful failure to file any tax return required under the Code on or before the due date (including extensions) unless failure is due to reasonable cause; (9) willful understatement of Federal tax liability, unless such understatement is due to reasonable cause; and (10) threatening to audit a taxpayer for the purpose of extracting personal gain or benefit.

The Act provides non-delegable authority to the Commissioner to determine that mitigating factors exist, that, in the Commissioner's sole discretion, mitigate against terminating the employee. The Act also provides that the Commissioner, in his sole discretion, may establish a procedure to determine whether an individual should be referred for such a determination by the Commissioner. The Treasury Inspector General ("IG") is required to track employee terminations and terminations that would have occurred had the Commissioner not determined that there were mitigation factors and include such information in the IG's annual report.

Description of Proposal

The proposal expands the scope of the violation concerning an IRS employee threatening to audit a taxpayer for the purpose of extracting personal gain or benefit. The proposal requires the IRS to terminate an employee for performing, delaying, or failing to perform (or threatening to perform, delay, or fail to perform) any official action (including any audit) with respect to a taxpayer for purpose of extracting personal gain or benefit or for a political purpose.

[1915] Pub. L. No. 105-206, sec. 1203(b), July 22, 1998.

Effective Date

The proposal is effective on the date of enactment.

7. Release of information regarding the status of certain investigations (sec. 6007 of the discussion draft and sec. 6103 of the Code)

Present Law

Section 6103: Rules and penalties associated with the disclosure of confidential returns and return information

Generally, tax returns and return information ("tax information") are confidential and may not be disclosed unless authorized in the Code.[1916] Return information includes data received, collected or prepared by the Secretary with respect to the determination of the existence or possible existence of liability of any person under the Code for any tax, penalty, interest, fine, forfeiture, or other imposition or offense. Criminal penalties apply for the unauthorized inspection or disclosure of tax information. Willful unauthorized disclosure is a felony under section 7213 and the willful unauthorized inspection of tax information is a misdemeanor under section 7213A. Taxpayers may also pursue a civil cause of action for disclosures and inspections not authorized by section 6103.[1917]

Section 6103 provides exceptions to the general rule of confidentiality, detailing permissible disclosures. Among those exceptions are disclosures to specified persons with a "material interest" in the return or return information. The Secretary may withhold return information which the Secretary determines will seriously impair tax administration.[1918]

Under section 6103(c), the IRS may disclose a taxpayer's return or return information to such person or persons as the taxpayer may designate in a request for or consent to such disclosure. There are no restrictions placed on the recipient of tax information received pursuant to the consent of the taxpayer, and the safeguard and recordkeeping procedures, as well as penalties for unauthorized disclosure or inspection do not apply to persons receiving tax information pursuant to a taxpayer's consent.

Section 7214: Other offenses by officers and employees of the United States

Section 7214 concerns offenses by officers and employees of the United States. It provides, upon conviction, for the dismissal from office, a $10,000 fine and/or five years imprisonment of any officer or employee:

(1) who is guilty of any extortion or willful oppression under color of law; or

[1916] Sec. 6103(a).

[1917] Sec. 7431.

[1918] Sec. 6103(e)(7).

(2) who knowingly demands other or greater sums than are authorized by law, or receives any fee, compensation, or reward, except as by law prescribed, for the performance of any duty; or

(3) who with intent to defeat the application of any provision of this title fails to perform any of the duties of his office or employment; or

(4) who conspires or colludes with any other person to defraud the United States; or

(5) who knowingly makes opportunity for any person to defraud the United States; or

(6) who does or omits to do any act with intent to enable any other person to defraud the United States; or

(7) who makes or signs any fraudulent entry in any book, or makes or signs any fraudulent certificate, return, or statement; or

(8) who, having knowledge or information of the violation of any revenue law by any person, or of fraud committed by any person against the United States under any revenue law, fails to report, in writing, such knowledge or information to the Secretary; or

(9) who demands, or accepts, or attempts to collect, directly or indirectly as payment or gift, or otherwise, any sum of money or other thing of value for the compromise, adjustment, or settlement of any charge or complaint for any violation or alleged violation of law, except as expressly authorized by law so to do.

In the discretion of the court, up to one-half of the amount of fine for a section 7214 violation may be awarded for the use of the informer. In addition, the court is to render judgment against said officer or employee for the amount of damages sustained in favor of the party injured.

Section 7214 also provides that any internal revenue officer or employee interested, directly or indirectly, in the manufacture of tobacco, snuff, cigarettes, or in the production, rectification or redistillation of distilled spirits is to be dismissed from office and each such officer or employee so interested in any such manufacture or production, rectification, or redistillation of fermented liquors is to be fined not more than $5,000.

Description of Proposal

In the case of an investigation involving the return or return information of an individual alleging a violation of sections 7213, 7213A or 7214, the Secretary may disclose to the complainant (or such person's designee) whether an investigation, based on the person's provision of information indicating a violation of sections 7213, 7213A or 7214 of the Code, has been intiated, is open or is closed. The Secretary may disclose whether the investigation substantiated a violation of sections 7213, 7213A or 7214 of the Code, and whether action has been taken with respect to the individual who committed the substantiated violation. The proposal does not permit the Secretary to describe what action was taken with respect to the individual, other than whether any referral has been made for criminal prosecution.

Effective Date

The proposal is effective on the date of enactment.

8. Review of Internal Revenue Service examination selection procedures (sec. 6008 of the discussion draft)

Present Law

In general, the IRS independently determines how enforcement cases are selected and processed.

Description of Proposal

The proposal requires the Comptroller General of the United States to study each IRS operating division to assess the process used for determining how enforcement cases are selected and processed. The study is required to include a review of: (i) the standards each operating division has established for enforcement case selection and case work (and handling of referrals and complaints), and whether such standards meet the objectives of impartiality, objectivity, and tax law compliance and reduce taxpayer burden (herein, the "IRS objectives"); (ii) the extent to which any cases are initiated by referrals or complaints from inside or outside of the operating division; (iii) the IRS controls for assuring that its standards for enforcement cases in each operating division are sufficient for achieving the IRS objectives; (iv) the IRS controls for assuring that is standards are adhered to by all division personnel and the effectiveness of such controls; and (v) whether the existing standards and controls provide reasonable assurance that each division's enforcement processes meet the IRS objectives.

The proposal requires the Comptroller General to submit to Congress and the Secretary of the Treasury a report on the study results and his recommendations within one year after the date of enactment.

The proposal also requires the Comptroller General to conduct follow-up studies and provide reports on each operating division every four years reviewing whether any previous recommendations have been implemented and are working as intended.

Effective Date

The proposal is effective on the date of enactment.

9. Prohibition of use of personal email for official government business (sec. 6009 of the discussion draft.)

Present and Prior Law

Federal executive agencies are required to maintain and preserve Federal records,[1919] whether in paper or electronic form, and protect against unauthorized removal of such records. Record retention and disposal policies must conform to the requirements of the record management procedures, as implemented by the Archivist of the United States.[1920] Email accounts are specifically included within the scope of records subject to the record retention policies.[1921] Each agency is required to provide instruction and guidance to persons conducting business on behalf of the agency, including employees, officers and contractors, and use of personal email accounts for agency business is to be discouraged.[1922]

The government-wide records management requirements are in addition to the obligations to protect the sensitive information for which the IRS is responsible. Tax information is sensitive and confidential.[1923] The Code imposes civil and criminal penalties to protect it from unauthorized use, inspection or disclosure.[1924] As a condition of receiving tax data, outside agencies must establish to the satisfaction of the IRS that they have adequate programs and security protocols in place to protect the data received.[1925] Personal email computer storage systems are not inspected by the IRS for security.

Given the sensitive and confidential nature of the information handled by the IRS and the need to be accountable for all agency records, the IRS has in place policies restricting the use of email accounts.[1926] Transmission of Federal tax information is only permitted outside the IRS in limited circumstances. In 2012, the IRS published a revised section of its manual in which it

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[1919] 44 U.S.C. sec. 3101. See 44 U.S.C. sec. 3301 for a definition of Federal records that generally includes all documentary materials that agencies receive or create in the conduct of official business and that may have evidentiary value with respect to official business, regardless of the physical form of the materials.

[1920] See generally Title 44, at chapter 29 (records management by the Archivist of the United States and the General Services Administration), chapter 31 (records management of Federal agencies) and chapter 33 (disposal of records).

[1921] 36 CFR sec. 1236.22(a).

[1922] A quarterly bulletin published by the National Archives and Records Administration provides guidance to executive agencies. See generally NARA Bulletin 2013-03, available at http://www.archives.gov/records-mgmt/bulletins/2013/2013-03.html.

[1923] Sec. 6103(a).

[1924] See secs. 7213 (criminal unauthorized disclosure), 7213A (criminal unauthorized inspection) and 7431 (civil remedy for uanauthorized inspection or disclosure).

[1925] Sec. 6103(p)(4).

[1926] I.R.M. paragraphs 1.10.3 *et seq.*, and 11.3.1.

updated its rules on e-records generally, and banned use of non-IRS/Treasury email for any governmental or official purpose.[1927]

Description of Proposal

Under the proposal, employees of the IRS are not permitted to use a personal email account for any official government business.

Effective Date

The proposal is effective on date of enactment.

10. Moratorium on IRS conferences (sec. 6010 of the discussion draft)

Present Law

The IRS has general authority to organize conferences to further its statutory functions.

Description of Proposal

The proposal prevents the IRS from holding any conference until the Treasury Inspector General for Tax Administration ("IG") submits a report to Congress certifying that the IRS has implemented all of the recommendations set out in such IG's report titled "Review of the August 2010 Small Business/Self-Employed Division's Conference in Anaheim, California," and describing such implementation.

Effective Date

The proposal is effective on the date of enactment.

11. Applicable standard for determining whether an organization is operated exclusively for the promotion of social welfare (sec. 6011 of the discussion draft)

Present Law

Section 501(c)(4) organizations, in general

Section 501(c)(4) provides a tax exemption for civic leagues or organizations not organized for profit, but operated exclusively for the promotion of social welfare, and no part of the net earnings of which inures to the benefit of any private shareholder or individual.[1928] Treasury regulations provide that an organization is operated exclusively for the promotion of social welfare if it is engaged primarily in promoting in some way the common good and general

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[1927] I.R.M. paragraph 10.8.1.4.6.3.1, "Privately Owned E-Mail Accounts." (May 3, 2012).

[1928] Sec. 501(c)(4).

welfare of the people of a community.[1929] An organization is not operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations that are operated for profit.[1930]

Political campaign activities of section 501(c)(4) organizations

Treasury regulations further provide that the promotion of social welfare does not include "direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office" (herein, "political campaign intervention").[1931] However, social welfare organizations are permitted to engage in political campaign intervention so long as the organization is primarily engaged in activities that promote social welfare.[1932]

Whether an activity constitutes political campaign intervention (and thus does not promote social welfare) depends on all the facts and circumstances of the particular case.[1933] The rules concerning political campaign intervention apply only to activities involving candidates for elective public office; the rules do not apply to activities involving officials who are selected or appointed, such as executive branch officials and judges.

Similar rules apply for determining whether other types of section 501(c) organizations have engaged in political campaign intervention, including charities (section 501(c)(3)), labor and horticultural organizations (section 501(c)(5)), and business leagues (section 501(c)(6)). However, while section 501(c)(4), (5), and (6) organizations may engage in some political campaign intervention without jeopardizing exempt status, section 501(c)(3) organizations are prohibited from engaging in any political campaign intervention.[1934]

The lobbying and advocacy activities of a section 501(c)(4) organization generally are not limited, provided the activities are in furtherance of the organization's exempt purpose.

[1929] Treas. Reg. secs. 1.501(c)(4)-1(a)(1) and (2)(i).

[1930] Treas. Reg. sec. 1.501(c)(4)-1(a)(2)(i).

[1931] Treas. Reg. sec. 1.501(c)(4)-1(a)(2)(ii).

[1932] See Rev. Rul. 81-95, 1981-1 C.B. 332.

[1933] See, *e.g.*, Rev. Rul. 2007-41, 2007 -25 I.R.B. 1421 (June 18, 2007) (analyzing 21 different factual scenarios involving section 501(c)(3) charitable organizations for political campaign intervention); Rev. Rul. 81-95, 1981-1 C.B. 332 (referencing section 501(c)(3) standards in determining whether activities of a section 501(c)(4) organization constitute political campaign intervention).

[1934] Sec. 501(c)(3).

Proposed regulations relating to the political campaign activities of section 501(c)(4) organizations

On November 29, 2013, the Department of the Treasury and the IRS published proposed regulations regarding the political campaign activities of section 501(c)(4) organizations.[1935] The proposed regulations seek to replace the present-law facts-and-circumstances test used in determining whether a section 501(c)(4) organization has engaged in political campaign intervention with an enumerated list of activities that constitute political campaign activities (and which therefore do not promote social welfare).[1936]

The proposed regulations replace the political campaign intervention reference in the existing section 501(c)(4) regulations (*i.e.*, "direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office") with a new defined term, "candidate-related political activity."[1937] Candidate-related political activity means: (1) communications that express a view on, whether for or against, the selection, nomination, election, or appointment of one or more clearly identified candidates (often referred to as express advocacy communications); (2) certain public communications (as defined) within 30 days of a primary election or 60 days of a general election that refer to one or more clearly identified candidates, or in the case of a general election one or more political parties; (3) communications the expenditures for which are reported to the Federal Election Commission; (4) contributions (including gifts, grants, subscriptions, loans, advances, or deposits) of money or anything of value to or the solicitation of contributions on behalf of a candidate, a section 527 political organization, or a section 501(c) organization that engages in candidate-related political activity; (5) conduct of a voter registration drive or "get-out-the-vote" drive; (6) distribution of any material prepared by or on behalf of a candidate or by a section 527 political organization; (7) preparation or distribution of a voter guide that refers to one or more clearly identified candidates, or in the case of a general election to one or more political parties; and (8) hosting or conducting a forum for candidates within 30 days of a primary election or 60 days of a general election.[1938]

For purposes of defining candidate-related political activity, the proposed regulations define the term "candidate" to mean "an individual who publicly offers himself, or is proposed by another, for selection, nomination, election, or appointment to any federal, state, or local public office or office in a political organization, or to be a Presidential or Vice-Presidential elector, whether or not such individual is ultimately selected, nominated, elected, or appointed,"

[1935] Notice of Proposed Rulemaking, *Guidance for Tax-Exempt Social Welfare Organizations on Candidate-Related Political Activities* REG-134417-13, 78 Fed. Reg. 71535 (November 29, 2013); incorporating Prop. Treas. Reg. secs. 1.501(c)(4)-1(a)(2)(ii), (a)(2)(iii), and (c).

[1936] Notice of Proposed Rulemaking, *Guidance for Tax-Exempt Social Welfare Organizations on Candidate-Related Political Activities* REG-134417-13, 78 Fed. Reg. 71535 (November 29, 2013), p. 71536.

[1937] Prop. Treas. Reg. secs. 1.501(c)(4)-1(a)(2)(ii) and (iii).

[1938] Prop. Treas. Reg. sec. 1.501(c)(4)-1(a)(2)(iii)(A).

including officeholders who are the subject of a recall election;[1939] this includes certain judicial and executive branch appointments.

The proposed regulations apply only to section 501(c)(4) organizations.[1940] Other section 501(c) organization (including section 501(c)(3) charitable organizations, section 501(c)(5) labor and horticultural organizations, and section 501(c)(6) business leagues) will continue to use present-law rules concerning political campaign intervention.

The proposed regulations are not immediately effective. They are proposed to be effective on the date they are published in the Federal Register as final regulations.[1941]

Description of Proposal

The proposal provides that the standards and definitions as in effect on January 1, 2010, which are used to determine whether an organization is operated exclusively for the promotion of social welfare for purposes of section 501(c)(4), shall apply for determining the tax-exempt status of organizations under section 501(c)(4).

The proposal also provides that neither the Secretary nor any delegate of the Secretary may issue, revise, or finalize any regulation (including the November 29, 2013 proposed regulations described above), revenue ruling, or other guidance that is not limited to a particular taxpayer relating to the standards or definitions used to determine whether an organization is operated exclusively for the promotion of social welfare for purposes of section 501(c)(4).

The proposal applies with respect to any organization claiming tax-exempt status as an organization described in section 501(c)(4) that was created on, before, or after the date of enactment.

The proposal sunsets such that it does not apply after the one-year period beginning on the date of enactment.

Effective Date

The proposal is effective on the date of enactment.

[1939] Prop. Treas. Reg. sec. 1.501(c)(4)-1(a)(2)(iii)(B)(1).

[1940] Notice of Proposed Rulemaking, *Guidance for Tax-Exempt Social Welfare Organizations on Candidate-Related Political Activities* REG-134417-13, 78 Fed. Reg. 71535 (November 29, 2013), p. 71537.

[1941] Prop. Treas. Reg. sec. 1.501(c)(4)-1(c). In the notice of proposed rulemaking, the IRS seeks comments on a number of issues, including: (1) whether the existing regulation that provides that an organization is operated exclusively for social welfare if it is engaged primarily in promoting in some way the common good and general welfare of the people of a community should be modified; and (2) whether the rules included in the proposed regulations should be extended to other section 501(c) organizations or to section 527 political organizations. Notice of Proposed Rulemaking, *Guidance for Tax-Exempt Social Welfare Organizations on Candidate-Related Political Activities* REG-134417-13, 78 Fed. Reg. 71535 (November 29, 2013), p. 71537.

B. Taxpayer Protection and Service Reforms

1. Extend Internal Revenue Service authority to require truncated social security numbers on Form W-2 (sec. 6101 of the discussion draft and sec. 6051 of the Code)

Present Law

Section 6051(a) of the Code generally requires that an employer provide a written statement to each employee on or before January 31st of the succeeding year showing the remuneration paid to that employee during the calendar year and other information including the employee's social security number ("SSN"). The Form W-2, Wage and Tax Statement, is used to provide this information to employees and contains the taxpayer's SSN, wages paid, taxes withheld, and other information.

Other statements provided to taxpayers, such as Forms 1099, generally issued to any individual or unincorporated business paid in excess of $600 per calendar year for services rendered, are subject to rules under section 6109 dealing with identifying numbers. Section 6109 requires that the filer provide the taxpayer's "identifying number" which is an individual's SSN except as otherwise specified in regulations. Accordingly, for some statements, the Treasury Department has the authority to require or permit filers to use a number other than a taxpayer's SSN.

Description of Proposal

The proposal provides the Treasury Department authority to require employers to include an "identifying number" for each employee, rather than an employee's SSN, on Form W-2. This change will permit the Treasury Department to promulgate regulations requiring or permitting a truncated SSN on Form W-2, as is currently provided under section 6109.

Effective Date

The proposal is effective on the date of enactment.

2. Free electronic filing (sec. 6102 of the discussion draft and sec. 6011 of the Code)

Present Law

The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998")[1942] states a Congressional policy to promote the paperless filing of Federal tax returns. Section 2001(a) of RRA 1998 set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007.[1943] Section 2001(b) of RRA 1998 requires the IRS to establish a 10-year strategic plan to eliminate barriers to electronic filing.

[1942] Pub. L. No. 105-206.

[1943] The Electronic Tax Administration Advisory Committee, the body charged with oversight of IRS progress in reaching that goal reported that e-filing by individuals exceeded 80 percent in the 2013 filing season, but

In October 2002, to help meet the 80 percent e-file target, the IRS partnered with the Free File Alliance, a group of tax preparation software manufactures, to create the Free File program which provides taxpayers with access to free online tax preparation and e-filing services. Taxpayers with adjusted gross income of $57,000 or less, regardless of filing status, are generally eligible to use the Free File program but participating software companies may establish other eligibility requirements and limit usage of their programs based on geographic location, military service, or other criteria.

Present law requires the Secretary to issue regulations regarding electronic filing and specifies certain limitations on the rules that may be included in such regulations.[1944] The statute requires that Federal income tax returns prepared by specified tax return preparers be filed electronically,[1945] and that all partnerships with more than 100 partners be required to file electronically. For taxpayers other than partnerships, the statute prohibits any requirement that persons who file fewer than 250 returns during a calendar year file electronically. With respect to individuals, estates, and trusts, the Secretary may permit, but generally cannot require, electronic filing of income tax returns. In crafting any of these required regulations, the Secretary must take into account the ability of taxpayers to comply at reasonable cost.

The regulations require corporations that have assets of $10 million or more and file at least 250 returns during a calendar year to file electronically their Form 1120/1120S income tax returns and Form 990 information returns for tax years ending on or after December 31, 2006. In determining whether the 250 return threshold is met, income tax, information, excise tax, and employment tax returns filed within one calendar year are counted.

Description of Proposal

The proposal requires the Secretary of the Treasury, in cooperation with the private sector, to maintain a program that provides free individual income tax preparation and electronic filing services to low-income taxpayers and elderly taxpayers. The proposal requires the Secretary to provide guidance detailing (i) the qualifications, selection process, and contract term for businesses participating in the program, (ii) a process for periodic review of businesses participating in the program, (iii) procedures for terminating business participation in the program for failure to comply with any program requirements, and (iv) such other procedures as the Secretary determines are necessary and appropriate to carry out the purposes of the program. The proposal provides that the IRS' current Free File program satisfies the requirements for a free filing program.

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projected an overall rate of 72.8 percent based on all Federal returns. See Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, June 2013, IRS Pub. 3415, p. 6.

[1944] Sec. 6011(e).

[1945] Section 6011(e)(3)(B) defines a "specified tax return preparer" as any return preparer who reasonably expects to file more than 10 individual income tax returns during a calendar year.

Effective Date

The proposal is effective on the date of enactment.

3. Pre-populated returns prohibited (sec. 6103 of the discussion draft)

Present Law

The Secretary does not generally compute taxes owed by taxpayers or prepare tax returns for taxpayers, except in two limited circumstances discussed below. The Secretary does not generally have the burden of proof to demonstrate that a third party information return is correct except in the limited circumstance discussed below.

In general, income taxes are due and payable at the time and place fixed for filing returns, even if the time for filing the return is extended.[1946] Individual taxpayers electing under the Code to have their taxes computed by the Secretary are not required to pay until thirty days after the IRS notifies them of the amount due and demands payment.[1947] This option is limited to persons with gross income of less than $10,000, derived entirely from services as an employee, dividends, and interest, whose income from sources other than wages (as defined for withholding purposes) does not exceed $100, and who do not itemize their deductions. This option also is not available to any individual who may be claimed as a depended on another taxpayer's return who is ineligible to claim a person exemption on his own return.

The Code permits the Secretary to prepare and receive a return that is signed by the taxpayer in circumstances where the taxpayer fails to make a return but consents to disclose information necessary for its preparation.[1948] When the Secretary prepares the return and the taxpayer signs it, that return is the taxpayer's return. In addition, if any taxpayer fails to make a required return or makes, willfully or otherwise, a false or fraudulent return, the Secretary is authorized to make a return from his or her own knowledge and from such information as can be obtained through testimony or otherwise.[1949] Any return made and subscribed by the Secretary shall be prima facie good and sufficient for all legal purposes. The execution of this return will not start the running of the period of limitations on assessment and collection without assessment.[1950]

The Code provides that if a taxpayer, in a court proceeding, asserts a reasonable dispute with respect to any item shown on an information return on which a proposed deficiency is based, and has fully cooperated with the Secretary with respect to the production of witnesses,

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[1946] Sec. 6151(a).

[1947] Sec. 6151(b)(1).

[1948] Sec. 6020(a).

[1949] Sec. 6020(b).

[1950] Sec. 6501(b)(3).

documents, and other information, then the Secretary shall have the burden of producing reasonable and probative evidence regarding the accuracy of the information return in dispute.[1951] For example, if the taxpayer disputes the income reported by a third party on its information return, and has fully cooperated with the Secretary as described, the burden to prove that the information return is correct then shifts to the Secretary. The taxpayer is not required to establish the correct amount due, but only the facts on the basis of which the court can redetermine the deficiency.

Description of Proposal

The proposal prohibits the Secretary of the Treasury from providing to any person a proposed final return or statement for use by such person to satisfy a filing or reporting requirement under the Code except to the extent provided in sections 6014, 6020, or 6201(d).

Effective Date

The proposal is effective on the date of enactment.

4. Simplified filing requirements for individuals over 65 years of age (sec. 6104 of the discussion draft and sec. 6011 of the Code)

Present Law

Persons required to make returns of income are generally required to file returns in the form prescribed by the Secretary in regulations.[1952] Income tax returns are required from each individual whose taxable year gross income equals or exceeds the exemption amount, with certain exceptions.[1953] The income tax returns are due on April 15 of the year following the taxable year, for taxpayers using a calendar year.

The standard form available for individuals subject to income tax are in the series of form known as Form 1040, and include two simplified versions, the Form 1040A and the Form 1040EZ. In recent filing seasons, the majority of returns filed by individuals were filed electronically.[1954]

[1951] Sec. 6201(d).

[1952] Sec. 6011.

[1953] See section 6012(a)(1)(A), which enumerates several conditions under which individuals with gross income in excess of the exemption amount in section 151(d) are nevertheless excused from the filing requirements.

[1954] The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998") states a Congressional policy to promote the paperless filing of Federal tax returns, and set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007. See sec. 2001(a) of RRA 1998. The Electronic Tax Administration Advisory Committee, the body charged with oversight of IRS progress in reaching that goal reported that e-filing by individuals exceeded 80 percent in the 2013 filing season, but projected an overall rate of 72.8 percent based on all Federal returns. See Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, June 2013, IRS Pub. 3415, p. 6.

Description of Proposal

The proposal requires that the IRS publish a simplified income tax return form designated a Form 1040SR, for use by persons who are age 65 or older by the close of the taxable year. The form is to be as similar as possible to the Form 1040EZ. The use of Form 1040SR is not to be restricted based on the amount of taxable income to be shown on the return, or the fact that the income to be reported for the taxable year includes social security benefits, distributions from qualified retirement plans, annuities or other such deferred payment arrangements, interest and dividends, or capital gains and losses taken into account in determining adjusted net capital gain.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

5. Increase refund and credit threshold for Joint Committee on Taxation review to $5 million for corporate taxpayers (sec. 6105 of the discussion draft and sec. 6405 of the Code)

Present and Prior Law

No refund or credit in excess of a specified dollar threshold of any income tax, estate or gift tax, or certain other specified taxes, may be made until 30 days after the date a report on the refund is provided to the Joint Committee on Taxation.[1955] A report is also required in the case of certain tentative refunds. Additionally, the staff of the Joint Committee on Taxation conducts post-audit reviews of large deficiency cases and other select issues. The specified dollar threshold for review is $2,000,000.

Description of Proposal

The proposal increases the threshold above which refunds must be submitted to the Joint Committee on Taxation for review from $2,000,000 to $5,000,000 in the case of an entity taxable as a corporation under subchapter C. The staff of the Joint Committee on Taxation continues to be authorized to conduct a program of expanded post-audit reviews of large deficiency cases and other select issues.

Effective Date

The proposal is effective on the date of enactment, except that the higher threshold does not apply to a refund or credit with respect to which a report was made before the date of enactment.

[1955] Sec. 6405.

C. Tax Return Due Date Simplification

Present Law

Persons required to file income tax returns[1956] must file such returns in the manner prescribed by the Secretary, in compliance with due dates established in the Code, if any, or by regulations. The Code includes a general rule that requires income tax returns to be filed on or before the 15th day of the fourth month following the end of the taxable year, but certain exceptions are provided both in the Code and in regulations.

A partnership generally is required to file a Federal income tax return on or before the 15th day of the fourth month after the end of the partnership taxable year.[1957] For a partnership with a taxable year that is a calendar year, for example, the partnership return due date (and the date by which Schedules K-1 must be furnished to partners) is April 15. However, a partnership is allowed an automatic five-month extension of time to file the partnership return and the Schedule K-1s (to September 15 in the foregoing example) by submitting an application on Form 7004 in accordance with the rules prescribed by the Treasury regulations.[1958]

A C corporation or an S corporation generally is required to file a Federal income tax return on or before the 15th day of the third month following the close of the corporation's taxable year. For a corporation with a taxable year that is a calendar year, for example, the corporate return due date is March 15.[1959] However, a corporation is allowed an automatic six-month extension of time to file the corporate return (to September 15 in the foregoing example) by submitting an application on Form 7004 in accordance with the rules prescribed by the Treasury regulations.[1960]

[1956] Section 6012 provides general rules identifying who must file an income tax return, while other Code provisions referenced herein specifically address filing requirements of partnerships, corporations, and other entities.

[1957] Secs. 6031, 6072.

[1958] Sec. 6081. Treas. Reg. sec. 1.6081-2. See Department of the Treasury, Internal Revenue Service, *2011 Instructions for Form 1065, U.S. Return of Partnership Income*, p. 3. Unlike other partnerships, an electing large partnership is required to furnish a Schedule K-1 to each partner by the first March 15 following the close of the partnership's taxable year (sec. 6031(b)). For calendar year 2012 partnerships, for example, the due date is March 15, 2013 even though the partnership return due date is April 15, 2013. However, an electing large partnership is allowed an automatic six-month extension of time to file the partnership return and the Schedule K-1s by submitting an application on form 7004 in accordance with the rules prescribed by the Treasury Regulations. Treas. Reg. sec. 1.6081-2(a)(2).

[1959] Secs. 6012, 6037, 6072. Section 6012(a)(2) provides that every corporation subject to taxation under subtitle A shall be required to file an income tax return. Section 6037, which governs the returns of S corporations, provides that any return filed pursuant to section 6037 shall, for purposes of chapter 66 (relating to limitations) be treated as a return filed by the corporation under section 6012. Section 6072, which sets forth the due dates for filing various income tax returns, provides that returns of corporations with a taxable year that is a calendar year under section 6012 (and section 6037 based on the language in that section) are due March 15.

[1960] Section 6081(b) provides that a corporation is allowed an automatic extension of three months to file its income tax return if the corporation files the form prescribed by the Secretary and pays on or before the due date

The annual returns required to be filed by various employee benefit plans are due on the last day of the seventh month following the close of the plan year, and may be extended up to the 15th day of the third month following the due date. For a calendar year plan, the original due date would be July 31, with a maximum extension until October 15.[1961]

U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign entities may be subject to self-reporting requirements under both Title 26 (the Internal Revenue Code) and Title 31 (the Bank Secrecy Act) of the United States Code. With respect to account holders, a U.S. citizen, resident, or person doing business in the United States is required to keep records and file reports, as specified by the Secretary, when that person enters into a transaction or maintains an account with a foreign financial agency.[1962] Regulations promulgated pursuant to broad regulatory authority granted to the Secretary in the Bank Secrecy Act[1963] provide additional guidance regarding the disclosure obligation with respect to foreign accounts. Treasury Department Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts," (the "FBAR") must be filed by June 30 of the year following the year in which the $10,000 filing threshold is met.[1964]

1. New due date for partnership form 1065, S corporation form 1120S and C corporation form 1120 (sec. 6201 of the discussion draft and sec. 6072 of the Code)

Description of Proposal

The proposal accelerates the due date for filing of Federal income tax returns of partnerships to conform to the due date for Federal income tax returns of S corporations, and removes C corporations from the scope of the exception to the general rule that requires income tax returns to be filed by the 15th day of the fourth month after the end of a taxable year.

Under the proposal, both partnership and S corporation returns must be filed on or before the 15th day of the third month following the close of the taxpayer's taxable year, or March 15 in the case of a calendar year taxpayer. The proposal requires that the C corporation return be filed

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prescribed for payment, the amount properly estimated as its tax. However, section 6081(a) provides that the Secretary may grant an automatic extension of up to six months to file and the Treasury regulations do so provide. Treas. Reg. sec. 1.6081-3.

[1961] Treas. Reg. sec. 1.6081-11 permits an automatic extension.

[1962] 31 U.S.C. sec. 5314. The term "agency" in the Bank Secrecy Act includes financial institutions.

[1963] 31 U.S.C. sec. 5314(a) ("Considering the need to avoid impeding or controlling the export or import of monetary instruments and the need to avoid burdening unreasonably a person making a transaction with a foreign financial agency, the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency.").

[1964] 31 C.F.R. sec. 103.27(c). The $10,000 threshold is the aggregate value of all foreign financial accounts in which a U.S. person has a financial interest or over which the U.S. person has signature or other authority.

on or before the 15th day of the fourth month after the close of a taxable year, or April 15 in the case of a calendar year taxpayer.

Effective Date

The proposal is generally effective for returns for taxable years beginning after December 31, 2014. The proposal is not effective for returns with respect to taxable years beginning in 2022 for C corporations that adopt a taxable year ending June 30.

2. Modification of due dates by regulation (sec. 6202 of the discussion draft)

Description of Proposal

The proposal requires that the Treasury Department modify its regulations that establish extensions of due dates by conforming the extension periods to the following terms. The maximum extension for the returns of partnerships using a calendar year is a six-month period ending on September 15. The maximum extension for the returns of trusts using a calendar year is a 5-1/2 month period ending on September 30. The maximum extension for the returns of employee benefit plans using a calendar year is an automatic 3-1/2 month period ending on November 15. The maximum extension for the returns of tax-exempt organizations using a calendar year is an automatic six-month period ending on November 15. The due date for forms relating to the Annual Information Return of Foreign Trust with a United States Owner for calendar year filers is April 15 with a maximum extension for a six-month period ending on October 15.

In addition to requiring modification of the regulatory deadlines established for extensions of time to file income tax returns, the proposal establishes a statutory due date for the form required under FBAR that generally conforms to income tax filing deadlines. Under the proposal, the due date of forms relating to Report of Foreign Bank and Financial Accounts is April 15 with a maximum extension for a six-month period ending on October 15 (with a proposal for extension). The proposal permits the Secretary to waive any penalties for failure to file a timely request for an extension if the reporting period to which the penalty relates is the first period for which the taxpayer was subject to the FBAR requirements.

Effective Date

The proposal is generally effective for returns for taxable years beginning after December 31, 2014.

3. Corporations permitted statutory automatic six-month extension of income tax returns (sec. 6203 of the discussion draft and sec. 6081 of the Code)

Description of Proposal

The proposal modifies the statute to provide (consistent with current Treasury regulations) that a corporation is allowed an automatic six-month extension of time to file its Federal corporate income tax return (to October 15 for a calendar year taxpayer, assuming the new filing dates as described in section 6201 above) if the corporation files the form prescribed by the Secretary and pays on or before the due date prescribed for payment, the amount properly estimated as its tax.

Effective Date

The proposal is effective for returns for taxable years beginning after December 31, 2014.

D. Compliance Reforms

1. Penalty for failure to file (sec. 6301 of the discussion draft and sec. 6651 of the Code)

Present Law

The Federal tax system is one of "self-assessment," *i.e.*, taxpayers are required to declare their income, expenses, and ultimate tax due, while the IRS has the ability to propose subsequent changes. This voluntary system requires that taxpayers comply with deadlines and adhere to the filing requirements. While taxpayers may obtain extensions of time in which to file their returns, the Federal tax system consists of specific due dates of returns. In order to foster compliance in meeting these deadlines, Congress has enacted a penalty for the failure to timely file tax returns.[1965]

A taxpayer who fails to file a tax return on or before its due date is subject to a penalty equal to five percent of the net amount of tax due for each month that the return is not filed, up to a maximum of 25 percent of the net amount.[1966] If the failure to file a return is fraudulent, the taxpayer is subject to a penalty equal to 15 percent of the net amount of tax due for each month the return is not filed, up to a maximum of 75 percent of the net amount.[1967] The net amount of tax due is the amount of tax required to be shown on the return reduced by the amount of any part of the tax which is paid on or before the date prescribed for payment of the tax and by the amount of any credits against tax which may be claimed on the return.[1968] The penalty will not apply if it is shown that the failure to file was due to reasonable cause and not willful neglect.[1969]

If a return is filed more than 60 days after its due date, and unless it is shown that such failure is due to reasonable cause, then the failure to file penalty may not be less than the lesser of $135 or 100 percent of the amount required to be shown as tax on the return. If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return.[1970] If a return is filed more than 60 days after its due date, then the penalty for failure to pay tax shown on a return may not reduce the penalty for failure to file below the lesser of $135 or 100 percent of the amount required to be shown on the return.[1971]

[1965] See *United States v. Boyle*, 469 U.S. 241, 245 (1985).

[1966] Sec. 6651(a)(1).

[1967] Sec. 6651(f).

[1968] Sec. 6651(b)(1).

[1969] Sec. 6651(a)(1).

[1970] Sec. 6651(c)(1).

[1971] *Ibid.*

The failure to file penalty applies to all returns required to be filed under subchapter A of Chapter 61 (relating to income tax returns of an individual, fiduciary of an estate or trust, or corporation; self employment tax returns, and estate and gift tax returns), subchapter A of chapter 51 (relating to distilled spirits, wines, and beer), subchapter A of chapter 52 (relating to tobacco, cigars, cigarettes, and cigarette papers and tubes), and subchapter A of chapter 53 (relating to machine guns and certain other firearms).[1972] The failure to file penalty does not apply to any failure to pay estimated tax required to be paid by sections 6654 or 6655.[1973]

Description of Proposal

Under the proposal, if a return is filed more than 60 days after its due date, then the failure to file penalty may not be less than the lesser of $400 or 100 percent of the amount required to be shown as tax on the return.

Effective Date

The proposal applies to returns with filing due dates (including extensions) after December 31, 2014.

2. Penalty for failure to file correct information returns and provide payee statements (sec. 6302 of the discussion draft and secs. 6721 and 6722 of the Code)

Present Law

Failure to comply with the information reporting requirements results in penalties, which may include a penalty for failure to file the information return,[1974] to furnish payee statements,[1975] or to comply with other various reporting requirements.[1976] No penalty is imposed if the failure is due to reasonable cause.[1977]

Any person who is required to file an information return, but who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the information return is filed. If a person files an information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $30 per return ("first-tier penalty"), with a maximum penalty of $250,000 per calendar year. If a person files an information return after the date that is 30 days after the prescribed filing date

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1972 Sec. 6651(a)(1).

1973 Sec. 6651(e).

1974 Sec. 6721.

1975 Sec. 6722.

1976 Sec. 6723. The penalty for failure to timely comply with a specified information reporting requirement is $50 per failure, not to exceed $100,000 per calendar year.

1977 Sec. 6724.

but on or before August 1, the amount of the penalty is $60 per return ("second-tier penalty"), with a maximum penalty of $500,000 per calendar year. If an information return is not filed on or before August 1 of any year, the amount of the penalty is $100 per return ("third-tier penalty"), with a maximum penalty of $1,500,000 per calendar year. If a failure to file is due to intentional disregard of a filing requirement, the minimum penalty for each failure is $250, with no calendar year limit.

Lower maximum levels for this failure to file correct information return penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $75,000 (instead of $250,000) if the failures are corrected on or before 30 days after the prescribed filing date; $200,000 (instead of $500,000) if the failures are corrected on or before August 1; and $500,000 (instead of $1,500,000) if the failures are not corrected on or before August 1.

Any person who is required to furnish a payee statement who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the payee statement is furnished, similar to the penalty for filing an information return discussed above. A first-tier penalty is $30, subject to a maximum of $250,000, a second-tier penalty is $60 per statement, up to $500,000, and a third-tier penalty is $100, up to a maximum of $1,500,000. If a failure to file is due to intentional disregard of a filing requirement, the minimum penalty for each failure is $250, with no calendar year limit.

Lower maximum levels for this failure to furnish correct payee statement penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $75,000 (instead of $250,000) if the failures are corrected on or before 30 days after the prescribed filing date; $200,000 (instead of $500,000) if the failures are corrected on or before August 1; and $500,000 (instead of $1,500,000) if the failures are not corrected on or before August 1.

Both the failure to file and failure to furnish penalties are adjusted to account for inflation every five years with the first adjustment to take place after 2012, effective for each year thereafter.

Description of Proposal

The proposal modifies the dollar values of the failure to file penalties and the failure to furnish payee statement penalties as follows.

The proposal increases the first-tier penalties from $30 to $50, and increases the calendar year maximum from $250,000 to $500,000. The second-tier penalties are increased from $60 to $100, and the calendar year maximum is increased from $500,000 to $1,500,000. The third-tier penalties are increased from $100 to $250, and the calendar year maximum is increased from $1,500,000 to $3,000,000. For small business filers, the calendar year maximum is increased from $75,000 to $175,000 for the first-tier penalty, from $200,000 to $500,000 for the second-tier penalty, and from $500,000 to $1,000,000 for the third-tier penalty.

If one or more failures are due to intentional disregard of the filing or information reporting requirement, the minimum penalty is increased from $250 to $500 for each return with respect to which such a failure occurs and the $3,000,000 limitation on total amounts imposed does not apply.

Effective Date

The proposal applies to information returns and statements required to be filed after December 31, 2014.

3. Clarification of six-year statute of limitations in case of overstatement of basis (sec. 6303 of the discussion draft and sec. 6501(e) of the Code)

Present Law

Taxes are generally required to be assessed within three years after a taxpayer's return is filed, whether or not it was timely filed.[1978] There are several circumstances under which the general three-year limitations period does not begin to run. If no return is filed,[1979] if a false or fraudulent return filed with the intent to evade tax is filed, if private foundation status is terminated, or a gift tax for certain gifts is not properly disclosed, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.[1980]

Other exceptions to the general rule result in an extension of the limitations period otherwise applicable. For example, the limitation period may be extended by taxpayer consent.[1981] Failure to disclose or report certain information may also result in extensions of the statute of limitations. For example, failure to disclose a listed transaction as required under section 6011 on any return or statement for a taxable year will result in an extension that ensures that the limitations period remains open for at least one year from the date the requisite information is provided. The limitation period with respect to such transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is provided the information so required, or (2) the date that a "material advisor" (as defined in section 6111) makes its section 6112(a) list available for inspection pursuant to a request by the Secretary under section 6112(b)(1)(A).[1982] In addition to the exceptions described above, there are also circumstances under which the three-year limitation period is suspended.[1983]

[1978] Sec. 6501(a). Returns that are filed before the date they are due are deemed filed on the due date. See sec. 6501(b)(1) and (2).

[1979] Sec. 6501(c)(3).

[1980] Sec. 6501(c)(1) and (2).

[1981] Sec. 6501(c)(4).

[1982] Sec. 6501(c)(10).

[1983] For example, service of an administrative summons triggers the suspension either (1) beginning six months after service (in the case of John Doe summonses) or (2) when a proceeding to quash a summons is initiated

A separate limitations period of six years from the date a return is filed is established for substantial omissions of items from gross income. An omission from gross income is substantial if the omission exceeds 25 percent of the gross income reported on the return or if the amount omitted exceeds $5,000 and is attributable to a foreign financial asset within the meaning of section 6038D (without regard to dollar thresholds and regulatory exceptions to reporting based on existence of duplicative disclosure requirements).[1984] Amounts that are disclosed on a return, even if not reflected in the amount recorded as gross income, are generally not considered to have been omitted for purposes of determining whether the 25 percent threshold was exceeded. For a trade or business, the threshold for determining a substantial omission is 25 percent of the gross receipts. For all others, an amount is considered to have been disclosed on a return if it is presented in a manner that is "adequate to apprise the Secretary of the nature and amount of such item."[1985] An overstatement of basis that contributes to an understatement of income due is not itself considered to be an omission of income, without regard to whether the return reveals the computation of basis.[1986]

Description of Proposal

In determining whether an amount greater than 25 percent of gross income was omitted from a return, the proposal provides that an understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission of gross income, without regard to whether or not the amount of unrecovered cost or basis claimed is disclosed on the return.

Effective Date

The proposal applies to returns filed after the date of enactment, as well as to any other return for which the assessment period specified in section 6501 had not expired as of that date.

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by a taxpayer named in a summons to a third-party record-keeper. Judicial proceedings initiated by the government to enforce a summons generally do not suspend the limitation period.

[1984] Sec. 6501(e)(1). Similar six year limitations periods are established for estate and gift taxes as well as excise taxes, based on 25 percent omissions from items required to be reported on the relevant tax returns. See secs. 6501(e)(2) and (3).

[1985] Sec. 6501(e)(1)(B).

[1986] *Home Concrete & Supply, LLC. v. United States*, 132 S. Ct. 1836; 182 L. Ed. 2d 746 (2012). In deciding in favor of the taxpayer, the Supreme Court followed its interpretation of the word "omits" in a predecessor to section 6501. See *The Colony Inc., v. Commissioner*, 357 U.S. 28 (1958). Having previously interpreted an unambiguous term in the statute, the Court held that a contrary interpretation by the Secretary in Treas. Reg. sec. 301.6501(e)-1 was invalid.

4. Reform of rules related to qualified tax collection contracts (sec. 6304 of the discussion draft and sec. 6306 of the Code)

Present Law

Code section 6306 permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities of any type[1987] and to arrange payment of those taxes by the taxpayers. There must be an assessment pursuant to section 6201 in order for there to be an outstanding tax liability. An assessment is the formal recording of the taxpayer's tax liability that fixes the amount payable. An assessment must be made before the IRS is permitted to commence enforcement actions to collect the amount payable. In general, an assessment is made at the conclusion of all examination and appeals processes within the IRS.[1988]

Several steps are involved in the deployment of private debt collection companies. First, the private debt collection company contacts the taxpayer by letter.[1989] If the taxpayer's last known address is incorrect, the private debt collection company searches for the correct address. Second, the private debt collection company telephones the taxpayer to request full payment.[1990] If the taxpayer cannot pay in full immediately, the private debt collection company offers the taxpayer an installment agreement providing for full payment of the taxes over a period of as long as five years. If the taxpayer is unable to pay the outstanding tax liability in full over a five-year period, the private debt collection company obtains financial information from the taxpayer and will provide this information to the IRS for further processing and action by the IRS.

The Code specifies several procedural conditions under which the provision would operate. First, provisions of the Fair Debt Collection Practices Act apply to the private debt collection company. Second, taxpayer protections that are statutorily applicable to the IRS are also made statutorily applicable to the private sector debt collection companies. In addition, taxpayer protections that are statutorily applicable to IRS employees are made statutorily applicable to employees of private sector debt collection companies. Third, subcontractors are prohibited from having contact with taxpayers, providing quality assurance services, and composing debt collection notices; any other service provided by a subcontractor must receive prior approval from the IRS.

[1987] This provision generally applies to any type of tax imposed under the Internal Revenue Code.

[1988] An amount of tax reported as due on the taxpayer's tax return is considered to be self-assessed. If the IRS determines that the assessment or collection of tax will be jeopardized by delay, it has the authority to assess the amount immediately (sec. 6861), subject to several procedural safeguards.

[1989] The provision requires that the IRS disclose confidential taxpayer information to the private debt collection company. Section 6103(n) permits disclosure of returns and return information for "the providing of other services ... for purposes of tax administration."

[1990] The private debt collection company is not permitted to accept payment directly. Payments are required to be processed by IRS employees.

The Code creates a revolving fund from the amounts collected by the private debt collection companies. The private debt collection companies will be paid out of this fund. The Code prohibits the payment of fees for all services in excess of 25 percent of the amount collected under a tax collection contract.

The Code also provides that up to 25 percent of the amount collected may be used for IRS collection enforcement activities. The law also requires Treasury to provide a biennial report to the Committee on Finance and the Committee on Ways and Means. The report is to include, among other items, a cost benefit analysis, the impact of the debt collection contracts on collection enforcement staff levels in the IRS, and an evaluation of contractor performance.

The Omnibus Appropriations Act of 2009 (the "Act"), which made appropriations for the fiscal year ending September 30, 2009, included a provision stating that none of the funds made available in the Act could be used to fund or administer section 6306.[1991] Around the same time, the IRS announced that the IRS would not renew its contracts with private debt collection agencies.[1992]

Description of Proposal

The proposal requires the Secretary to enter into qualified tax collection contracts for the collection of inactive tax receivables. Inactive tax receivables are defined as any tax receivable (i) removed from the active inventory for lack of resources or inability to locate the taxpayer, (ii) for which more than 1/3 of the applicable limitations period has lapsed and no IRS employee has been assigned to collect the receivable; and (iii) for which, a receivable has been assigned for collection but more than 365 days have passed without interaction with the taxpayer or a third party for purposes of furthering the collection. Tax receivables are defined as any outstanding assessment which the IRS includes in potentially collectible inventory.

The proposal designates certain tax receivables as not eligible for collection under qualified tax collection contracts, specifically a contract that: (i) is subject to a pending or active offer-in-compromise or installment agreement; (ii) is classified as an innocent spouse case; (iii) involves a taxpayer identified by the Secretary as being (a) deceased, (b) under the age of 18, (c) in a designated combat zone, or (d) a victim of identity theft; (iv) is currently under examination, litigation, criminal investigation, or levy; or (v) is currently subject to a proper exercise of a right of appeal. The proposal grants authority to the Secretary to prescribe procedures for taxpayers in presidentially declared disaster areas to request relief from immediate collection measures under the proposal.

The proposal requires the Secretary to give priority to private collection contractors and debt collection centers currently approved by the Treasury Department's Financial Management Service on the schedule required under section 3711(g) of title 31 of the United States Code, to the extent appropriate to carry out the purposes of the proposal.

[1991] Pub. L. No. 111-8, March 11, 2009.

[1992] IR-2009-19, March 5, 2009.

The proposal adds an additional exception to section 6103 to allow contractors to identify themselves as such and disclose the nature, subject, and reason for the contact. Disclosures are permitted only in situations and under conditions approved by the Secretary.

The proposal requires the Secretary to prepare two reports for the House Committee on Ways and Means and the Senate Committee on Finance. The first report is required annually and due not later than 90 days after each fiscal year and is required to include: (i) the total number and amount of tax receivables provided to each contractor for collection under this section; (ii) the total amounts collected by and installment agreements resulting from the collection efforts of each contactor and the collection costs incurred by the IRS; (iii) the impact of such contacts on the total number and amount of unpaid assessments, and on the number and amount of assessments collected by IRS personnel after initial contact by a contractor; (iv) the amount of fees retained by the Secretary under subsection (e) and a description of the use of such funds; and (v) a disclosure safeguard report in a form similar to that required under section 6103(p)(5).

The second report is required biannually and is required to include: (i) an independent evaluation of contactor performance; and (ii) a measurement plan that includes a comparison of the best practices used by private collectors to the collection techniques used by the IRS and mechanisms to identify and capture information on successful collection techniques used by the contractors that could be adopted by the IRS.

Effective Date

The proposal applies to tax receivables identified by the Secretary after the date of enactment. The requirement to give priority to certain private collection contractors and debt collection centers applies to contracts and agreements entered into after the date of enactment, and the new exception to section 6103 applies to disclosures made after the date of enactment. The requirement of the reports to Congress is effective on the date of enactment.

5. 100 percent continuous levy authority on payments to Medicare providers and suppliers (sec. 6305 of the discussion draft and sec. 6331 of the Code)

Present Law

In general

Levy is the administrative authority of the IRS to seize a taxpayer's property, or rights to property, to pay the taxpayer's tax liability.[1993] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[1994] the property is not exempt from levy,[1995] and the IRS has provided both notice of intention to levy[1996] and notice

[1993] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[1994] *Ibid.*

[1995] Sec. 6334.

of the right to an administrative hearing (the notice is referred to as a "collections due process notice" or "CDP notice" and the hearing is referred to as the "CDP hearing")[1997] at least 30 days before the levy is made. A levy on salary or wages generally is continuously in effect until released.[1998] A Federal tax lien arises automatically when: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[1999]

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable when determining whether assessment of tax without following the normal deficiency procedures is permitted.[2000]

The CDP notice (and pre-levy CDP hearing) is not required if: (1) the Secretary finds that collection would be jeopardized by delay; (2) the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund; (3) the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served; or (4) the Secretary has served a Federal contractor levy. In each of these four cases, however, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy.[2001]

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[2002] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments" by the Federal government if the payees are delinquent on their tax obligations. With respect to payments to vendors of goods, services, or property sold or leased to the Federal government, the continuous levy may be up to 100 percent of each payment.[2003] The levy (either up to 15 percent or up to 100 percent) generally continues in effect until the liability is paid or the IRS releases the levy.

[1996] Sec. 6331(d).

[1997] Sec. 6330. The notice and the hearing are referred to collectively as the CDP requirements.

[1998] Secs. 6331(e) and 6343.

[1999] Sec. 6321.

[2000] Secs. 6331(d)(3), and 6861.

[2001] Sec. 6330(f).

[2002] Pub. L. No. 105-34.

[2003] Sec. 6331(h)(3). The word "property" was added to "goods or services" in section 301 of the "3% Withholding Repeal and Job Creation Act," Pub. L. No. 112-56.

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by the Department of the Treasury's Financial Management Service ("FMS"), such as certain Social Security benefit and Federal wage records. When these records match, the delinquent taxpayer is provided both the notice of intention to levy and the CDP notice. If the taxpayer does not respond after 30 days, the IRS can instruct FMS to levy the taxpayer's Federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or the IRS releases the levy.

Payments to Medicare Providers

In 2008, the Government Accountability Office ("GAO") found that over 27,000 Medicare providers (*i.e.*, about six percent of all such providers) owed more than $2 billion of tax debt, consisting largely of individual income and payroll taxes.[2004] As of 2008, the Centers for Medicare & Medicaid Services ("CMS") had not incorporated most of its Medicare payments into the continuous levy program, despite the IRS authority to continuously levy up to 15 percent of these payments. The GAO noted that CMS officials promised to incorporate about 60 percent of all Medicare fee-for-service payments into the levy program by October 2008 and the remaining 40 percent in the next several years. Following the GAO study, Congress directed CMS to participate in the FPLP and ensure that all Medicare provider and supplier payments are processed through it, in specified graduated percentages, by the end of fiscal year 2011.[2005] CMS has since incorporated its payments into the continuous levy program to ensure that it collects delinquent tax debts from Medicare providers as authorized.

Description of Proposal

The proposal allows the Secretary to levy up to 100 percent of a payment to a Medicare provider to collect unpaid taxes.

Effective Date

The proposal is effective for levies issued after the date of enactment.

[2004] Government Accountability Office, *Medicare: Thousands of Medicare Providers Abuse the Federal Tax System* (GAO-08-618), June 13, 2008.

[2005] Medicare Improvement for Patients and Providers Act of 2008, Pub. L. No. 110-275, sec. 189.

6. Treatment of refundable credits for purposes of certain penalties (sec. 6306 of the discussion draft and secs. 6664 and 6676 of the Code)

Present Law

Underpayment penalties

Under present law, an accuracy-related penalty or a fraud penalty may be imposed on certain underpayments of tax.[2006] The Code imposes a 20 percent penalty on the portion of an underpayment attributable to: negligence or disregard of rules or regulations, a substantial understatement, a substantial valuation overstatement, a substantial overstatement of pension liabilities, a substantial estate or gift tax valuation understatements, any disallowance of tax benefits by reason of lacking economic substance, or any undisclosed foreign financial asset understatement.[2007] A penalty of 75 percent of an underpayment is imposed in the case of fraud. An exception to these penalties for reasonable cause generally applies.[2008] An underpayment, for this purpose, means the excess of the amount of tax imposed over the amount of tax shown on the return.[2009]

These penalties are assessed in the same manner as taxes.[2010] In the case of income taxes, a taxpayer may contest any deficiency in tax determined by the IRS in the Tax Court before an assessment of the tax may be made.[2011] Generally a deficiency in tax is the excess of the amount of tax imposed over the amount of tax shown on the return.[2012]

The Code allows certain credits against the income tax.[2013] Most of the credits may not exceed the taxpayer's income tax. However certain credits ("refundable credits") may exceed the tax and the amount of these credits in excess of the tax imposed (reduced by the other credits)

[2006] Secs. 6662 and 6663. Present law also imposes a separate accuracy-related 20 percent penalty on portions of an underpayment attributable to a listed or reportable transaction. Sec. 6662A(a). The penalty increases to 30 percent if the transaction is not adequatelydisclosed. Secs. 6662A(c) and 6664(d)(2)(A).

[2007] The 20-percent penalty is increased to 40 percent when there is a gross valuation misstatement involving a substantial valuation overstatement, a substantial overstatement of pension liabilities, a substantial estate or gift tax valuation understatement, or when a transaction lacking economic substance is not properly disclosed. Secs. 6662(h) and 6662(i).

[2008] Sec.6664(c). There is no reasonable cause exception for tax benefits disallowed by reason of a transaction lacking economic substance and certain valuation overstatements related to charitable dednction property.

[2009] Sec. 6664(a). Previous assessments and rebates may also be taken into account.

[2010] Sec. 6665(a).

[2011] Sec. 6211-6215.

[2012] Sec. 6211. Previous assessments and rebates may also be taken into account.

[2013] Secs. 21-54AA.

is an overpayment which creates a refund or credit.[2014] Refundable credits include a portion of the child credit, the American opportunity tax credit, and the earned income credit.[2015]

In determining a deficiency in tax, the refundable credits in excess of tax are treated as negative amounts of tax.[2016] Thus, the amounts of tax imposed and the tax shown on the return may be negative amounts. The Code does not provide a similar rule for the determination of an underpayment for purposes of the penalties.[2017]

The Tax Court ruled that for purposes of determining the amount of an underpayment for purposes of the penalty provisions, the tax shown on the return may not be less than zero.[2018] Thus, no accuracy-related penalty or fraud penalty may be imposed to the extent the refundable credits reduce the tax imposed below zero.

Erroneous claims

Present law imposes a penalty of 20 percent on the amount by which a claim for refund or credit exceeds the amount allowable unless it is shown that the claim has a reasonable basis.[2019] The penalty does not apply to claims relating to the earned income credit. The penalty does not apply to the portion of any claim to which the accuracy-related and fraud penalties apply. The deficiency procedures do not apply to this penalty.

Description of Proposal

The proposal amends the definition of underpayment applicable to the determination of accuracy-related and fraud penalties by incorporating in the definition the rule that in determining the tax imposed and the amount of tax shown on the return, the excess of the refundable credits over the tax is taken into account as negative amount of tax. Thus, if a taxpayer files an income tax return erroneously claiming refundable credits in excess of tax, there is an underpayment on which a penalty may be imposed.

The proposal also repeals the exception from the erroneous claims penalty for the earned income credit.

[2014] Sec. 6401(b).

[2015] Refundable credits include credits for withholding of taxes. Treas. Reg. secs. 1-6664-2(b) and (c) provide special rules for the withholding credits.

[2016] Sec. 6211(b)(4).

[2017] The Improved Penalty Administration and Compliance Tax Act (the "Act"), Pub. L. No. 101-239, sec. 7721(c), revised the penalties to provide a single accuracy-related penalty for various types of misconduct. The definition of underpayment for purposes of similar penalties prior to that Act was defined by reference to the definition of a deficiency. See sec. 6653(c)(1) prior to its repeal by the Act.

[2018] *Rand v. Commissioner*, 141 T.C. No. 12 (November 18, 2013).

[2019] Sec. 6676.

Effective Date

The proposal amending the definition of underpayment is effective for all open tax years. The proposal repealing the exception from the erroneous claims penalty is effective for claims filed after February 26, 2014.

TITLE VII – EXCISE TAXES

1. Repeal of medical device excise tax (sec. 7001 of the discussion draft and sec. 4221 of the Code)

Present Law

A tax equal to 2.3 percent of the sale price is imposed on the sale of any taxable medical device by the manufacturer, producer, or importer of such device.[2020] A taxable medical device is any device, as defined in section 201(h) of the Federal Food, Drug, and Cosmetic Act,[2021] intended for humans. Regulations further define a medical device as one that is listed by the Food and Drug Administration ("FDA") under section 510(j) of the Federal Food, Drug, and Cosmetic Act and 21 C.F.R. Part 807, pursuant to FDA requirements.[2022]

The excise tax does not apply to eyeglasses, contact lenses, hearing aids, and any other medical device determined by the Secretary to be of a type that is generally purchased by the general public at retail for individual use ("retail exemption"). Regulations provide guidance on the types of devices that are exempt under the retail exemption. A device is exempt under these provisions if: (1) it is regularly available for purchase and use by individual consumers who are not medical professionals; and (2) the design of the device demonstrates that it is not primarily intended for use in a medical institution or office or by a medical professional.[2023] Additionally, the regulations provide certain safe harbors for devices eligible for the retail exemption.[2024]

The medical device excise tax is generally subject to the rules applicable to other manufacturers excise taxes. These rules include certain general manufacturers excise tax exemptions including the exemption for sales for use by the purchaser for further manufacture (or for resale to a second purchaser in further manufacture) or for export (or for resale to a

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[2020] Sec. 4191.

[2021] 21 U.S.C. sec. 321. Section 201(h) defines device as an instrument, apparatus, implement, machine, contrivance, implant, in vitro reagent, or other similar or related article, including any component, part, or accessory, which is (1) recognized in the official National Formulary, or the United States Pharmacopeia, or any supplement to them, (2) intended for use in the diagnosis of disease or other conditions, or in the cure, mitigation, treatment, or prevention of disease, in man or other animals, or (3) intended to affect the structure or any function of the body of man or other animals, and which does not achieve its primary intended purposes through chemical action within or on the body of man or other animals and which is not dependent upon being metabolized for the achievement of its primary intended purposes.

[2022] Treas. Reg. sec. 48.4191-2(a). The regulations also include as devices items that should have been listed as a device with the FDA as of the date the FDA notifies the manufactner or importer that corrective action with respect to listing is required.

[2023] Treas. Reg. sec. 48.4191-2(b)(2).

[2024] Treas. Reg. sec. 48.4191-2(b)(2)(iii). The safe harbor includes devices that are described as over-the-counter devices in relevant FDA classification headings as well as certain other FDA device classifications listed in the regulations.

second purchaser for export).[2025] If a medical device is sold free of tax for resale to a second purchaser for further manufacture or for export, the exemption does not apply unless, within the six-month period beginning on the date of sale by the manufacturer, the manufacturer receives proof that the medical device has been exported or resold for use in further manufacturing.[2026] In general, the exemption does not apply unless the manufacturer, the first purchaser, and the second purchaser are registered with the Secretary of the Treasury. Foreign purchasers of articles sold or resold for export are exempt from the registration requirement.

The lease of a medical device is generally considered to be a sale of such device.[2027] Special rules apply for the imposition of tax to each lease payment. The use of a medical device subject to tax by manufacturers, producers, or importers of such device, is treated as a sale for the purpose of imposition of excise taxes.[2028]

There are also rules for determining the price of a medical device on which the excise tax is imposed.[2029] These rules provide for (1) the inclusion of containers, packaging, and certain transportation charges in the price, (2) determining a constructive sales price if a medical device is sold for less than the fair market price, and (3) determining the tax due in the case of partial payments or installment sales.

Description of Proposal

The proposal repeals the medical device excise tax.

Effective Date

The proposal applies to sales after the date of enactment.

[2025] Sec. 4221(a). Other general manufacturers excise tax exemptions (*i.e.*, the exemption for sales to vessels or aircraft, to a State or local government, to a nonprofit educational organization, or to a qualified blood collector organization) do not apply to the medical device excise tax.

[2026] Sec. 4221(b).

[2027] Sec. 4217(a).

[2028] Sec. 4218.

[2029] Sec. 4216.

2. Modifications relating to the Oil Spill Liability Trust Fund (sec. 7002 of the discussion draft and secs. 4611 and 4612 of the Code)

Present Law

Oil Spill Liability Trust Fund

Amounts in the Oil Spill Liability Trust Fund are available, as provided in appropriation Acts or section 6002(b) of the Oil Pollution Act of 1990, for the following oil spill-related expenditures:

1. Payment of removal costs and other costs, expenses, claims, and damages under section 1012 of the 1990 Act;

2. Costs relating to oil pollution or the substantial threat of oil pollution (under sections 5 and 7 of the Intervention on the High Seas Act);

3. Payment of liabilities incurred by the revolving fund under section 311(k) of the Federal Water Pollution Control Act;

4. Payments for prevention, removal, and enforcement related to oil discharges (under section 311(b)-(d), (j), and (l) of the Federal Water Pollution Control Act);

5. Payment of liabilities incurred by the Deepwater Port Liability Fund; and

6. Payment of liabilities incurred by the Offshore Pollution Compensation Fund.

There is a general limit of $1 billion per incident that may be paid out of the Oil Spill Liability Trust Fund, with costs of natural resource damage assessments and claims for any single incident limited to $500 million. Except in the case of payments of oil removal costs, payments may be made from the Trust Fund only if the Fund maintains a minimum balance of $30 million after such payment. Any claim filed against the Oil Spill Liability Trust Fund may be paid only out of the Fund.

Tax and exemptions

The Oil Spill Liability Trust Fund is largely financed with revenues from an eight-cents-per-barrel[2030] excise tax on crude oil received at a United States refinery and on imported petroleum products.[2031] The tax rate is scheduled to increase to nine cents per barrel in calendar

[2030] A barrel equals 42 gallons.

[2031] Sec. 4611(a). Petroleum products include crude oil (sec. 4612(a)(3)). Statutorily, the tax also applies to domestic crude oil exported from the United States before being received at a U.S. refinery (sec. 4611(b)(1)).

year 2017, after which it currently is scheduled to expire.[2032] A back-up "use tax" is imposed on crude oil that is used in or exported from the United States before being received at a refinery.[2033]

Types of "oil"

Tar sands[2034]

"Tar sands" or "oil sands" generally refers to a mixture of sand, clay or other minerals, water and bitumen. Bitumen is a form of crude oil that is very dense, often said to have the consistency of molasses and very viscous (resistant to flow). Because bitumen is resistant to flow, and thus impractical for pipeline transportation, the bitumen is processed or diluted to facilitate transportation. "Upgraded bitumen," also known as "synthetic crude oil" or "SCO" is produced from bitumen to convert the heavy hydrocarbon into lighter material. "Diluted bitumen," or "dilBit", is bitumen that is blended with lighter hydrocarbons (typically natural gas condensates) to create a lighter, easier flowing and transportable material. "Synthetic bitumen," or "Synbit," is typically a combination of synthetic crude oil and bitumen, which improves the flow properties of the bitumen. The vast majority of oil derived from tar sands is transported via pipeline.

Shale oil[2035]

Shale oil is petroleum that is trapped in low permeability sedimentary shale. The low permeability prevents the petroleum from freely flowing into a drilled well. The current practice is to hydraulically fracture the shale rock surrounding the well in order to release the petroleum from the rock and allow it to flow into the well hole and be produced.

Oil shale[2036]

Oil shale is sedimentary rock containing organic matter known as "kerogen." The kerogen must be heated to release a petroleum-like product.

2032 For Federal budget scorekeeping purposes, the oil spill excise tax is assumed to be permanent.

2033 Sec. 4611(b).

2034 See, U.S. Bureau of Land Management, 2012 Oil Shale & Tar Sands Programmatic EIS Information Center, Tar Sands Basics (2012) <http://osteis.anl.gov/guide/tarsands/indes.cfm>; United States Geological Survey, Natural Bitumen Resources of the United States (Fact Sheet 2006-3133, November 2006); and Congressional Research Service, Oil Sands and the Keystone XL Pipeline: Background and Selected Environmental Issues (CRS Report R42611, July 16, 2012).

2035 See, Congressional Research Service, The Bakken Formation: An Emerging Unconventional Oil Resource (CRS Report R42032, September 28, 2011) at p.1.

2036 *Ibid.*

"Crude oil" for purposes of the Oil Spill Trust Fund financing rate

Under the Code, the term "crude oil" is defined to include crude oil condensates and natural gasoline. "Domestic crude oil" means "any crude oil produced from a well located in the United States. Under a special rule, natural gasoline produced from natural gas at a refinery is treated as received at the refinery at the time of its production and is subject to tax at that time.

Relying on a House Ways and Means Committee report, the IRS stated in a technical advice memorandum that tar sands are not subject to tax for purposes of the Code.[2037] The committee report provides that the term "crude oil," for purposes of this tax does not include synthetic petroleum. Thus, the Committee stated, "'crude oil' does not include shale oil, liquids from coal, tar sands, or biomass, or refined oil."[2038]

"Oil" for purposes of the Oil Pollution Act of 1990

Under the Oil Pollution Act of 1990 and for purposes of making expenditures from the Oil Spill Liability Trust Fund, the definition of oil is very broad.[2039] "Oil" means oil of any kind in any form, including petroleum, fuel oil, sludge, oil refuse and oil mixed with wastes other than dredged spoil. It does not include any substance that is specifically listed or designated as a hazardous substance under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and subject to the provisions of that Act.

Tar sands and oil from tar sands would fit within this definition of "oil" but under the IRS interpretation, such material is not subject to the tax that funds the Oil Spill Liability Trust Fund. As a result, costs of a spill of oil from tar sands would be covered by the Oil Spill Liability Trust Fund, although oil from tar sands is not subject to the tax. For example, in 2010, there was a pipeline spill into the Kalamazoo River in Michigan involving oil from tar sands.[2040]

[2037] See Tech. Adv. Memo 201120019; 2011 WL 1915850 (January 12, 2011) noting that the statutory text was ambiguous and, based on House Committee report language, concludes that tar sands imported into the United States are not subject to the excise tax on petroleum imposed by section 4611 (which provides for the Oil Spill Liability Trust Fund financing rate and the expired Hazardous Substance Superfund financing rate for the tax on crude oil and petroleum products).

[2038] H.R. Rep. 96-1016(II), 1980 U.S.C.C.A.N. 6151, 6154 (96th Cong. 2nd Sess. 1980).

[2039] 33 U.S.C. sec. 2701(23).

[2040] See, Environmental Protection Agency, EPA's Response to the Enbridge Oil Spill in Michigan (October 3, 2012) <http://www.epa.gov/enbridgespill/ar/index.html>. ("Enbridge Energy Partners LLP (Enbridge) reported a 30-inch pipeline ruptured on Monday, July 26, 2010, near Marshall, Michigan. The release, estimated at 819,000 gallons, entered Talmadge Creek and flowed into the Kalamazoo River, a Lake Michigan Tributary." As of October 3, 2012, oil response workers had collected over 1.1 million gallons of oil.). According to information obtained by the Congressional Research Service from the U.S. Coast Guard, as of January 30, 2012, approximately $45 million had been obligated from the Oil Spill Liability Trust Fund with respect to this spill.

Description of Proposal

The proposal extends the Oil Spill Trust Fund financing rate through December 31, 2023. In addition, the proposal provides that crude oil, for purposes of the tax to fund the Oil Spill Liability Trust Fund, includes bitumen and bituminous mixtures (for example, tar sands, and oil derived from tar sands, such as synthetic crude oil from bitumen, and mixtures, such as diluted bitumen, and synthetic bitumen). The proposal also expands crude oil to include oil from kerogen-bearing sources, such as oil shale. It is also intended that shale oil be included within the definition of crude oil for this purpose since it is a form of petroleum. In addition, since tar sands and oil shale may be mined or quarried rather than produced from a well, the proposal modifies the definition of domestic crude oil to eliminate the requirement that the oil be produced from a well.

Effective Date

The proposal is effective for calendar quarters beginning more than 60 days after the date of enactment.

3. Modification relating to Inland Waterways Trust Fund financing rate (sec. 7003 of the discussion draft and sec. 4042 of the Code)

Present Law

Tax and exemptions

A 20-cents-per-gallon excise tax is imposed on fuel used in powering commercial cargo vessels on a designated system of inland or intra-coastal waterways.[2041] This tax is permanent. The tax applies to fuel used on any specified inland or intracoastal waterway of the United States in the business of transporting property for compensation or hire, or in transporting property in the business of the owner, lessee, or operator of the vessel (other than fish or other aquatic animal life caught on the voyage).[2042] The inland waterways excise tax is a use tax, imposed on the boat operator.

Exemptions are provided for vessels designed primarily for use on the high seas which have a draft of more than 12 feet ("deep-draft ocean-going vessels"), for vessels used primarily for transportation of persons, for State or local government vessels engaged in governmental business, and for use in tugboat movement of LASH ("lighter-aboard-ship") and SEABEE ocean-going barges used exclusively to ferry international cargoes to or from their carriers.

[2041] Sec. 4042. Like other taxable motor fuels, inland waterway fuels are subject to an additional excise tax of 0.1 cent per gallon to fund the Leaking Underground StorageTrust Fund.

[2042] The term inland or intracoastal waterway of the United States means any inland or intracoastal waterway of the United States which is described in section 206 of the Inland Waterways Revenue Act of 1978 and includes the Mississippi River upstream from Baton Rouge, the Mississippi River's tributaries, and specified waterways, including the Gulf of Mexico and Atlantic Intra-coastal Waterways, and the Tennessee-Tombigbee Waterway.

Overview of Inland Waterways Trust Fund expenditure provisions

Amounts in the Inland Waterways Trust Fund are available, as provided by appropriation Acts, for making construction and rehabilitation expenditures for navigation on the inland and coastal waterways of the United States described in section 206 of the Inland Waterways Revenue Act of 1978, as in effect on the date of the enactment of section 9506. There is a limit of 50 percent that can be paid from the Inland Waterways Trust Fund for the cost of any construction under section 102(a) of the Water Resources Development Act of 1986 (as in effect on the date of enactment of section 9506). The remaining 50 percent is to be paid from the General Fund.

Description of Proposal

The proposal increases the inland waterways fuel excise tax from 20 cents to 26 cents per gallon.

Effective Date

The proposal is effective for fuel used after December 31, 2014.

4. Excise tax on systemically important financial institutions (sec. 7004 of the discussion draft and new sec. 4491 of the Code)

Present Law

There is no sector-specific Federal excise tax applicable to financial institutions.

Corporations generally

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income. The taxable income of a C corporation[2043] generally is composed of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Corporations that make a valid election pursuant to section 1362 of subchapter S of Chapter 1 of the Code, referred to as S corporations, are taxed differently. In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead,

[2043] Corporations snbject to tax are commonly referred to as C corporations after subchapter C of the Code, which sets forth corporate tax rules. Certain specialized entities that invest primarily in real estate related assets (Real Estate Investment Trusts) or in stock and securities (Regulated Investment Companies) and that meet other requirements, generally including annual distribution of 90 percent of their income, are allowed to deduct their distributions to shareholders, thus generally paying little or no corporate-level tax despite otherwise being subject to subchapter C.

an S corporation passes through to shareholders its items of income and loss. The shareholders separately take into account their shares of these items on their individual income tax returns. To prevent double taxation of these items upon a subsequent disposition of S corporation stock, each shareholder's basis in such stock is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the S corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

To qualify for S corporation status, a corporation must be a small business corporation as defined in section 1361(b)(1) and not be an ineligible corporation as defined in section 1361(b)(2). A corporation qualifies as a small business corporation if it has 100 or fewer shareholders, has only individuals or certain trusts and estates as shareholders, has no nonresident aliens as shareholders, and has only one class of stock. Ineligible corporations include any financial institution using the reserve method of accounting for bad debts (discussed below) and any insurance company subject to subchapter L of the Code.

Banks, thrifts, and credit unions

In general

Financial institutions are subject to the same Federal income tax rules and rates as are applied to other corporations or entities, with certain specified exceptions. There is no sector-specific Federal income tax currently applied to financial institutions, and there are currently no corporate taxes assessed on the balance sheet liabilities of an entity.

Certain special rules and exceptions that are applicable to determining the Federal income tax liability of banks and thrifts, certain other financial institutions, insurance companies, and broker dealers are discussed below.

C corporation banks and thrifts

A bank is generally taxed for Federal income tax purposes as a C corporation. For this purpose a bank generally means a corporation, a substantial portion of whose business is receiving deposits and making loans and discounts, or exercising certain fiduciary powers.[2044] A bank for this purpose generally includes domestic building and loan associations, mutual stock or savings banks, and certain cooperative banks that are commonly referred to as thrifts.[2045] Prior to 1951, thrifts were exempt from Federal taxation. In 1951, mutual savings banks and savings

[2044] Sec. 581.

[2045] See Treas. Reg. sec. 1.581-1 ("in order to be a bank as defined in section 581, an institution must be a corporation for Federal tax purposes") and Treas. Reg. sec. 1.581-(2)(a) ("While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, or a cooperative bank...there are certain exceptions and special rules [for such institutions]").

and loan associations lost their tax exemption because they were viewed as being "in active competition with commercial banks and life insurance companies for the public savings."[2046]

S corporation banks

A bank is generally eligible to elect S corporation status under section 1362, provided it meets the other requirements for making this election and it does not use the reserve method of accounting for bad debts as described in section 585.[2047]

Special bad debt loss rules for small banks

Section 166 provides a deduction for any debt that becomes worthless (wholly or partially) within a taxable year. For taxable years beginning before 1987, section 166(c) allowed taxpayers to deduct annual reasonable additions to a reserve established for bad debts (in lieu of deducting specific debts as worthless in the year in which the bank determined the debt was worthless). The reserve method of accounting for bad debts was repealed in 1986[2048] for most taxpayers, but is allowed under section 585 for any bank (as defined in section 581) other than a large bank. For this purpose, a bank is a large bank if for the taxable year (or for any preceding taxable year after 1986) the average adjusted basis of all its assets (or the assets of the controlled group of which it was a member) exceeds $500 million. Deductions for reserves are taken in lieu of a worthless debt deduction under section 166. Accordingly, a small bank is able to take deductions for additions to a bad debt reserve. Additions to the reserve are determined under an experience method that looks to the ratio of (1) total bad debts sustained during a taxable year to (2) the total bad debts over the five preceding taxable years. A large bank is allowed a deduction for specific bad debts charged off during a taxable year.

Prior to 1996, thrifts (mutual savings banks, domestic savings and loan associations, and cooperative banks) had separate bad debt reserve rules under section 593. The special rules for thrifts were repealed for tax years beginning on or after January 1, 1996.[2049]

Credit unions

Credit unions are exempt from Federal income taxation.[2050] The exemption is based on their status as not-for-profit mutual or cooperative organizations (without capital stock) operated for the benefit of their members, who generally must share a common bond. The definition of

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[2046] S. Rep. No. 82-781, Revenue Act of 1951, p. 25.

[2047] Sec. 1361(b)(2).

[2048] Tax Reform Act of 1986, Pub. L. No. 99-514.

[2049] The Small Business and Job Protection Act of 1996, Pub. L. No. 104-188.

[2050] Sec. 501(c)(14). For a discussion of the history of and reasons for Federal tax exemption, see United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, available at http://www.ustreas.gov/press/releases/report3070.htm.

common bond has been expanded to permit greater utilization of credit unions.[2051] While significant differences between the rules under which credit unions and banks operate have existed in the past, most of those differences have disappeared over time.[2052]

Gains and losses with respect to securities held by financial institutions

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain of a corporation is currently taxed at a rate not to exceed 35 percent, which is also the maximum corporate income tax rate. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. Individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Section 1211 provides that, in the case of a corporation, losses from sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges. Thus, in taxable years in which a corporation does not recognize gain from the sale of capital assets, its capital losses do not reduce its income. However, in general, corporations (other than S corporations) may carry capital losses back to each of the three taxable years preceding the loss year and forward to each of the five taxable years succeeding the loss year.

In the case of an S corporation, net capital losses flow through to the corporation's shareholders and could be considered losses attributable to a banking business in such shareholders' hands. Banks hold a wide range of financial assets in the ordinary course of their banking business. For convenience, those assets often are described as "loans" or "investments," but both serve the same overall purpose (to earn a return on the bank's capital and borrowings consistent with prudent banking practices). A bank's investments are subject to the same regulatory capital adequacy supervision as are its loans, and a bank may acquire only certain types of financial assets as permitted investments. Banks determine how much of their assets to hold as loans or as investments based on the exercise of their commercial and financial judgment, taking into account such factors as return on the assets, liabilities, relative liquidity, and diversification objectives. As a result, for Federal income tax purposes, gains and losses on a bank's investment portfolio would be considered an integral part of the business operations of the bank, and ordinary losses that pass through to the shareholder of a bank that is an S corporation therefore could comprise part of such shareholder's net operating loss for the year

[2051] The Credit Union Membership Access Act, Pub. L. No. 105-219, allows multiple common bond credit unions. The legislation in part responds to *National Credit Union Administration v. First National Bank & Trust Co.*, 522 U.S. 479 (1998), which interpreted the permissible membership of tax-exempt credit unions narrowly.

[2052] The Treasury Department has concluded that any remaining regulatory differences do not raise competitive equity concerns between credit unions and banks. Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report-3070, January 15, 2001, p. 2, available at http://www.ustreas.gov/press/releases/report3070.htm.

attributable to that banking business. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except: (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (2) depreciable or real property used in the taxpayer's trade or business; (3) specified literary or artistic property; (4) business accounts or notes receivable; (5) certain U.S. publications; (6) certain commodity derivative financial instruments; (7) hedging transactions; and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Under section 582(c)(1), the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness by a financial institution described in section 582(c)(2) is not considered a sale or exchange of a capital asset. Thus, generally, as a manufacturer receives ordinary income treatment on sale of its inventory, so does a financial institution on the sale or exchange of its loans under section 582. A financial institution described in section 582(c)(2) includes: (1) any bank (including any corporation which would be a bank except for the fact that it is a foreign corporation); (2) any financial institution referred to in section 591, which includes mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law; (3) any small business investment company operating under the Small Business Investment Act of 1958; and (4) any business development corporation, defined as a corporation which was created by or pursuant to an act of a State legislature for purposes of promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans to be used in trades and businesses which would generally not be made by banks within such region or State in the ordinary course of their business (except on the basis of a partial participation) and which is operated primarily for such purposes. In the case of a foreign corporation, section 582(c)(1) applies only with respect to gains or losses that are effectively connected with the conduct of a banking business in the United States.

Stock (including preferred stock) is not considered indebtedness for tax purposes and therefore is not treated as an asset entitled to ordinary gain or loss treatment under section 582.[2053] However, under section 301 of Division A of the Emergency Economic Stabilization Act of 2008, gain or loss recognized by an "applicable financial institution" from the sale or exchange of "applicable preferred stock" is treated as ordinary income or loss. An applicable financial institution is a financial institution referred to in section 582(c)(2) or a depository institution holding company, as defined in the Federal Deposit Insurance Act.[2054] Applicable

[2053] Under section 306 of the Code, the sale of certain preferred stock can produce ordinary income to any taxpayer (without regard to section 582).

[2054] 12 U.S.C. sec. 1813(w)(1).

preferred stock is preferred stock of Fannie Mae or Freddie Mac that was (1) held by the applicable financial institution on September 6, 2008, or (2) sold or exchanged by the applicable financial institution on or after January 1, 2008, and before September 7, 2008.[2055]

Insurance companies

Present law provides special rules for determining the taxable income of insurance companies (subchapter L of the Code). Separate sets of rules apply to life insurance companies and to property and casualty insurance companies. Generally, an insurance company is subject to tax as a life insurance company if its life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves comprise more than 50 percent of its total reserves.[2056] All other taxable insurance companies are treated as property and casualty insurance companies for Federal income tax purposes. Insurance companies are subject to tax at regular corporate income tax rates.

A life insurance company is subject to tax on its life insurance company taxable income.[2057] Life insurance company taxable income is the sum of premiums and other consideration on insurance and annuity contracts, decreases in certain reserves, and other amounts includible in gross income, reduced by allowable deductions for all claims and benefits accrued and all losses incurred during the taxable year, increases in certain reserves, policyholder dividends, dividends received, operations losses, certain reinsurance payments, and other deductions allowable for purposes of computing taxable income.[2058]

The taxable income of a property and casualty insurance company is the sum of the amount earned from underwriting income and from investment income (as well as gains and other income items), reduced by allowable deductions.[2059] For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

Certain special rules apply to both life insurance and property and casualty companies. These rules relate to foreign tax credits, foreign companies carrying on insurance business within the United States, annual accounting period, special loss carryovers, certain reinsurance

[2055] On September 7, 2008, the Federal Housing Finance Agency ("FHFA") placed both Fannie Mae and Freddie Mac in a conservatorship. Also on September 7, 2008, FHFA and the Treasury Department entered into Preferred Stock Purchase Agreements, contractual agreements between the Treasury and the conserved entities. Under these agreements, the Treasury Department received senior preferred stock in the two companies and warrants to buy 79.9 percent of the common stock of such companies.

[2056] Sec. 816.

[2057] Sec. 801.

[2058] Secs. 801-818.

[2059] Sec. 832.

agreements, discounted unpaid losses, special estimated tax payments, and capitalization of certain policy acquisition expenses.[2060]

Broker-dealers

For Federal income tax purposes, a person generally is a securities dealer if such person regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.[2061] The determination of dealer status is made based on all facts and circumstances. The courts and the IRS have considered the following factors in evaluating dealer status: (1) being licensed as a dealer;[2062] (2) holding oneself out to the public as a dealer;[2063] (3) selling inventoried securities to customers;[2064] (4) the frequency, extent, and regularity of securities transactions;[2065] (5) profiting from commissions as opposed to appreciation in the value of securities;[2066] and (6) ownership of a securities exchange membership.[2067]

Securities dealers must account for their securities inventory using the mark-to-market accounting method.[2068] In general, under that method, securities held by a dealer in its inventory are marked to fair market value at the close of the taxable year, with any resulting difference between value and basis included as ordinary income or loss in computing taxable income for such year. For this purpose a security is defined as any share of stock in a corporation, partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, note, bond, debenture, or other evidence of indebtedness, interest rate, currency, or equity notional principal contract, and evidence of an interest in, or a derivative financial instrument in any of the foregoing, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency.[2069] Additionally, a security

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[2060] Secs. 841-848.

[2061] Sec. 475(c)(1) (defining a securities dealer for purposes of section 475); cf. Treas. Reg. sec. 1.864-2(c)(2)(iv) (defining a dealer in stock or securities for purposes of the trader safe harbors to section 864) and Treas. Reg. sec. 1.471-5 (as amended in 1993).

[2062] *Polachek v. Commissioner*, 22 T.C. 858, 859 (1954).

[2063] *Verito v. Commissioner*, 43 T.C. 429, 441-442 (1965), acq. 1965-2 C.B. 7.

[2064] *United States v. Chinook Investment Co.*, 136 F.2d 984 (9th Cir. 1943).

[2065] *Purvis v. Commissioner*, 530 F.2d 1332, 1334 (9th Cir. 1976).

[2066] *Kemon v. Commissioner*, 16 T.C. 1026, 1033 (1951).

[2067] *Securities Allied Corp. v. Commissioner*, 95 F.2d 284, 286 (2d Cir. 1938), aff'g 36 B.T.A 168 (1937), cert denied, 305 U.S. 617 (1938).

[2068] Sec. 475.

[2069] Sec. 475(c)(2). The definition of securities under section 475 excludes sec. 1256 contracts, which include futures contracts and certain exchange-traded options.

includes a position that is not one of the foregoing, but is a hedge with respect to such security, and is clearly identified in the dealer's records as a security before the close of the day on which it was acquired.[2070]

Special rules apply to gains and losses of a securities dealer with respect to "section 1256 contracts."[2071] Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market rule and generally is treated as short-term capital gain or loss, to the extent of 40 percent of the gain or loss, and long-term capital gain or loss, to the extent of the remaining 60 percent of the gain or loss.[2072] Gains and losses upon the termination (or transfer) of a section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, also generally are treated as 40 percent short-term and 60 percent long-term capital gains or losses.[2073]

A securities dealer may also hold securities for investment rather than as inventory (such securities are not subject to mark-to-market accounting, and any gains or losses with respect thereto treated as capital rather than ordinary).[2074] Additionally, a dealer is not subject to mark-to-market accounting for debt securities originated or entered into in the ordinary course of its trade or business that are not held for sale.[2075] For either of these exceptions to apply, the dealer must clearly identify that the security is either held for investment or not held for sale by the close of the day the security is acquired and the security may not at any time thereafter be held primarily for sale to customers.[2076]

Description of Proposal

The proposal applies a tax of 0.035 percent on the excess total consolidated assets of any systemically important financial institution at the close of each calendar quarter. The tax is due on the first day of the third month beginning after the close of each calendar quarter.

[2070] Sec. 475(c)(2)(F).

[2071] Section 1256(b) provides that a "section 1256 contract" is any (1) regulated futures contract, (2) foreign currency contract; (3) nonequity option, (4) dealer equity optiou; and (5) dealer securities futures contract, but does not include any securities future contract or option on such contract unless such contract or option is a dealer securities future contract, or any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.

[2072] Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that but for the rule in section 1256(a)(3) would be ordinary income property.

[2073] Sec. 1256(c)(1). Additionally, section 1212(c) provides that a taxpayer other than a corporation may elect to carry back its net section 1256 contracts loss for three taxable years.

[2074] Secs. 1236 and 475(b)(1).

[2075] Sec. 475(b)(1).

[2076] Secs. 1236(a) and (d)(1). See also section 475(b)(2).

A systemically important financial institution is any person subject to section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[2077] Generally, an institution is subject to the section 165 of Dodd-Frank if it is a nonbank financial company supervised by the Board of Governors of the Federal Reserve ("Federal Reserve Board") or a bank holding company with total consolidated assets equal to or greater than $50 billion.

Excess total consolidated assets are total consolidated assets in excess of $500 billion. The term total consolidated assets has the same meaning as for section 165 of Dodd-Frank. Generally, total consolidated assets are reported on regulatory filings required by the Federal Reserve Board.[2078]

In the case of any calendar year beginning after 2015, the $500 billion threshold is indexed to the change in gross domestic product ("GDP"). GDP for any calendar year means the latest estimate of GDP as published by the Department of Commerce for the preceding calendar year. Thus, for 2016, the $500 billion amount is multiplied by the ratio of the latest estimate of GDP for 2014 over the latest estimate of GDP for 2013.

Effective Date

The proposal applies to calendar quarters beginning after December 31, 2014.

5. Clarification of orphan drug exception to annual fee on branded prescription pharmaceutical manufacturers and importers (sec. 7005 of the discussion draft)

Present Law

An annual fee is imposed on covered entities engaged in the business of manufacturing or importing branded prescription drugs for sale to any specified government program or pursuant to coverage under any such program. Fees collected are credited to the Medicare Part B trust fund.

The aggregate annual fee imposed on all covered entities is $3 billion for calendar years 2014 through 2016, $4 billion for calendar year 2017, $4.1 billion for calendar year 2018, and $2.8 billion for calendar year 2019 and thereafter. The aggregate fee is apportioned among the covered entities each year based on their relative share of branded prescription drug sales taken into account during the previous calendar year.

A covered entity's relative market share for a calendar year is the entity's branded prescription drug sales taken into account during the preceding calendar year as a percentage of the aggregate branded prescription drug sales of all covered entities taken into account during the preceding calendar year. Sales taken into account during any calendar year with respect to a

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[2077] Pub. L. No. 111-203. Any reference to Dodd-Frank is treated as a reference to such provision as in effect on the date of the enactment of the proposal.

[2078] 12 CFR Part 246, Federal Register Volume 78, no. 164, Friday, August 23, 2013, pp. 52391-52405.

covered entity is: (1) zero percent of sales not more than $5 million; (2) 10 percent of sales over $5 million but not more than $125 million; (3) 40 percent of sales over $125 million but not more than $225 million; (4) 75 percent of sales over $225 million but not more than $400 million; and (5) 100 percent of sales over $400 million.

A covered entity is any manufacture or importer with gross receipts from branded prescription drug sales. All persons treated as a single employer under section 52(a) or (b) or under section 414(m) or 414(o) are treated as a single covered entity. In applying the single employer rules under 52(a) and (b), foreign corporations are not excluded. If more than one person is liable for payment of the fee, all such persons are jointly and severally liable for payment of such fee.

Branded prescription drug sales are sales of branded prescription drugs made to any specified government program, or pursuant to coverage under any such program. The term branded prescription drugs includes any drug which is subject to section 503(b) of the Federal Food, Drug, and Cosmetic Act and for which an application was submitted under section 351(a) of such Act. Branded prescription drug sales do not include sales of any drug or biological product with respect to which an orphan drug tax credit was allowed for any taxable year under section 45C. The exception for orphan drug sales does not apply to any drug or biological product after such drug or biological product is approved by the Food and Drug Administration for marketing for any indication other than the rare disease or condition with respect to which the section 45C credit was allowed.

Specified government programs include: (1) the Medicare Part D program under part D of title XVIII of the Social Security Act; (2) the Medicare Part B program under part B of title XVIII of the Social Security Act; (3) the Medicaid program under title XIX of the Social Security Act; (4) any program under which branded prescription drugs are procured by the Department of Veterans Affairs; (5) any program under which branded prescription drugs are procured by the Department of Defense; or (6) the TRICARE retail pharmacy program under section 1074g of title 10, United States Code.

For purposes of procedure and administration, the fees are treated in the same manner as those excise taxes identified in subtitle F, "Procedure and Administration" for which the only avenue for judicial review is a civil action for refund. Thus, the fees may be assessed and collected using the procedures in subtitle F without regard to the restrictions on assessment in section 6213.

The fee is required to be paid no later than an annual payment date determined by the Secretary of the Treasury, but in no event later than September 30th each calendar year.

For purposes of section 275, relating to the nondeductibility of specified taxes, the fee is considered to be a nondeductible tax described in section 275(a)(6).

Description of Proposal

The proposal modifies the exception for orphan drugs from the computation of branded prescription drug sales. The proposal retains the exception for orphan drug sales for a drug or biological product with respect to which an orphan drug tax credit was allowed for any taxable year under section 45C (as in effect before its repeal by the Tax Reform Act of 2014). Additionally, the proposal exempts from the computation of branded prescription drug sales, a sale of any drug or biological product which is approved or licensed by the Food and Drug Administration for marketing solely for one or more rare diseases or conditions. These exceptions do not apply to the sale of any drug or biological product after such drug or biological product is approved by the Food and Drug Administration for marketing for any indication other than the treatment of a rare disease or condition.

The proposal incorporates the present law section 45C definition of rare disease or condition, thus under the proposal a rare disease or condition is any disease or condition which (A) affects less than 20,000 persons in the United States, or (B) affects more than 200,000 persons in the United States but for which there is no reasonable expectation that the cost of developing and making available in the United States a drug for such disease or condition will be recovered from sales in the United States of such drug.[2079]

Under present law, the determination of whether a disease or condition is a rare disease or condition is made on the basis of the facts and circumstances as of the date the drug is designated under section 526 of the Federal Food, Drug, and Cosmetic Act. For purposes of the proposal, the determination with regard to a drug or biological product not so designated will be made based on the facts and circumstances as of the date the drug or biological product is approved or licensed by the Food and Drug Administration for marketing for the treatment of a rare disease or condition.

Effective Date

The proposal applies to the annual fee imposed under section 9008 of PPACA with annual dates after 2013.

[2079] This definition is the same as originally used in section 9008 of the Patient Protection and Affordable Care Act ("PPACA"), Pub. L. No. 111-148; however, section 9008 of PPACA relied on the definition of rare disease or condition found in section 45C(d)(1) which is repealed under another section of this discussion draft.

TITLE VIII – DEADWOOD AND TECHNICAL PROVISIONS

A. Repeal of Deadwood Provisions (sec. 8001 of the discussion draft)

Present Law

A number of provisions in the Code have long since expired or are otherwise inapplicable to current taxpayers. Other provisions remain valid but contain transition rules or other time-limited elements (decades old in many cases) that have no current effect. These provisions, transition rules, or time-limited elements are considered "deadwood" in that they have no application in current or future taxable years (other than possibly as generators of net operating loss carryforwards, credit carryforwards, etc.).

Description of Proposal

The proposal repeals as deadwood all or portions of a number of provisions. Below is a list of those deadwood provisions repealed in their entirety.[2080]

- Puerto Rico economic activity credit (sec. 30A)
- Making work pay credit (sec. 36A)
- Environmental tax (sec. 59A)
- Qualified group legal services plans (sec. 120)
- Deduction for clean-fuel vehicles and certain refueling property (sec. 179A)
- Deduction for capital costs incurred in complying with environmental protection agency sulfur regulations (sec. 179B)
- Dividends received on certain preferred stock; and dividends paid on certain preferred stock of public utilities (secs. 244 and 247)
- Expatriation to avoid tax (sec. 877)
- Puerto Rico and possession tax credit (sec. 936)
- Property acquired during affiliation (sec. 1051)
- Credit for State death taxes (secs. 2011 and 2604)
- Family-owned business interest (sec. 2057)
- Luxury passenger vehicles excise tax (secs. 4001, 4002, and 4003)
- 2008 recovery rebates (sec. 6428)
- Advance payment of portion of increased child credit for 2003 (sec. 6429)

[2080] Repeal of various transition rules and other deadwood cleanup are not listed.

- COBRA premium assistance (sec. 6432)

The proposal includes a "savings clause" to mitigate the effects of repealing the deadwood items in the event those items have any remaining applicability.

Effective Date

The proposal is effective on the date of enactment.

ESTIMATED REVENUE EFFECTS OF THE "TAX REFORM ACT OF 2014"

Fiscal Years 2014 - 2023

[Billions of Dollars]

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
I. Tax Reform for Individuals													
A. Individual Income Tax Rate Reform													
1. Simplification of individual income tax rates [1]	tyba 12/31/14	---	-43.4	-62.5	-61.7	-64.1	-62.8	-64.8	-60.1	-64.6	-59.9	-231.9	-543.8
2. Deduction for adjusted net capital tax:													
a. Tax capital gains at ordinary rates, with a 40% deduction for net capital gain	tyba 12/31/14	---	0.3	2.0	2.4	2.7	3.0	3.3	3.7	4.1	4.4	7.4	26.0
b. Tax dividends at ordinary rates, with a 40% deduction for qualifying dividends	tyba 12/31/14	---	0.7	2.1	2.2	2.2	2.3	2.3	2.3	2.3	2.3	7.2	18.7
3. Conforming amendments related to simplification of individual income tax rates	tyba 12/31/14	*Estimate Included in Item I.A.1.*											
B. Simplification of Tax Benefits for Families													
1. Increase in standard deduction, including phase-out of benefit for all filers with MAGI exceeding certain thresholds [1]	tyba 12/31/14	---	-44.2	-66.0	-70.3	-73.0	-76.3	-79.4	-82.2	-85.8	-89.1	-253.5	-666.2
2. Increase and expansion of child tax credit, including phase-out of credit for taxpayers with MAGI above certain thresholds [1]	tyba 12/31/14	---	-5.0	-45.7	-48.0	-55.1	-72.6	-74.6	-82.3	-84.0	-86.5	-153.9	-554.0
3. Modification of earned income tax credit [1]	tyba 12/31/14	---	0.2	15.9	15.9	16.2	32.5	33.1	33.8	34.4	35.2	48.2	217.2
4. Repeal of deduction for personal exemptions [1]	tyba 12/31/14	---	66.1	99.0	104.2	108.1	112.3	116.6	121.5	126.8	132.6	377.4	987.2
C. Simplification of Education Incentives													
1. American opportunity tax credit [1]	tyba 12/31/14	---	0.3	5.4	5.8	5.7	-5.3	-4.9	-5.3	-5.3	-5.2	17.2	-8.7
2. Expansion of Pell Grant exclusion from gross income	tyba 12/31/14	*Estimate Included in Item I.C.1.*											
3. Repeal of exclusion of income from United States savings bonds used to pay higher education tuition and fees	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1
4. Repeal of deduction for interest on education loans	tyba 12/31/14	---	0.3	1.5	1.5	1.5	1.6	1.6	1.6	1.6	1.7	4.8	13.0
5. Repeal of deduction for qualified tuition and related expenses	tyba 12/31/13	*Provision Expired December 31, 2013*											
6. No new contributions to Coverdell education savings accounts	cma 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.2
7. Repeal of exclusion for discharge of student loan indebtedness	ada 12/31/14	---	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.4	1.1

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
8. Repeal of exclusion for qualified tuition reductions	tyba 12/31/14	---	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.8	2.5
9. Repeal of exclusion for education assistance programs	apoeia 12/31/14	---	0.2	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.4	3.8	10.5
10. Repeal of exception to 10-percent early distribution tax for higher education expenses	dma 12/31/14	*Estimate Included in Item I.G.6.*											
D. Repeal of Certain Credits for Individuals													
1. Repeal of dependent care credit [1]	tyba 12/31/14	---	[2]	3.1	3.2	3.2	3.2	3.3	3.3	3.3	3.4	9.5	26.0
2. Repeal of credit for adoption expenses	apoia 12/31/14	---	0.1	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	1.7	4.7
3. Repeal of credit for nonbusiness energy property	ppisa 12/31/13	*Provision Expired December 31, 2013*											
4. Repeal of credit for residential energy efficient property	ppisa 12/31/14	---	0.5	1.1	0.6	---	---	---	---	---	---	2.3	2.3
5. Repeal of credit for qualified electric vehicles	vaa 12/31/11	*Provision Expired December 31, 2011*											
6. Repeal of alternative motor vehicle credit	ppa 12/31/14	*Provision Expires December 31, 2014*											
7. Repeal of alternative fuel vehicle refueling property credit	ppisa 12/31/14	*Provision Expires December 31, 2014*											
8. Repeal of credit for new qualified plug-in electric drive motor vehicles	vaa 12/31/14	---	0.1	0.3	0.4	0.6	0.7	0.8	0.7	0.7	0.6	1.4	5.0
9. Repeal of credit for health insurance costs of eligible individuals	mba 12/31/13	*Provision Expired December 31, 2013*											
10. Repeal of first-time homebuyer credit	rpa 6/30/11	*Provision Expired December 31, 2010*											
E. Deductions, Exclusions and Certain Other Provisions													
1. Changes to certain itemized deductions [1]	tyba 12/31/14	---	48.0	82.9	85.9	92.1	97.5	103.3	109.8	116.1	122.9	309.0	858.4
2. Exclusion of gain from sale of a principal residence	saea 12/31/14	---	0.6	1.3	1.7	1.8	1.9	2.0	2.1	2.2	2.3	5.5	15.8
3. Mortgage interest (includes lodging allowance exemption limitation)	tyba 12/31/14	*Estimate Included in Item I.E.1.*											
4. Charitable contributions	cmi tyba 12/31/14	*Estimate Included in Item I.E.1.*											
5. Denial of deduction for expenses attributable to the trade or business of being an employee	tyba 12/31/14	*Estimate Included in Item I.E.1.*											
6. Repeal of deduction for taxes not paid or accrued in a trade or business	tyba 12/31/14	*Estimate Included in Item I.E.1.*											
7. Repeal of deduction for personal casualty losses	tyba 12/31/14	*Estimate Included in Item I.E.1.*											
8. Limitation on wagering losses	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1
9. Repeal of deduction for tax preparation expenses	tyba 12/31/14	*Estimate Included in Item I.E.1.*											
10. Repeal of deduction for medical expenses	tyba 12/31/14	*Estimate Included in Item I.E.1.*											
11. Repeal of disqualification of expenses for over-the-counter drugs under certain accounts and arrangements [3]	eia 12/31/14	---	-0.2	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.5	-0.5	-1.1	-3.3
12. Repeal of deduction for alimony payments and corresponding inclusion in gross income	dosaeia 12/31/14	---	0.1	0.2	0.3	0.4	0.6	0.7	0.9	1.1	1.2	1.0	5.5
13. Repeal of deduction for moving expenses	tyba 12/31/14	---	0.5	0.7	0.8	0.8	0.9	1.0	1.0	1.1	1.2	2.9	8.0
14. Termination of deduction and exclusions for contributions to Archer medical savings accounts	tyba 12/31/14	*Negligible Revenue Effect*											

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
15. Repeal of 2-percent floor on miscellaneous itemized deductions	tyba 12/31/14	*Estimate Included in Item I.E.1.*											
16. Repeal of overall limitation on itemized deductions	tyba 12/31/14	*Estimate Included in Item I.E.1.*											
17. Deduction for amortizable bond premium allowed in determining adjusted gross income	tyba 12/31/14	---	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
18. Repeal of exclusion, etc., for employee achievement awards [5]	tyba 12/31/14	---	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.5	1.3	3.4
19. Clarification of special rule for certain governmental plans	pa DOE	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
20. Limitation on exclusion for employer-provided housing	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
21. Fringe benefits [6] [7]	tyba 12/31/14	---	2.7	3.8	4.1	4.3	4.5	4.6	4.8	5.0	5.1	15.0	39.0
22. Repeal of exclusion of net unrealized appreciation in employer securities	da 12/31/14	---	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.9
23. Consistent basis reporting between estate and person acquiring property from decedent	tfwaetrifa DOE	[2]	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.6	1.6
F. Employment Tax Modifications													
1. Modifications of deduction for Social Security taxes in computing net earnings from self-employment [8]	tyba 12/31/14	---	0.4	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	2.0	5.1
2. Determination of net earnings from self-employment [9]	tyba 12/31/14	---	0.3	0.9	1.2	1.5	1.7	1.9	2.2	2.6	2.9	4.0	15.3
3. Repeal of exemption from FICA taxes for certain foreign workers [10]	rrfspa 12/31/14	---	0.5	0.8	0.8	0.8	0.9	0.9	1.0	1.0	1.1	2.9	7.7
4. Repeal of exemption from FICA taxes for certain students [11]	rrfspa 12/31/14	---	0.9	1.2	1.3	1.4	1.5	1.5	1.6	1.7	1.8	4.8	13.0
5. Override of Treasury guidance providing that certain employer-provided supplemental unemployment benefits are not subject to employment taxes [12]	generally Apa 12/31/14	[4]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.9
6. Treatment of certified professional employer organizations	[13]	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
G. Pensions and Retirement													
1. Elimination of income limits on contributions to Roth IRAs	tyba 12/31/14	---	1.1	2.3	2.2	2.1	2.0	1.9	1.8	1.7	1.6	7.7	16.7
2. No new contributions to traditional IRAs [1]	tyba 12/31/14	*Estimate Included in Item I.G.1.*											
3. Inflation adjustment for Roth IRA contributions	tyba 12/31/14	*Estimate Included in Item I.G.1.*											
4. Repeal of special rule permitting recharacterization of Roth IRA contributions as traditional IRA contributions	tyba 12/31/14	[2]	[2]	[2]	[2]	[2]	0.1	0.1	0.1	0.1	0.1	0.2	0.4
5. Repeal of exception to 10-percent early distribution tax for first home purchases; and elimination of first time home purchase as a basis for a distribution from a Roth IRA being a qualified distribution	da 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.3
6. Termination for new SEPs	tyba 12/31/14	---	[2]	[2]	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.6

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
7. Termination for new Simple 401(k)s	pyba 12/31/14	Estimate Included in Item I.G.6.											
8. Rules related to designated Roth contributions	cyba pyba tyba 12/31/14	---	10.3	14.7	15.1	15.6	16.0	16.9	17.7	18.4	18.9	55.8	143.7
9. Modifications of required distribution rules for pension plans	generally dwrteda 12/31/14	---	[2]	[2]	0.1	0.2	0.4	0.7	0.7	0.7	0.7	0.4	3.5
10. In-service distribution age lowered to 59 1/2 for pension plans and governmental 457(b) plans	da 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.2
11. Modification of rules governing hardship distributions	pyba 12/31/14	Negligible Revenue Effect											
12. Extended rollover period for the rollover of plan loan offset amounts in certain cases	tyba 12/31/14	Negligible Revenue Effect											
13. Coordination of contribution limitations for 403(b) plans and governmental 457(b) plans	pya tyba 12/31/14	---	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.9
14. Application of 10-percent early distribution tax to governmental 457 plans	wo/a 2/26/14	---	[2]	[2]	[2]	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.6
15. Inflation adjustments for qualified plan benefit and contribution limitations	yewowa cyba 2014	---	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.7	1.8
16. Inflation adjustments for qualified plan elective deferral limitations [14]	pya tyba 12/31/14	---	1.1	2.1	3.7	4.7	6.3	7.8	9.8	11.5	13.6	11.6	60.5
17. Inflation adjustments for SIMPLE retirement accounts	cyba 2014	---	[2]	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.3	1.1
18. Inflation adjustments for catch-up contributions for certain employer plans	pya tyba 12/31/14	Estimate Included in Item I.G.16											
19. Inflation adjustments for governmental and tax-exempt organization plans	tyba 12/31/14	Estimate Included in Item I.G.16											
H. Certain Provisions Related to Members of Indian Tribes													
1. Indian general welfare benefits	DOE	Negligible Revenue Effect											
2. Tribal Advisory Committee	DOE	Estimate Included in Item I.H.1											
3. Other relief for Indian tribes	DOE	Estimate Included in Item I.H.1											
Total of Tax Reform for Individuals		**---**	**43.5**	**70.5**	**77.2**	**77.6**	**76.8**	**84.5**	**94.4**	**100.9**	**117.4**	**268.9**	**743.4**
II. Alternative Minimum Tax Repeal													
1. Repeal of alternative minimum tax on individuals	tyba 12/31/14	---	-12.0	-147.9	-135.8	-147.4	-157.2	-166.7	-177.2	-188.6	-198.9	-443.2	-1,331.8
2. Repeal of alternative minimum tax on corporations	tyba 12/31/14	---	-9.0	-20.1	-19.7	-15.5	-12.1	-9.9	-8.3	-7.8	-8.0	-64.0	-110.2
Total of Alternative Minimum Tax Repeal		**---**	**-21.0**	**-168.0**	**-155.5**	**-162.9**	**-169.3**	**-176.6**	**-185.5**	**-196.4**	**-206.9**	**-507.2**	**-1,442.0**
III. Business Tax Reform													
A. Tax Rates													
1. Phase-in 25-percent corporate tax rate	tyba 12/31/14	8.1	-14.3	-31.9	-55.4	-76.1	-97.5	-96.2	-104.3	-105.5	-107.3	-169.5	-680.3
B. Reform of Business-Related Exclusions and Deductions													
1. Revision of treatment of contributions to capital	cmateia DOE	1.4	1.5	1.3	1.1	0.9	0.7	0.6	0.5	0.5	0.5	6.1	8.8
2. Repeal of deduction for local lobbying expenses	apoia 12/31/14	---	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.6

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
3. Expenditures for repairs in connection with casualty losses	lsa 12/31/14	Negligible Revenue Effect											
4. Reform of accelerated cost recovery system (with indexing for inflation) [15]	ppisa 12/31/16	-2.5	-9.0	-1.0	26.0	45.9	50.6	47.2	42.4	36.8	33.1	59.4	269.5
5. Repeal amortization of pollution control facilities	fpisa 12/31/14	---	0.1	0.5	1.0	1.2	1.4	1.4	1.0	0.7	0.5	2.9	7.9
6. Net operating loss deduction	tyba 12/31/14	---	5.7	8.5	8.2	7.6	7.6	7.9	8.0	8.2	8.4	30.2	70.5
7. Circulation expenditures	apoii tyba 12/31/15	---	---	0.2	0.3	0.2	[2]	-0.1	[4]	[2]	[2]	0.6	0.6
8. Amortization of research and experimental expenditures	apoii tyba 12/31/14	---	19.0	25.2	23.0	20.6	18.1	20.5	21.6	21.9	22.8	87.8	192.6
9. Repeal of deductions for soil and water conservation expenditures and endangered species recovery expenditures	apoia 12/31/14	---	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.8
10. Amortization of certain advertising expenses (with phaseout of exemption)	apoii tyba 12/31/14	---	6.1	14.7	19.2	23.7	25.2	23.3	21.2	19.0	16.7	63.7	169.0
11. Expensing certain depreciable business assets for small business	tyba 12/31/13	-5.6	-10.1	-8.3	-7.3	-6.0	-4.5	-3.6	-3.3	-2.9	-3.3	-37.3	-54.9
12. Repeal of election to expense certain refineries	ppisa 12/31/13	Provision Expired December 31, 2013											
13. Repeal of deduction for energy efficient commercial buildings	ppisa 12/31/13	Provision Expired December 31, 2013											
14. Repeal of election to expense advanced mine safety equipment	ppisa 12/31/13	Provision Expired December 31, 2013											
15. Repeal of deduction for expenditures by farmers for fertilizer, etc	epoii tyba 12/31/14	---	1.4	1.0	0.4	0.1	0.1	0.1	0.1	0.1	0.1	2.9	3.4
16. Repeal of special treatment of certain qualified film and television productions	pca 12/31/13	Provision Expired December 31, 2013											
17. Repeal of special rules for recoveries of damages of antitrust violations, etc	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
18. Treatment of reforestation expenditures	epoii tyba 12/31/14	---	0.2	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.5	1.4
19. 20-year amortization of goodwill and certain other intangibles	paa 12/31/14	---	0.3	0.8	1.0	1.2	1.5	1.8	2.0	2.3	2.1	3.3	13.0
20. Treatment of environmental remediation costs	epoia 12/31/14	---	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
21. Repeal of expensing of qualified disaster expenses	apoia 12/31/14	No Revenue Effect											
22. Phaseout and repeal of deduction for income attributable to domestic production activities	tyba 12/31/14	---	2.5	9.3	15.2	16.9	15.2	14.0	14.0	14.2	14.5	43.9	115.8
23. Unification of deduction for organizational expenditures	epoii tyba 12/31/14	---	[4]	[4]	[4]	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.6
24. Prevention of arbitrage of deductible interest expense and tax-exempt interest income	generally tyba 12/31/14 & oio/a 2/26/14	[4]	-0.1	[4]	0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.2	1.6
25. Prevention of transfer of certain losses from tax indifferent parties	saea 12/31/14	[16]	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.7
26. Entertainment, etc. expenses [17]	apoia 12/31/14	---	1.2	1.6	1.6	1.6	1.7	1.7	1.7	1.8	1.8	6.0	14.7
27. Repeal of limitation on corporate acquisition indebtedness	ipoiwrtiia 12/31/14	---	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	-0.1	-0.1

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
28. Denial of deductions and credits for expenditures in illegal businesses	apoia DOE in tyea DOE	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
29. Limitation on deduction for FDIC premiums	tyba 12/31/14	---	0.9	1.3	1.3	1.3	1.4	1.4	1.5	1.5	1.6	4.8	12.2
30. Repeal of percentage depletion	tyba 12/31/14	---	0.5	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	2.4	5.3
31. Repeal of passive activity exception for working interests in oil and gas property	tyba 12/31/14	[16]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.1
32. Repeal of special rules for gain or loss on timber, coal, or domestic iron ore	tyba 12/31/14	*Estimate Included in Item I.A.1.*											
33. Repeal of like-kind exchanges	generally ta 12/31/14	[16]	0.6	1.1	1.7	2.4	3.5	4.8	6.5	8.7	11.7	5.8	40.9
34. Restriction on trade or business property treated as similar or related in service to involuntarily converted property in disaster areas	dda 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1
35. Repeal of rollover of publicly traded securities gain into specialized small business investment companies	sa 12/31/14	---	[2]	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.5	1.3
36. Termination of special rules for gain from certain small business stock	saea DOE	---	[4]	-0.1	-0.1	-0.1	0.8	1.0	1.0	1.1	1.2	-0.2	4.8
37. Certain self-created property not treated as a capital asset	Da 12/31/14	---	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.6
38. Repeal of special rule for sale or exchange of patents	Da 12/31/14	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.2
39. Depreciation recapture on gain from disposition of certain depreciable realty	Da 12/31/14	*Estimate Included in Item I.A.1.*											
40. Common deduction conforming amendments	various	*No Revenue Effect*											
C. Reform of Business Credits													
1. Repeal of credit for alcohol, etc., used as fuel [18]	fsoua 12/31/13	*Provision Expired December 31, 2013*											
2. Repeal of credit for biodiesel and renewable diesel used as fuel	fsoua 12/31/13	*Provision Expired December 31, 2013*											
3. Research credit modified and made permanent	tyba 12/31/13 & apoia 12/31/13	-1.1	-1.9	-2.4	-2.9	-3.3	-3.7	-4.1	-4.5	-4.9	-5.3	-11.6	-34.1
4. Modify low-income housing program and repeal 4% credits	caa 12/31/14	---	[2]	0.2	0.4	0.8	1.1	1.5	1.9	2.2	2.6	1.4	10.7
5. Repeal of enhanced oil recovery credit	DOE	*No Revenue Effect*											
6. Phaseout and repeal of electricity produced from certain renewable resources	earcpasa 12/31/14, tybbo/a DOE, & earcpasa 12/31/14	---	0.6	1.2	1.3	1.3	1.3	1.2	1.0	0.9	0.9	4.4	9.6
7. Repeal of Indian employment credit	tyba 12/31/13	*Provision Expired December 31, 2013*											
8. Repeal of credit for portion of employer Social Security taxes paid with respect to employee cash tips	tfspa 12/31/14	---	0.5	0.9	1.0	1.1	1.2	1.2	1.3	1.4	1.4	3.6	10.1
9. Repeal of credit for clinical testing expenses for certain drugs for rare diseases or conditions	apoii tyba 12/31/14	[4]	0.6	0.9	1.0	1.0	1.1	1.1	1.1	1.2	1.2	3.4	9.1
10. Repeal of credit for small employer pension plan startup costs	cpoia 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
11. Repeal of employer-provided child care credit	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.2
12. Repeal of railroad track maintenance credit	tyba 12/31/13	*Provision Expired December 31, 2013*											

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
13. Repeal of credit for production of low sulfur diesel fuel	epoii tyba 12/31/14	*No Revenue Effect*											
14. Repeal of credit for producing oil and gas from marginal wells	tyba 12/31/14	*No Revenue Effect*											
15. Repeal of credit for production from advanced nuclear power facilities	epasa 12/31/14	---	---	0.1	0.1	0.1	0.1	[2]	[2]	[2]	[2]	0.3	0.6
16. Repeal of credit for producing fuel from a nonconventional source	fpasa 12/31/13	*Provision Expired December 31, 2009*											
17. Repeal of new energy efficient home credit	haa 12/31/13	*Provision Expired December 31, 2013*											
18. Repeal of energy efficient appliance credit	apa 12/31/13	*Provision Expired December 31, 2013*											
19. Repeal of mine rescue team training credit	tyba 12/31/13	*Provision Expired December 31, 2013*											
20. Repeal of agricultural chemicals security credit	apoia 12/31/12	*Provision Expired December 31, 2012*											
21. Repeal of credit for carbon dioxide sequestration	tyba 12/31/14	---	[2]	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.4	1.1
22. Repeal of credit for employee health insurance expenses of small employers [1]	apoif tyba 12/31/14	---	1.0	1.4	1.0	1.3	1.3	1.4	1.5	1.6	1.7	4.6	12.2
23. Repeal of rehabilitation credit	[19]	---	0.3	0.7	0.8	1.1	1.4	1.5	1.5	1.6	1.6	2.9	10.5
24. Repeal of energy credit	ppisa 12/31/16	*Provision Expires December 31, 2016*											
25. Repeal of qualifying advanced coal project credit	aara 12/31/14	---	0.1	0.1	0.2	0.2	0.2	0.1	[2]	[2]	[2]	0.6	0.9
26. Repeal qualifying gasification project credit	aara 12/31/14	---	0.1	0.1	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.2	0.3
27. Repeal of qualifying advanced energy project credit	aara 12/31/14	---	0.1	[2]	[2]	[2]	[2]	[4]	[4]	[4]	[4]	0.4	0.3
28. Repeal of qualifying therapeutic discovery project credit	aara 12/31/14	*Provision Generally Expired December 31, 2010*											
29. Repeal of work opportunity tax credit	apoitiwbwftea 12/31/13	*Provision Expired December 31, 2013*											
30. Repeal of deduction for certain unused business credits	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.1
D. Accounting Methods													
1. Limitation on use of cash method of accounting	tyba 12/31/14	---	0.5	1.1	0.3	0.9	1.6	3.1	4.3	6.9	5.0	2.8	23.6
2. Rules for determining whether taxpayer has adopted a method of accounting	tyba 12/31/14	*Negligible Revenue Effect*											
3. Certain special rules for taxable year of inclusion	[20]	---	1.7	2.7	2.1	2.0	0.8	0.2	0.2	0.3	0.3	8.6	10.4
4. Installment sales	saoda 12/31/14	---	0.2	0.4	0.2	[2]	[2]	0.1	0.1	0.1	0.1	0.8	1.1
5. Repeal of special rule for prepaid subscription income	pra 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.2	0.2
6. Repeal of special rule for prepaid dues income of certain membership organizations	pra 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.2	0.2
7. Repeal of special rule for magazines, paperbacks, and records returned after close of the taxable year	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.2	0.2
8. Modification of rules for long-term contracts	ceia 12/31/14	---	0.6	1.8	1.5	0.7	0.4	0.3	0.4	0.4	0.4	4.6	6.5
9. Nuclear decommissioning reserve funds	tyba 12/31/14	---	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.6	1.2
10. Repeal of last-in, first-out method of inventory	tyba 12/31/14	---	0.9	1.7	1.7	1.6	4.8	9.7	14.6	26.1	18.0	5.9	79.1
11. Repeal of lower of cost or market method of inventory	tyba 12/31/14	---	[2]	0.1	0.1	0.1	0.2	0.5	0.7	1.3	0.9	0.3	3.8

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
12. Modification of rules for capitalization and inclusion in inventory costs of certain expenses	tyba 12/31/14	---	-0.3	-0.6	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-1.9	-4.5
13. Modification of income forecast method	ppisa 12/31/14	---	0.2	0.1	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.3	0.5
14. Repeal of averaging of farm income	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.3
15. Treatment of patent or trademark infringement awards	prptjasa 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.1
16. Repeal of redundant rules with respect to carrying charges	apoia 12/31/14	Negligible Revenue Effect											
17. Repeal of recurring item exception for spudding of oil or gas wells	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.2
E. Financial Instruments													
1. Treatment of certain derivatives	[21]	---	0.1	0.8	1.6	2.2	2.4	2.5	2.3	2	1.8	4.7	15.7
2. Modification of certain rules related to hedges	teia 12/31/14	Negligible Revenue Effect											
3. Current inclusion in income of market discount	oaa 12/31/14	---	[2]	[2]	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.2	0.9
4. Treatment of certain exchanges of debt instruments	ta 12/31/14	---	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.3	-0.8
5. Coordination with rules for inclusion not later than for financial accounting purposes	tyba 12/31/14	---	1.1	2.2	2.1	1.9	1.1	0.3	0.3	0.3	0.3	7.3	9.5
6. Rules regarding certain government debt	DOE	Negligible Revenue Effect											
7. Cost basis of specified securities determined without regard to identification	seaoda 12/31/14	[2]	0.3	0.6	0.6	0.3	0.4	0.4	0.4	0.4	0.4	1.9	3.8
8. Wash sales by related parties	saoda 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.1
9. Nonrecognition for derivative transactions by a corporation with respect to its stock	teia DOE	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.2
10. Termination of private activity bonds	bia 12/31/14	-0.2	-0.6	-0.4	0.7	1.8	2.7	3.7	4.5	5.4	6.2	1.4	23.9
11. Termination of credit for interest on certain home mortgages	tyea 12/31/14	Estimate Included in Item III.E.10.											
12. Repeal of advance refunding bonds	ar bia 12/31/14	[4]	-0.3	[2]	0.7	1.0	1.2	1.3	1.4	1.5	1.5	1.4	8.3
13. Repeal of tax credit bond rules [1]	bia DOE	[2]	[2]	0.1	0.1	0.2	0.3	0.3	0.4	0.4	0.4	0.5	2.2
F. Insurance Reforms													
1. Exception to pro rata interest expense disallowance for corporate owned life insurance restricted to 20-percent owners	cia 12/31/14	---	0.1	0.3	0.6	0.8	0.9	1.0	1.1	1.2	1.3	1.8	7.3
2. Net operating losses of life insurance companies	tyba 12/31/14	---	0.1	0.1	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.2	0.3
3. Repeal of small life insurance company deduction	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.2	0.3
4. Computation of life insurance tax reserves	tyba 12/31/14	---	0.8	2.8	3.1	3.2	3.2	3.2	3.2	2.9	2.1	9.9	24.5
5. Adjustment for change in computing reserves	tyba 12/31/14	---	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.0	2.5
6. Modification of rules for life insurance proration for purposes of determining the dividends received deduction	tyba 12/31/14	---	0.2	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.6	1.7	4.5
7. Repeal of special rule for distributions to shareholders from pre-1984 policyholders surplus account	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
8. Modification of proration rules for property and casualty insurance companies	tyba 12/31/14	---	0.1	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.4	1.0	2.9

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
9. Repeal of special treatment of Blue Cross and Blue Shield organizations, etc.	tyba 12/31/14 & tyba 12/31/16	---	0.2	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.6	1.4	4.0
10. Modification of discounting rules for property and casualty insurance companies	tyba 12/31/14	---	0.6	2.2	2.5	2.6	2.6	2.6	2.6	1.9	0.3	7.9	17.9
11. Repeal of special estimated tax payments	tyba 12/31/14	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
12. Capitalization of certain policy acquisition expenses	tyba 12/31/14	---	0.5	1.9	1.8	1.6	1.5	1.3	1.2	1.0	0.9	5.8	11.7
13. Tax reporting for life settlement transactions	generally tyba 12/31/14	---	[4]	[4]	[2]	[2]	[2]	[2]	[2]	0.1	0.1	[2]	0.2
14. Clarification of tax basis of life insurance contracts	generally teia 8/25/09	*Estimate Included in Item III.F.13.*											
15. Exception to transfer for valuable consideration rules	ta 12/31/14	*Estimate Included in Item III.F.13.*											
G. Pass-Thru and Certain Other Entities													
1. Reduced recognition period for built-in gains made permanent	tyba 12/31/13	-0.2	-0.2	-0.3	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-1.4	-3.0
2. Modifications to S corporation passive investment income rules	tyba 12/31/14	[16]	-0.1	-0.3	-0.3	-0.4	-0.4	-0.5	-0.5	-0.5	-0.5	-1.1	-3.6
3. Expansion of qualifying beneficiaries of an electing small business trust	1/1/15	[16]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	-0.1
4. Charitable contribution deduction for electing small business trusts	tyba 12/31/14	[16]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	-0.1
5. Permanent rule regarding basis adjustment to stock of S corporations making charitable contributions of property	cmi tyba 12/31/13	[4]	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.4	-1.1
6. Extension of time for making S corporation elections	tyba ora 12/31/14	[16]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
7. Relocation of C corporation definition	DOE	*No Revenue Effect*											
8. Repeal of rules relating to guaranteed payments and liquidating distributions	tyba 12/31/14	[16]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.3
9. Mandatory adjustments to basis of partnership property in case of transfer of partnership interests	ta 12/31/14	[16]	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.3	1.1
10. Mandatory adjustments to basis of undistributed partnership property	da 12/31/14	*Estimate Included in Item III.G.9.*											
11. Corresponding adjustments to basis of properties held by partnership where partnership basis adjusted	toda 12/31/14	*Estimate Included in Item III.G.9.*											
12. Charitable contributions and foreign taxes taken into account in determining limitation on allowance of partner's share of loss	tyba 12/31/14	[16]	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.9
13. Revisions related to unrealized receivables and inventory items	da 12/31/14 & tyba 12/31/14	[16]	[2]	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.8
14. Repeal of time limitation on taxing precontribution gain	Pca 12/31/14	[16]	[16]	[16]	[16]	[16]	[16]	[16]	0.1	0.1	0.2	[16]	0.4
15. Partnership interests created by gift	tyba 12/31/14	[16]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	[2]	[2]	0.5	0.8
16. Repeal of technical termination of partnerships	tyba 12/31/14	[16]	[2]	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.5
17. Publicly traded partnership exception restricted to mining and natural resources partnerships	tyba 12/31/16	[16]	[16]	[16]	0.4	0.6	0.6	0.6	0.7	0.7	0.7	1.0	4.3

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
18. Ordinary income treatment in the case of partnership interests held in connection with performance of services (with exception for real estate)........................	tyba 12/31/14	0.2	0.1	0.3	0.5	0.5	0.4	0.3	0.3	0.2	0.2	1.6	3.1
19. Partnership audits and adjustments..	generally rffp tyea 12/31/14	[16]	0.8	1.2	1.3	1.4	1.5	1.6	1.7	1.9	2.0	4.7	13.4
20. Immediate recognition of certain built-in-gains and prevention of tax-free spinoffs involving REITs............	generally 2/26/14	[2]	0.2	0.3	0.4	0.5	0.6	0.7	0.9	1.1	1.2	1.4	5.9
21. Extension of period for prevention of REIT election following revocation or termination.............................	tora 12/31/14	[16]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
22. Certain short-life property not treated as real property for purposes of REIT provisions.................................	tyba 12/31/16	[16]	[2]	[2]	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.6
23. Repeal of special rules for timber held by REITs...........	tyba 12/31/16	[16]	[16]	[16]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.2
24. Limitation on fixed percentage rent and interest exceptions for REIT income tests................................	generally leia & diaa 12/31/14	[16]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
25. Repeal of preferential dividend rule for publicly offered REITs..	di tyba 12/31/14	----------	----------	----------	----------	----------	*Negligible Revenue Effect*	----------	----------	----------	----------	----------	----------
26. Authority for alternative remedies to address certain REIT distribution failures...	di tyba 12/31/14	[16]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
27. Limitations on designation of dividends by REITs.........	di tyba 12/31/14	[16]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
28. Non-REIT earnings and profits required to be distributed by REIT in cash..	dmo/a 2/26/14	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.1
29. Debt instruments of publicly offered REITs and mortgages treated as real estate assets..........................	tyba 12/31/14	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
30. Asset and income test clarification regarding ancillary personal property..	tyba 12/31/14	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
31. Hedging provisions..	tyba 12/31/14	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
32. Modification of REIT earnings and profits calculation to avoid duplicate taxation..	tyba 12/31/14	[16]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
33. Reduction in percentage limitation on assets of REIT which may be taxable REIT subsidiaries.......................	tyba 12/31/16	[16]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1
34. Treatment of certain services provided by taxable REIT subsidiaries..	tyba 12/31/14	[16]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
35. Study relating to taxable REIT subsidiaries...................	DOE	----------	----------	----------	----------	----------	*No Revenue Effect*	----------	----------	----------	----------	----------	----------
36. C Corporation election to become, or transfer assets to, a RIC or REIT...	eato/a 2/26/14	----------	----------	----------	----------	----------	*Estimate Included in Item III.G.20.*	----------	----------	----------	----------	----------	----------
37. Interests in RICs and REITs not excluded from definition of United States real property interests...........	Da 12/31/14	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1
38. Dividends derived from RICs and REITs ineligible for deduction for United States source portion of dividends from certain foreign corporations...................	dro/a 2/26/14	[2]	[2]	[2]	[2]	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.5
39. Exclusion of dividends from controlled foreign corporations from the definition of personal holding company income for purposes of the personal holding company rules........	tyba 12/31/14	[4]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
H. Taxation of Foreign Persons													
1. Prevention of avoidance of tax through reinsurance with non-taxed affiliates	tyba 12/31/14	---	0.4	0.9	0.9	0.9	1.0	1.0	1.1	1.2	1.3	3.1	8.7
2. Taxation of passenger cruise gross income of foreign corporations and nonresident alien individuals	tyba 12/31/14	---	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.9
3. Restriction on insurance business exception to passive foreign investment company rules	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.1	0.1	0.1	0.4
4. Modification of limitation on earnings stripping	tyba 12/31/14	---	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.2	2.9
5. Limitation on treaty benefits for certain deductible payments	pma DOE	0.1	0.4	0.6	0.7	0.7	0.7	0.8	0.8	0.8	1.3	2.5	6.9
I. Provisions Related to Compensation													
1. Nonqualified deferred compensation	aat spa 12/31/14	-1.3	-0.3	0.6	-0.2	0.7	1.7	1.8	1.6	2.8	1.8	-0.5	9.2
2. Modification of limitation on excessive employee remuneration	tyba 12/31/14	0.4	0.7	2.2	2.0	1.7	1.4	1.1	1.0	0.9	0.8	7.0	12.1
3. Excise tax on excess tax-exempt organization executive compensation	tyba 12/31/14	---	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4	1.7	4.0
4. Denial of deduction as research expenditure for stock transferred pursuant to an incentive stock option	sto/a 2/26/14	*Negligible Revenue Effect*											
5. Determination of worker classification [22]	spa 12/31/14	---	-0.1	-0.2	-0.3	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.8	-2.6
J. Zones and Short-Term Regional Benefits													
1. Repeal of provisions relating to Empowerment Zones and Enterprise Communities	DOE	*Provisions Expired December 31, 2013*											
2. Repeal of DC Zone provisions	DOE	*Provisions Expired December 31, 2011*											
3. Repeal of provisions relating to renewal communities	DOE	*Provisions Expired December 31, 2009*											
4. Repeal of various short-term regional benefits	DOE	*Provisions Expired December 31, 2011*											
Total of Business Tax Reform		**-0.8**	**17.5**	**54.8**	**68.7**	**76.0**	**65.4**	**71.6**	**67.0**	**77.5**	**61.2**	**219.1**	**562.4**
IV. Participation Exemption System for the Taxation of Foreign Income													
A. Establishment of Exemption System													
1. Deduction for dividends received by domestic corporations from certain foreign corporations	[23]	-6.5	-14.7	-19.9	-23.7	-24.0	-23.7	-23.6	-24.4	-25.0	-26.4	-88.8	-212.0
2. Limitation on losses with respect to specified 10-percent owned foreign corporations	dri tyba 12/31/14 & ta 12/31/14	*Estimate Included in Item IV.A.1.*											
3. Treatment of deferred foreign income upon transition to participation exemption system of taxation and modifications to OFL rules [24]	[25]	-1.2	12.3	23.3	20.5	11.6	11.8	16.6	24.8	31.4	19.0	66.5	170.4
4. Look-thru rule for related controlled foreign corporations made permanent	[26]	-0.8	-1.1	-1.2	-1.2	-1.2	-1.3	-1.4	-1.5	-1.7	-1.8	-5.4	-13.1
B. Modifications Related to Foreign Tax Credit System													
1. Repeal of section 902 indirect foreign tax credits; determination of section 960 credit on current year basis	[23]	*Estimate Included in Item IV.A.1.*											

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
2. Foreign tax credit limitation applied by allocating only directly allocable deductions to foreign source income	[23]	*Estimate Included in Item IV.A.1.*											
3. Passive category income expanded to include other mobile income	[23]	*Estimate Included in Item IV.C.1.*											
4. Source of income from sales of inventory determined solely on basis of production activities	tyba 12/31/14	---	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.9	1.8
C. Rules Related to Passive and Mobile Income													
1. Subpart F reform	[23]	-0.1	8.1	14.6	13.8	14.4	13.7	13.1	13.0	12.7	12.3	50.8	115.6
2. Subpart F income to only include low-taxed foreign income	[23]	*Estimate Included in Item IV.C.1.*											
3. Foreign base company sales income	[23]	*Estimate Included in Item IV.C.1.*											
4. Inflation adjustment of de minimis exception for foreign base company income	[23]	*Estimate Included in Item IV.C.1.*											
5. Active financing exception extended with limitation for low-taxed foreign income	[26]	-2.9	-1.6	-2.9	-4.0	-4.6	-2.4	---	---	---	---	-16.0	-18.4
6. Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment	[23]	[2]	[2]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[2]	[2]
7. Foreign intangible income subject to taxation at reduced rate; intangible income treated as subpart F income	[23] & tyba 12/31/14	*Estimate Included in Item IV.C.1.*											
8. Denial of deduction for interest expense of United States shareholders which are members of worldwide affiliated groups with excess domestic indebtedness	tyba 12/31/14	---	2.2	3.8	3.1	3.0	3.0	2.8	2.3	2.0	1.7	12.1	24.0
Total of Participation Exemption System for the Taxation of Foreign Income		**-11.5**	**5.4**	**18.0**	**8.7**	**-0.6**	**1.3**	**7.7**	**14.4**	**19.6**	**5.0**	**20.1**	**68.3**
V. Tax Exempt Entities													
A. Unrelated Business Income Tax													
1. Clarification of unrelated business income tax treatment of State and local retirement plans	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.1
2. Name and logo royalties treated as unrelated business taxable income	tyba 12/31/14	---	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.8	1.8
3. Unrelated business taxable income separately computed for each trade or business activity	tyba 12/31/14	---	0.2	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	1.3	3.2
4. Exclusion of research income limited to publicly available research	tyba 12/31/14	---	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.7
5. Parity of charitable contribution limitation between trusts and corporations	tyba 12/31/14	*Negligible Revenue Effect*											
6. Increased specific deduction	tyba 12/31/14	---	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	-0.1	-0.3

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
7. Repeal of exclusion of gain or loss from disposition of distressed property	paa 12/31/14	*Negligible Revenue Effect*											
8. Qualified sponsorship payments	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
B. Penalties													
1. Increase in information return penalties	irrtbfooa 1/1/15	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1
2. Manager-level accuracy-related penalty on underpayment of unrelated business income tax	tyba 12/31/14	*Negligible Revenue Effect*											
C. Excise Taxes													
1. Modification of intermediate sanctions	tyba 12/31/14	*Negligible Revenue Effect*											
2. Modification of taxes on self-dealing	tyba 12/31/14	*Negligible Revenue Effect*											
3. Excise tax on failure to distribute within 5 years contribution to donor advised fund	generally cma 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
4. Simplification of excise tax on private foundation investment income	tyba 12/31/14	---	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.6	-1.6
5. Repeal of exception for private operating foundation failure to distribute income	tyba 12/31/14	*Negligible Revenue Effect*											
6. Excise tax based on investment income of private colleges and universities	tyba 12/31/14	---	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.6	1.7
D. Requirements for Organizations Exempt from Tax													
1. Repeal of tax-exempt status for professional sports leagues	tyba 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1
2. Repeal of exemption from tax for certain insurance companies and co-op health insurance issuers	tyba 12/31/14	[2]	[2]	[2]	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.7
3. In-State requirement for workmen's compensation insurance organization	pia 12/31/14	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
4. Repeal of Type II and Type III supporting organizations	generally DOE & tyba 12/31/15 feo	[2]	[2]	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.5	1.4
Total of Tax Exempt Entities		**[2]**	**0.5**	**0.7**	**0.8**	**1.0**	**1.0**	**1.0**	**1.0**	**1.0**	**1.0**	**3.0**	**8.0**
VI. Tax Administration and Compliance													
A. IRS Investigation-Related Reforms													
1. Organizations required to notify Secretary of intent to operate as 501(c)(4)	generally ooa 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
2. Declaratory judgments for 501(c)(4) organizations	pfa DOE	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
3. Restriction on donation reporting for certain 501(c)(4) organizations	rff tyba 12/31/13	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
4. Mandatory electronic filing for annual returns of exempt organizations	generally tyba DOE	*No Revenue Effect*											
5. Duty to ensure that IRS employees are familiar with and act in accord with certain taxpayer rights	DOE	*No Revenue Effect*											

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
6. Termination of employment of Internal Revenue Service employees for taking official actions for political purposes	DOE	No Revenue Effect											
7. Release of information regarding the status of certain investigations	DOE	No Revenue Effect											
8. Review of IRS examination selection procedures	DOE	No Revenue Effect											
9. IRS employees prohibited from using personal email accounts for official business	DOE	No Revenue Effect											
10. Moratorium on IRS conferences	DOE	No Revenue Effect											
11. Applicable standard for determinations of whether an organization is operated exclusively for the promotion of social welfare (sunset one year after the date of enactment)	DOE	Negligible Revenue Effect											
B. Taxpayer Protection and Service Reforms													
1. Extend Internal Revenue Service authority to require truncated Social Security numbers on Form W-2	DOE	Negligible Revenue Effect											
2. Free electronic filing	DOE	Negligible Revenue Effect											
3. Pre-populated returns prohibited	DOE	No Revenue Effect											
4. Form 1040SR for seniors	tyba 12/31/14	No Revenue Effect											
5. Increased refund and credit threshold for Joint Committee on Taxation review of C corporation return	DOE	Negligible Revenue Effect											
C. Tax Return Due Date Simplification													
1. Due dates for returns of partnerships, S corporations, and C corporations	generally tyba 12/31/14	---	[4]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1
2. Modification of due dates by regulation	generally tyba 12/31/14	Estimate Included in Item VI.C.1.											
3. Corporations permitted statutory automatic 6-month extension of income tax returns	generally tyba 12/31/14	Estimate Included in Item VI.C.1.											
D. Compliance Reforms													
1. Penalty for failure to file	rrtbfa 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.3
2. Penalty for failure to file correct information returns and provide payee statements	irrtbfa 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1
3. Clarification of 6-year statute of limitations in case of overstatement of basis	[27]	[2]	[2]	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.3	1.1
4. Reform of rules related to qualified tax collection contracts [1]	DOE	[2]	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.8	2.2
5. 100 percent continuous levy on payments to Medicare providers and suppliers	lia DOE	[2]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.7
6. Treatment of refundable credits for purposes of certain penalties	[28]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.1
Total of Tax Administration and Compliance		**[2]**	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**	**0.6**	**0.6**	**0.6**	**1.6**	**4.6**

Provision	Effective	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
VII. Excise Taxes													
1. Repeal of medical device excise tax	sa DOE	-1.6	-2.4	-2.5	-2.7	-2.9	-3.1	-3.3	-3.5	-3.7	-3.8	-12.2	-29.5
2. Modifications relating to oil spill liability trust fund	[29]	---	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.4	1.2
3. Modification relating to inland waterways trust fund financing rate	fua 12/31/14	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.2
4. Excise tax on systemically important financial institutions (.035% quarterly tax rate)	cqba 12/31/14	---	3.1	7.5	9.2	9.8	10.3	10.8	11.3	11.9	12.5	29.6	86.4
5. Clarification of orphan drug exception to annual fee on branded prescription pharmaceutical manufacturers and importers	fiwapda 12/31/13	*No Revenue Effect*											
Total of Excise Taxes		**-1.6**	**0.8**	**5.1**	**6.6**	**7.0**	**7.3**	**7.6**	**8.0**	**8.4**	**8.9**	**17.9**	**58.3**
VIII. Deadwood and Technical Provisions													
A. Repeal of Deadwood	DOE	*No Revenue Effect*											
B. Conforming Amendments Related to Multiple Sections	DOE	*Estimates Included in the Sections to Which the Changes Relate*											
Total of Deadwood and Technical Provisions		***No Revenue Effect***											
NET TOTAL		**-13.9**	**47.1**	**-18.5**	**6.9**	**-1.5**	**-17.2**	**-3.7**	**-0.2**	**11.5**	**-12.8**	**23.5**	**3.0**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. Revenue provisions as submitted in statutory draft CAMP_041.

[Legend and Footnotes for the Revenue Table appear on the following pages]

Legend for the Revenue Table:

Legend for "Effective" column:

aara = allocations and reallocations after
aat = amounts attributable to
ada = amounts discharged after
apa = appliances produced after
Apa = amounts paid after
apoeia = amounts paid or expenses incurred after
apoia = amounts paid or incurred after
apoif = amounts paid or incurred for
apoii = amounts paid or incurred in
apoitiwbwftea = amounts paid or incurred to individuals who begin work for the employer after
ar = advance refunding
bia = bonds issued after
caa = credits allocated after
ceia = contracts entered into after
cia = contracts issued after
cma = contributions made after
cmatcia = contributions made and transactions entered into after
cmi = contributions made in
cpoia = costs paid or incurred after
cqba = calendar quarter beginning after
cyba = calendar years beginning after
Da = dispositions after
da = distributions after
dda = disasters declared after
dwrteda = distributions with respect to employees dying after
di = distributions in
diaa = debt instruments acquired after
dma = distributions made after
dmo/a = distributions made on or after
DOE = date of enactment
dosacia = divorce or separation agreement entered into after
dro/a = dividends received on or after
dri = dividends received in
ea = expenditures after
earcpasa = electricity and refined coal produced and sold after
eato/a = elections and transfers on or after
eia = expenses incurred after
epasa = electricity produced and sold after
epoia = expenses paid or incurred after
epoii = expenses paid or incurred in
feo = for existing organizations
fiwapda = fees imposed with annual payment dates after
fpasa = fuel produced and sold after
fpisa = facilities placed in service after
fsoua = fuel sold or used after
fua = fuel used after
haa = homes acquired after
ipoiwrtiia = interest paid or incurred with respect to indebtedness incurred after
irrtbfooa = information returns required to be filed on or after
irrtbfa = information returns required to be filed after
leia = leases entered into after
lia = levies issued after
lsa = losses sustained after
mba = months beginning after
oaa = obligations acquired after
ooa = organizations organized after
oio/a = obligations issued on or after
ora = or revocations after
pa = payments after
paa = property acquired after
pca = productions commencing after
Pca = property contributed after
pfa = pleadings filed after
pia = policies issued after
pma = payments made after
ppa = property purchased after
ppisa = property placed in service after
pra = payments received after
prptjasa = payments received pursuant to judgments and settlements after
pyba = plan years beginning after
pya = plan years and
rff = returns filed for
rffp = returns filed for partnership
rpa = residences purchased after
rrfspa = remuneration received for services performed after
rrtbfa = returns required to be filed after
sa = sales after
saea = sales and exchanges after
saoda = sales and other dispositions after
seaoda = sales, exchanges, and other dispositions after
spa = services performed after
sto/a = stock transferred on or after
ta = transfers after
teia = transactions entered into after
tfwaetrifa = transfers for which an estate tax return is filed after
toda = transfers or distributions after
tora = terminations or revocations after
tfspa = tips for services performed after
tyba = taxable years beginning after
tybbo/a = taxable years beginning before, on, or after
tyea = taxable years ending after
yewowa = years ending with or within a
vaa = vehicles acquired after
wo/a = withdrawals on or after

[Footnotes for the Revenue Table appear on the following pages]

Footnotes for the Revenue Table:

[1] Estimate includes the following outlay effects:	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
Simplification of individual income tax rates:												
Eliminate HOH status	---	---	-2.2	-2.5	-2.8	-2.6	-2.6	-2.7	-2.8	-2.9	-7.5	-21.1
10% and 25% income tax rate brackets	---	---	3.0	4.3	4.6	4.5	4.6	4.6	4.6	4.7	11.9	35.0
Use alternative inflation measure	---	---	-0.3	-0.6	-1.2	-1.3	-1.7	-2.3	-2.7	-3.3	-2.1	-13.5
Increase in standard deduction, including phase-out of benefit for all filers with MAGI exceeding certain thresholds	---	---	9.1	10.9	11.4	10.8	11.1	11.3	11.5	11.8	31.4	87.9
Increase and expansion of child tax credit, including phase-out of credit for taxpayers with MAGI above certain thresholds	---	---	20.3	20.6	24.0	39.9	39.9	43.7	43.8	43.9	65.0	276.1
Modification of earned income tax credit	---	---	-36.5	-36.5	-37.0	-51.5	-52.6	-53.6	-54.5	-55.8	-110.0	-378.0
Repeal of deduction for personal exemptions	---	-5.0	-18.9	-15.8	-15.6	-14.0	-14.3	-14.5	-14.8	-15.2	-55.3	-128.1
American opportunity tax credit	---	---	1.7	1.5	1.3	6.7	6.5	6.9	6.8	6.8	4.5	38.1
Repeal of dependent care credit	---	---	-0.8	-0.8	-0.8	-0.7	-0.7	-0.7	-0.7	-0.7	-2.4	-6.0
Changes to certain itemized deductions	---	---	-0.6	-0.5	-0.5	-0.5	-0.6	-0.6	-0.7	-0.7	-1.7	-4.7
No new contributions to traditional IRAs	---	---	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3	-0.2	-0.2	-0.7	-1.9
Repeal of credit for employee health insurance expenses of small employers	---	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.4	-1.1
Repeal of tax credit bond rules	[4]	[4]	-0.1	-0.2	-0.2	-0.3	-0.4	-0.4	-0.5	-0.5	-0.5	-2.6
Reform of rules related to qualified tax collection contracts	[2]	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.8	2.2

[2] Gain of less than $50 million.

[3] Estimate includes the following off-budget	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
effects	[4]	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.3	-0.9

[4] Loss of less than $50 million.

[5] Estimate includes the following budget effects:	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
Total Revenue Effects	---	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.5	1.3	3.4
On-budget effects	---	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.8	2.1
Off-budget effects	---	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.5	1.3

[6] Includes denial of deduction for transportation fringes from item III.B.26.

[7] Estimate includes the following budget effects:	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
Total Revenue Effects	---	2.7	3.8	4.1	4.3	4.5	4.6	4.8	5.0	5.1	15.0	39.0
On-budget effects	---	1.8	2.5	2.7	2.8	2.9	3.1	3.2	3.3	3.4	9.9	25.8
Off-budget effects	---	0.9	1.3	1.4	1.5	1.5	1.6	1.6	1.7	1.7	5.1	13.3

[8] Estimate includes the following budget effects:	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
Total Revenue Effects	---	0.4	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	2.0	5.1
On-budget effects	---	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	1.4	3.6
Off-budget effects	---	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.6	1.5

[9] Estimate includes the following budget effects:	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
Total Revenue Effects	---	0.3	0.9	1.2	1.5	1.7	1.9	2.2	2.6	2.9	4.0	15.3
On-budget effects	---	1.4	2.6	2.8	3.0	3.2	3.3	3.5	3.8	4.0	9.8	27.6
Off-budget effects	---	-1.0	-1.7	-1.6	-1.5	-1.5	-1.4	-1.3	-1.2	-1.1	-5.9	-12.3

[Footnotes for the Revenue Table are continued on the following pages]

Footnotes for the Revenue Table continued:

[10] Estimate includes the following budget effects:	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
Total Revenue Effects	---	0.5	0.8	0.8	0.8	0.9	0.9	1.0	1.0	1.1	2.9	7.7
On-budget effects	---	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.6	1.5
Off-budget effects	---	0.4	0.6	0.6	0.7	0.7	0.7	0.8	0.8	0.9	2.4	6.3

[11] Estimate includes the following budget effects:	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
Total Revenue Effects	---	0.9	1.2	1.3	1.4	1.5	1.5	1.6	1.7	1.8	4.8	13.0
On-budget effects	---	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.5	1.3
Off-budget effects	---	0.8	1.1	1.2	1.2	1.3	1.4	1.5	1.6	1.6	4.3	11.7

[12] Estimate includes the following budget effects:	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
Total Revenue Effects	[4]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.9
On-budget effects	[4]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1
Off-budget effects	[4]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.8

[13] Effective for wages for services performed on or after January 1 of the first calendar year beginning more than 12 months after date of enactment.

[14] Estimate includes the following budget effects:	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
Total Revenue Effects	---	1.1	2.1	3.7	4.7	6.3	7.8	9.8	11.5	13.6	11.6	60.5
On-budget effects	---	1.1	2.1	3.7	4.7	6.3	7.7	9.7	11.4	13.5	11.6	60.3
Off-budget effects	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.1	[2]	0.3

[15] Includes interaction with section 179.

[16] Negligible revenue effect.

[17] Estimate includes the following budget effects:	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
Total Revenue Effects	---	1.2	1.6	1.6	1.6	1.7	1.7	1.7	1.8	1.8	6.0	14.7
On-budget effects	---	1.1	1.5	1.6	1.6	1.6	1.7	1.7	1.7	1.8	5.9	14.5
Off-budget effects	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	0.1	0.3

[18] Provision expires September 30, 2014, in the case of liquefied hydrogen.

[19] Generally effective for amounts paid after December 31, 2014, except the provision is effective for amounts paid after December 31, 2016 in the case of buildings acquired before January 1, 2015.

[20] Generally effective for taxable years beginning after, destruction and damage or natural disasters after, and sales and exchanges after December 31, 2014, except the provision is effective for sales or dispositions to implement electric restructuring policy after December 31, 2013.

[21] Effective for taxable years ending after December 31, 2014, in the case of property acquired and positions established after December 31, 2014, and taxable years ending after December 31, 2019, in the case of any other property or position.

[22] Estimate includes the following budget effects:												
Total Revenue Effects	---	-0.1	-0.2	-0.3	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.8	-2.6
On-budget effects	---	[4]	[4]	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.6
Off-budget effects	---	[4]	-0.1	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.7	-2.1

[23] Effective for taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

[24] Funds designated under section 965 for the Highway Trust Fund included	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-18	2014-23
in item IV.A.3	---	5.1	10.1	10.1	10.1	10.1	14.5	22.1	28.5	15.8	35.4	126.5

[25] Effective for the last taxable year of foreign corporations beginning before January 1, 2015, and to taxable years of the U.S. shareholders in which or with which such taxable years of foreign corporations end.

[Footnotes for the Revenue Table are continued on the following page]

Footnotes for the Revenue Table continued:

[26] Effective for taxable years of foreign corporations beginning after December 31, 2013, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.
[27] Effective for returns filed after the date of enactment and returns filed on or before the date of enactment if the statute of limitations has not expired as of such date.
[28] The amended definition of underpayment is effective for all open tax years, but the revision of section 6676 is effective only for claims filed after February 26, 2014.
[29] Effective for calendar quarters beginning more than 60 days after date of enactment.

DISTRIBUTIONAL EFFECTS OF THE "TAX REFORM ACT OF 2014" (1)

Calendar Year 2015

INCOME CATEGORY (2)	CHANGE IN FEDERAL TAXES (3)		FEDERAL TAXES (3) UNDER PRESENT LAW		FEDERAL TAXES (3) UNDER PROPOSAL		Average Tax Rate (4)	
							Present Law	Proposal
	Millions	Percent	Billions	Percent	Billions	Percent	Percent	Percent
Less than $10,000..........	$102	1.5%	$6.8	0.2%	$6.9	0.2%	8.2%	8.3%
$10,000 to $20,000.........	$62	1.3%	$4.8	0.2%	$4.9	0.2%	1.5%	1.5%
$20,000 to $30,000.........	-$1,602	-5.1%	$31.6	1.1%	$30.0	1.1%	5.7%	5.4%
$30,000 to $40,000.........	-$2,519	-4.6%	$54.9	1.9%	$52.4	1.9%	9.3%	8.9%
$40,000 to $50,000.........	-$7,842	-8.8%	$88.8	3.1%	$80.9	2.9%	12.7%	11.6%
$50,000 to $75,000.........	-$7,950	-3.2%	$247.8	8.7%	$239.8	8.5%	15.2%	14.7%
$75,000 to $100,000.......	-$15,991	-5.6%	$283.1	10.0%	$267.1	9.5%	17.8%	16.8%
$100,000 to $200,000......	-$2,504	-0.3%	$820.8	28.9%	$818.3	29.2%	22.1%	22.0%
$200,000 to $500,000......	$1,149	0.2%	$553.8	19.5%	$555.0	19.8%	27.1%	27.2%
$500,000 to $1,000,000...	$2,505	1.3%	$194.4	6.9%	$196.9	7.0%	30.9%	31.1%
$1,000,000 and over........	$3,462	0.6%	$550.2	19.4%	$553.6	19.7%	33.0%	32.9%
Total, All Taxpayers.......	**-$31,126**	**-1.1%**	**$2,836.9**	**100.0%**	**$2,805.8**	**100.0%**	**21.0%**	**20.7%**

Source: Joint Committee on Taxation

Detail may not add to total due to rounding.

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(1) This distributional analysis includes the following provisions from revenue table JCX-20-14: *(i)* I. Tax Reform for Individual sections A, B, C.1., C4., D.1., D.2, E.1-E.7., E.9.-E.10., E.12.-E.13., E.15.-E.16., G.2, G.8., G.15.-G.16., G18.-G19.; *(ii)* II. Alternative Mininum Tax Repeal; (iii) III. Business Tax Reform; *(iv)* IV. Taxation of Foreign Income; *(v)* V. Tax Exempt Entities sections A.2.-A.8., C.3., D.1.; *and (vi)* VII. Excise Taxes sections 1., 2., 4.

(2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, [8] individual share of business taxes, and [9] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels.

(3) Federal taxes are equal to individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), excise taxes (attributed to consumers), and corporate income taxes. The estimates of Federal taxes are preliminary and subject to change. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

(4) The average tax rate is equal to Federal taxes described in footnote (3) divided by income described in footnote (2).

DISTRIBUTIONAL EFFECTS OF THE "TAX REFORM ACT OF 2014" (1)

Calendar Year 2017

INCOME CATEGORY (2)	CHANGE IN FEDERAL TAXES (3)		FEDERAL TAXES (3) UNDER PRESENT LAW		FEDERAL TAXES (3) UNDER PROPOSAL		Average Tax Rate (4)	
							Present Law	Proposal
	Millions	Percent	Billions	Percent	Billions	Percent	Percent	Percent
Less than $10,000.........	-$4	-0.1%	$5.5	0.2%	$5.5	0.2%	5.9%	5.9%
$10,000 to $20,000........	-$103	-4.1%	$2.5	0.1%	$2.4	0.1%	0.7%	0.7%
$20,000 to $30,000........	-$1,217	-4.2%	$29.3	0.9%	$28.1	0.9%	4.9%	4.7%
$30,000 to $40,000........	-$2,233	-4.1%	$54.5	1.7%	$52.2	1.6%	8.5%	8.1%
$40,000 to $50,000........	-$9,133	-9.5%	$96.6	3.0%	$87.5	2.7%	12.2%	11.0%
$50,000 to $75,000........	-$6,925	-2.5%	$280.3	8.6%	$273.4	8.5%	15.2%	14.8%
$75,000 to $100,000......	-$17,641	-5.4%	$326.1	10.1%	$308.4	9.6%	18.1%	17.1%
$100,000 to $200,000.....	$3,332	0.4%	$936.7	28.9%	$940.0	29.2%	22.5%	22.6%
$200,000 to $500,000.....	$2,565	0.4%	$639.1	19.7%	$641.7	19.9%	27.6%	27.7%
$500,000 to $1,000,000..	$3,861	1.7%	$225.6	7.0%	$229.4	7.1%	31.0%	31.6%
$1,000,000 and over.......	$3,083	0.5%	$645.1	19.9%	$648.2	20.1%	33.5%	33.5%
Total, All Taxpayers......	**-$24,415**	**-0.8%**	**$3,241.2**	**100.0%**	**$3,216.7**	**100.0%**	**21.2%**	**21.0%**

Source: Joint Committee on Taxation

Detail may not add to total due to rounding.

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(1) This distributional analysis includes the following provisions from revenue table JCX-20-14: *(i)* I. Tax Reform for Individual sections A, B, C.1., C4., D.1., D.2, E.1-E.7., E.9.-E.10., E.12.-E.13., E.15.-E.16., G.2, G.8., G.15.-G.16., G18.-G19.; *(ii)* II. Alternative Mininum Tax Repeal; (iii) III. Business Tax Reform; *(iv)* IV. Taxation of Foreign Income; *(v)* V. Tax Exempt Entities sections A.2.-A.8., C.3., D.1.; *and (vi)* VII. Excise Taxes sections 1., 2., 4.

(2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, [8] individual share of business taxes, and [9] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels.

(3) Federal taxes are equal to individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), excise taxes (attributed to consumers), and corporate income taxes. The estimates of Federal taxes are preliminary and subject to change. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

(4) The average tax rate is equal to Federal taxes described in footnote (3) divided by income described in footnote (2).

DISTRIBUTIONAL EFFECTS OF THE "TAX REFORM ACT OF 2014" (1)

Calendar Year 2019

INCOME CATEGORY (2)	CHANGE IN FEDERAL TAXES (3)		FEDERAL TAXES (3) UNDER PRESENT LAW		FEDERAL TAXES (3) UNDER PROPOSAL		Average Tax Rate (4)	
							Present Law	Proposal
	Millions	Percent	Billions	Percent	Billions	Percent	Percent	Percent
Less than $10,000..........	-$404	-5.7%	$7.1	0.2%	$6.7	0.2%	7.1%	6.6%
$10,000 to $20,000.........	-$1,270	-17.4%	$7.3	0.2%	$6.0	0.2%	1.9%	1.6%
$20,000 to $30,000.........	-$1,982	-5.9%	$33.7	0.9%	$31.7	0.9%	5.2%	4.9%
$30,000 to $40,000.........	-$3,709	-6.3%	$58.5	1.6%	$54.8	1.5%	8.4%	7.9%
$40,000 to $50,000.........	-$12,653	-11.6%	$108.9	3.0%	$96.3	2.7%	12.4%	10.9%
$50,000 to $75,000.........	-$11,558	-3.7%	$314.2	8.8%	$302.7	8.5%	15.2%	14.7%
$75,000 to $100,000.......	-$23,064	-6.4%	$360.5	10.0%	$337.4	9.5%	18.0%	16.9%
$100,000 to $200,000......	-$1,614	-0.2%	$1,040.5	29.0%	$1,038.9	29.3%	22.5%	22.5%
$200,000 to $500,000......	$182	0.0%	$703.1	19.6%	$703.3	19.9%	27.6%	27.5%
$500,000 to $1,000,000...	$6,771	2.8%	$243.8	6.8%	$250.6	7.1%	30.9%	31.4%
$1,000,000 and over........	$3,043	0.4%	$709.6	19.8%	$712.7	20.1%	33.4%	33.2%
Total, All Taxpayers.......	**-$46,258**	**-1.3%**	**$3,587.3**	**100.0%**	**$3,541.1**	**100.0%**	**21.3%**	**20.9%**

Source: Joint Committee on Taxation

Detail may not add to total due to rounding.

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(1) This distributional analysis includes the following provisions from revenue table JCX-20-14: *(i)* I. Tax Reform for Individual sections A, B, C.1., C4., D.1., D.2, E.1-E.7., E.9.-E.10., E.12.-E.13., E.15.-E.16., G.2, G.8., G.15.-G.16., G18.-G19.; *(ii)* II. Alternative Mininum Tax Repeal; (iii) III. Business Tax Reform; *(iv)* IV. Taxation of Foreign Income; *(v)* V. Tax Exempt Entities sections A.2.-A.8., C.3., D.1.; *and (vi)* VII. Excise Taxes sections 1., 2., 4.

(2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, [8] individual share of business taxes, and [9] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels.

(3) Federal taxes are equal to individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), excise taxes (attributed to consumers), and corporate income taxes. The estimates of Federal taxes are preliminary and subject to change. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

(4) The average tax rate is equal to Federal taxes described in footnote (3) divided by income described in footnote (2).

DISTRIBUTIONAL EFFECTS OF THE "TAX REFORM ACT OF 2014" (1)

Calendar Year 2021

INCOME CATEGORY (2)	CHANGE IN FEDERAL TAXES (3)		FEDERAL TAXES (3) UNDER PRESENT LAW		FEDERAL TAXES (3) UNDER PROPOSAL		Average Tax Rate (4)	
							Present Law	Proposal
	Millions	Percent	Billions	Percent	Billions	Percent	Percent	Percent
Less than $10,000..........	-$339	-5.5%	$6.2	0.2%	$5.9	0.2%	5.7%	5.4%
$10,000 to $20,000.........	-$1,247	-28.1%	$4.4	0.1%	$3.2	0.1%	1.1%	0.8%
$20,000 to $30,000.........	-$1,744	-5.6%	$31.3	0.8%	$29.6	0.8%	4.6%	4.3%
$30,000 to $40,000.........	-$4,239	-7.2%	$59.1	1.5%	$54.8	1.4%	8.0%	7.4%
$40,000 to $50,000.........	-$13,640	-11.4%	$119.5	3.0%	$105.9	2.7%	12.2%	10.8%
$50,000 to $75,000.........	-$11,271	-3.3%	$345.0	8.7%	$333.7	8.5%	15.1%	14.6%
$75,000 to $100,000.......	-$23,841	-6.1%	$393.7	10.0%	$369.8	9.5%	17.8%	16.7%
$100,000 to $200,000......	$3,446	0.3%	$1,145.2	29.0%	$1,148.7	29.4%	22.4%	22.5%
$200,000 to $500,000......	$2,823	0.4%	$789.9	20.0%	$792.7	20.3%	27.7%	27.8%
$500,000 to $1,000,000...	$8,800	3.3%	$267.8	6.8%	$276.6	7.1%	30.8%	31.5%
$1,000,000 and over........	$4,552	0.6%	$782.8	19.8%	$787.3	20.1%	33.4%	33.3%
Total, All Taxpayers.......	**-$36,698**	**-0.9%**	**$3,944.9**	**100.0%**	**$3,908.2**	**100.0%**	**21.2%**	**21.0%**

Source: Joint Committee on Taxation

Detail may not add to total due to rounding.

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(1) This distributional analysis includes the following provisions from revenue table JCX-20-14: *(i)* I. Tax Reform for Individual sections A, B, C.1., C4., D.1., D.2, E.1-E.7., E.9.-E.10., E.12.-E.13., E.15.-E.16., G.2, G.8., G.15.-G.16., G18.-G19.; *(ii)* II. Alternative Mininum Tax Repeal; (iii) III. Business Tax Reform; *(iv)* IV. Taxation of Foreign Income; *(v)* V. Tax Exempt Entities sections A.2.-A.8., C.3., D.1.; *and (vi)* VII. Excise Taxes sections 1., 2., 4.

(2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, [8] individual share of business taxes, and [9] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels.

(3) Federal taxes are equal to individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), excise taxes (attributed to consumers), and corporate income taxes. The estimates of Federal taxes are preliminary and subject to change. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

(4) The average tax rate is equal to Federal taxes described in footnote (3) divided by income described in footnote (2).

DISTRIBUTIONAL EFFECTS OF THE "TAX REFORM ACT OF 2014" (1)

Calendar Year 2023

INCOME CATEGORY (2)	CHANGE IN FEDERAL TAXES (3)		FEDERAL TAXES (3) UNDER PRESENT LAW		FEDERAL TAXES (3) UNDER PROPOSAL		Average Tax Rate (4)	
							Present Law	Proposal
	Millions	Percent	Billions	Percent	Billions	Percent	Percent	Percent
Less than $10,000..........	-$402	-7.6%	$5.3	0.1%	$4.9	0.1%	4.6%	4.3%
$10,000 to $20,000.........	-$836	-49.9%	$1.7	0.0%	$0.8	0.0%	0.4%	0.2%
$20,000 to $30,000.........	-$1,766	-5.8%	$30.4	0.7%	$28.7	0.7%	4.2%	3.9%
$30,000 to $40,000.........	-$5,222	-8.4%	$62.2	1.4%	$56.9	1.3%	7.9%	7.2%
$40,000 to $50,000.........	-$15,036	-11.2%	$133.7	3.1%	$118.7	2.8%	12.3%	10.9%
$50,000 to $75,000.........	-$13,237	-3.5%	$380.5	8.8%	$367.3	8.6%	15.0%	14.5%
$75,000 to $100,000.......	-$26,767	-6.1%	$436.3	10.1%	$409.6	9.6%	17.5%	16.4%
$100,000 to $200,000......	$374	0.0%	$1,270.4	29.3%	$1,270.7	29.8%	22.2%	22.2%
$200,000 to $500,000......	-$1,724	-0.2%	$870.6	20.1%	$868.9	20.4%	27.7%	27.6%
$500,000 to $1,000,000...	$6,911	2.4%	$288.6	6.7%	$295.5	6.9%	30.7%	31.2%
$1,000,000 and over........	-$4,143	-0.5%	$850.5	19.6%	$846.4	19.8%	33.4%	33.0%
Total, All Taxpayers.......	**-$61,845**	**-1.4%**	**$4,330.2**	**100.0%**	**$4,268.3**	**100.0%**	**21.1%**	**20.8%**

Source: Joint Committee on Taxation

Detail may not add to total due to rounding.

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(1) This distributional analysis includes the following provisions from revenue table JCX-20-14: *(i)* I. Tax Reform for Individual sections A, B, C.1., C4., D.1., D.2, E.1-E.7., E.9.-E.10., E.12.-E.13., E.15.-E.16., G.2, G.8., G.15.-G.16., G18.-G19.; *(ii)* II. Alternative Mininum Tax Repeal; (iii) III. Business Tax Reform; *(iv)* IV. Taxation of Foreign Income; *(v)* V. Tax Exempt Entities sections A.2.-A.8., C.3., D.1.; *and (vi)* VII. Excise Taxes sections 1., 2., 4.

(2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, [8] individual share of business taxes, and [9] excluded income of U.S. citizens living abroad. Categories are measured at 2013 levels.

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(4) The average tax rate is equal to Federal taxes described in footnote (3) divided by income described in footnote (2).

MACROECONOMIC ANALYSIS OF THE TAX REFORM ACT OF 2014

A. Introduction and Summary

This section, prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), provides an analysis of the macroeconomic effects of a proposal to modify both the individual and corporate income tax by broadening their tax bases and changing statutory tax rates. This analysis is based on the proposal as it corresponds to the estimates presented in *Estimated Revenue Effects of the "Tax Reform Act of 2014"* reproduced above at page 640 (and described in Discussion Draft CAMP_041).

The following analysis uses both an overlapping generations lifecycle model and the Joint Committee staff's Macroeconomic Equilibrium Growth model to simulate the macroeconomic effects of the proposal. In general, the lower effective marginal tax rates resulting from the combination of lower statutory tax rates and changes to the definition of taxable income provide an incentive for increased labor effort, and under some modeling assumptions for some years, increased business investment. Relative to present law, the policy provides an incentive for increased consumer purchases of goods and services by increasing after-tax income of households. This effect can be important when the economy is operating below full capacity. The extent of both supply and demand effects depends on the sensitivity of individual labor choices to changing effective marginal rates, the responsiveness of individual savings choices to changes in the after-tax return on earnings from investment, and the responsiveness of businesses to changing incentives for overall investment and the location of investment and taxable profits in the United States. In addition, the projected impacts of the proposal on the economy depend on assumptions about the monetary policy response by the Federal Reserve Board. In general, under most modeling assumptions, the proposal is projected to increase overall economic activity as measured by changes in gross domestic product ("GDP") relative to the present law baseline over the 10-year budget period.

B. Description of Proposal

The following discussion analyzes the macroeconomic effects of a proposal to broaden the bases for the individual and corporate income tax and to restructure statutory tax rates on individual and corporate income. The proposal would be generally effective for taxable years beginning after December 31, 2014. This analysis is presented relative to the 2013 economic and receipts baseline ("present law"), published by the Congressional Budget Office ("CBO") in February, 2013.[2081]

1. Individual income tax

Under present law, there are seven different regular individual income tax brackets, starting (in 2015 dollars) at 10 percent for single filers with taxable income under $9,200 and joint filers with taxable income under $18,400, and topping out at 39.6 percent for single filers with taxable income above $412,650 and joint filers with taxable income above $464,200. The proposal would reduce the number of tax brackets to two: single filers with taxable income below $37,400 and joint filers with taxable income below $74,800 would pay a top statutory tax rate of 10 percent while all other taxpayers would pay a statutory tax rate of 25 percent on taxable income above these amounts. Specific tax brackets are shown below in Table 9. The proposal slows the indexing of individual income tax brackets and other income thresholds by changing the index from the Consumer Price Index - for all urban consumers ("CPI-U") to the chained CPI. The proposal includes several other changes to tax rates on capital gains and dividends, phases out the 10 percent rate bracket and certain other deductions, eliminates the alternative minimum tax, and creates a surtax on certain income. Table 10 provides more detail about these changes.

Table 9.–Statutory Individual Income Tax Rates Under Present Law and Proposal

2015 Income Brackets for Single Filers (estimated)	2015 Income Brackets for Joint Filers (estimated)	Statutory Tax Rates (present law)	Statutory Tax Rates (proposal)
<$9,200	<$18,400	10	10
$9,200-$37,400	$18,401-$74,800	15	10
$37,401-$90,600	$74,801-$151,100	25	25
$90,601 - $189,000	$151,101-$230,100	28	25
$189,001-$410,950	$230,101-$410,950	33	25
$410,951-$412,650	$410,951-464,200	35	25
>$412,650	>$464,200	39.6	25

[2081] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013-2023*, February 5, 2013.

The proposal also provides for a 10-percent surtax on certain sources of income as defined in a modified definition of adjusted gross income ("MAGI") above $400,000 for single filers and $450,000 for joint filers. In addition to the statutory rate changes, the proposal modifies or eliminates a number of individual income tax deductions, exclusions, and credits. The biggest changes include eliminating the deduction for State and local tax payments, reducing the principal cap associated with deductible home mortgage interest payments for new mortgages from $1 million to $500,000, reducing credit rates for the earned income credit, and converting certain excludable contributions to section 401(k) accounts into taxable contributions, with an exclusion at withdrawal. Other significant changes to the individual income tax base include an increase in the standard deduction but with a phase-out for filers with income above certain levels, repeal of the personal exemption, modification of credits for education expenses, and changes in allowable contributions to Roth Individual Retirement Arrangements.

Table 10.—Changes in Miscellaneous Statutory Tax Rates Between Present Law and the Proposal

Tax Rate Feature	Present Law	Proposal
Top tax rate on long term capital gains and qualified dividends	20%	Same as ordinary income rate, with 40% of gains and dividends excluded
Phase-out of the 10% statutory rate bracket.	No phase-out of the 10% statutory rate bracket	The 10% rate is phased out for single filers with income above $250,000 and joint filers with income above $300,000 (2013 dollars).
Phase-out of personal exemptions and itemized deductions	Personal exemptions and itemized deductions are phased out for single filers with income above $250,000 and joint filers with income above $300,000 (2013 dollars)	Personal exemptions are eliminated. The standard deduction or an equivalent amount of itemized deductions, followed by the child credit are phased out sequentially starting at the top of the phaseout range for the 10% rate bracket.
Surtax on modified AGI ("MAGI") where MAGI = AGI less charitable contributions and qualified domestic manufacturing income, plus various other sources of income excluded and expenses deducted from AGI under present law, including employer provided health benefits and the self-employed health deduction, 911 income, tax exempt interest, and untaxed social security benefits, and excluded 401(k) contributions	None	10% on modified AGI above $400,000 for single filers and $450,000 for joint filers
Alternative Minimum Tax	26% on alternative minimum taxable income below $175,000 (in 2012 dollars, indexed to inflation) and 28% on alternative minimum taxable income above that amount	None

2. Corporate Income Tax and Business-Related Provisions for Pass-Through Entities

Under present law, C corporations are taxed at a top statutory rate of 35 percent for corporations with taxable income over $10,000,000. C corporations with taxable income less than $50,000 are taxed at a rate of 15 percent; corporations with taxable income from $50,001-$75,000 are taxed at a rate of 25 percent, and C corporations with taxable income from $75,001 to $10,000,000 are taxed at a rate of 34 percent. The proposal would tax all C corporations at a rate of 25 percent, phased in at a two percentage point reduction from 2015 through 2019. Income of other business forms, including S corporations, partnerships and sole proprietorships, is taxed through the individual income tax code; thus the changes to statutory tax rates for the individual income tax under this proposal would also apply to the taxation of the business income of these pass-through entities.

Both the individual and corporate income tax frameworks include many different deductions, credits, and other special treatment of certain types of income and expenses of businesses. This proposal repeals or modifies a number of them. Some of the larger changes include eliminating the modified accelerated cost recovery system ("MACRS") and lengthening depreciable lives for depreciation of property placed in service after December 31, 2015, and requiring amortization instead of expensing of research and experimental expenditures and certain advertising expenses beginning in 2015. The repeal of MACRS is accompanied by indexing of depreciable basis to chained CPI-U. The proposal also repeals the 20-percent tax on minimum alternative taxable income of corporations.

3. Taxation of Multinational Corporations

The proposal also makes significant changes to the taxation of foreign income earned by U.S. multinational corporations. Under present law, the income of U.S. corporations is subject to U.S. corporate income tax whether it is earned within the U.S. or abroad, but a number of provisions reduce that liability. Such provisions include deferral of U.S. taxation of business income earned abroad by foreign subsidiaries until the income is repatriated; a credit against U.S. tax allowed for foreign income taxes paid; and current deductibility of expenses of U.S. parent companies, such as interest that supports foreign income on which U.S. tax is deferred. Many U.S. multinational corporations reduce their overall tax liability significantly relative to the amount of tax they would pay under a worldwide corporate income tax system in which they would pay U.S. tax on all their income, domestic and foreign, when earned. The proposal broadly replaces the current system with a 95-percent exemption for dividends received by U.S. corporations from foreign subsidiaries attributable to foreign business income of those subsidiaries.

Present law includes rules (commonly referred to as subpart F) to tax certain items of passive or mobile foreign subsidiary income when that income is earned rather than when it is repatriated. The proposal substantially modifies the subpart F rules, chiefly by providing broad taxation of all intangible income of foreign subsidiaries when the income is earned, with intangible income from serving foreign markets taxed at a reduced rate of 15 percent once the proposal is fully phased in. The proposal provides the same reduced rate of tax on foreign intangible income of U.S. parent companies. The proposal includes a one-time transition tax, subject to a foreign tax credit, on all previously untaxed foreign earnings and profits of foreign subsidiaries of U.S. corporations. The proposal also includes thin capitalization rules that restrict the deduction for interest expense of U.S. parent companies when, among other requirements, the U.S. members of the worldwide group are more heavily leveraged than the overall group. The net effect of the proposed changes to taxation of U.S. multinational corporations is to increase their U.S. income tax liability.

4. Conventional Estimate of the Effects of the Proposal

Under our conventional revenue estimating methodology, this proposal is projected to result in an increase in revenues of about $3 billion over the 2014-2023 budget period relative to present law. The proposal is projected to result in a reduction in individual income tax payments (not including revenues due to broadening the taxable base of pass-through businesses) of about $590 billion over that budget period. The year-by-year conventional revenue estimate for this proposal relative to current policy appears in *Estimated Revenue Effects of the "Tax Reform Act of 2014,"* (JCX-20-14).

C. Modeling Approaches and Macroeconomic Analysis

The following analysis was performed using the Joint Committee on Taxation staff's Macroeconomic Equilibrium Growth model ("MEG")[2082] and an overlapping generations lifecycle model ("OLG").[2083] Information about parameter assumptions that are key to determining behavioral responses in each model appear in the Appendix. Both models start with the standard, neoclassical assumption that the amount of output is determined by the availability of labor and capital, and in the long run aggregate demand equals aggregate supply. Individuals are assumed to make decisions based on observed characteristics of the economy, including wages, prices, interest rates, tax rates, and government spending levels.

In the MEG model, monetary policy conducted by the Federal Reserve Board is explicitly modeled, with lagged price adjustments allowing for the economy to be temporarily out of equilibrium in response to fiscal and monetary policy changes. Labor supply decisions are modeled separately for four groups: low income primary earners, low income secondary earners, other primary earners, and other secondary earners. Firms make investment decisions based on an expected after-tax rate of return. Individuals in the MEG model do not anticipate future changes in the economy or government finances; thus, this type of model is often referred to as a "myopic" behavior model. This feature of the MEG model allows the simulation of tax and government expenditure policy that may result in an unsustainable growth path. Specifically, policies that result in the Federal debt increasing or decreasing at a faster rate than the growth of GDP can be modeled.

In the OLG model, individuals are assumed to make consumption and labor supply decisions in order to maximize their lifetime well-being given the resources they can foresee will be available to them. They are assumed to have complete information, or "perfect foresight," about economic conditions, such as wages, prices, interest rates, tax rates, and government spending, over their lifetimes. Economic decisions are modeled separately for each of 55 adult-age cohorts. Firms' investment decisions respond to the effects of tax policy on the expected future value of the firm. Changes in marginal tax rates on firm profits, and changes in the value of deductions for investment affect this future valuation. The version of OLG used in this analysis includes a separate multinational corporation ("MNC") sector that uses both capital and intellectual property in the production of goods and services.

We analyze the proposal using varying assumptions about several types of taxpayer and Federal Reserve Board response to the proposed tax changes. We rely on information from

[2082] A detailed description of the MEG model and its behavioral parameters may be found in: Joint Committee on Taxation, *Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief*, (JCX-4-05), March 1, 2005, and Joint Committee on Taxation, *Overview of the Work of the Staff of the Joint Committee on Taxation to Model the Macroeconomic Effects of Proposed Tax Legislation to Comply with House Rule XIII.3(h)(2)*, (JCX-105-03), December 22, 2003.

[2083] The OLG model used in this analysis was leased from Tax Policy Advisers. Information about this model may be found in John W. Diamond and George R. Zodrow, *Description of the Tax Policy Advisers Model*, unpublished document, 2013.

various JCT tax models[2084] used in the production of conventional revenue estimates to obtain information about the effects of the proposal on individual and business average and effective marginal tax rates, and on after-tax returns to capital and labor to characterize the tax proposal within the MEG and OLG models. Changes in both statutory tax rates and the definition of taxable income can impact effective marginal tax rates as well as average tax rates.

The MEG model is used to examine the importance of different assumptions about Federal Reserve policy. Under the "Aggressive Fed" policy, it is assumed that the Federal Reserve Board would work to counteract any demand incentives resulting from fiscal policy. For this proposal, since the policy results in a net decrease in income tax paid by individuals, providing them with more take home income for consumption purposes, the aggressive Fed simulation would include an immediate increase in interest rates to counteract these demand effects. The "Neutral Fed" simulations assume that the Federal Reserve Board targets a fixed monetary growth rate, and does not try to counteract fiscal policy.

The MEG model is also used to present results using differing assumptions about the responsiveness of labor to changes in effective marginal tax rates and average taxes for each proposal. The "High Labor Elasticity" simulations use labor supply responsiveness parameters that are consistent with the upper range of measured response levels from empirical studies. The "Low Labor Elasticity" simulations reduce the responsiveness to changes in effective marginal tax rates by 50 percent.

Both the MEG and OLG models are used to explore the impact of varying assumptions about the responsiveness of capital investment and international capital flows to tax policy changes. In the MEG model, there is no explicit distinction between domestic and multinational corporations. International capital flows respond to changes in the after-tax rate of return on capital between the United States and the rest of the world, as well as to changes in the relative attractiveness of imports and exports. In contrast, the OLG model has several different types of businesses, including a multinational corporate ("MNC") sector with foreign subsidiaries. The addition of foreign subsidiaries presents the MNC with the ability to optimize over both the location of investments (both highly mobile intellectual property ("IP") and capital), as well as some ability to shift profits from the U.S. parent to low tax subsidiaries. The ability of MNC to shift profits from the United States to low tax jurisdictions is meant to capture the many ways that firms can shift their profit overseas, including transfer pricing, debt leveraging, interest stripping, and hybrid instruments. The OLG model treats all of these different types of profit shifting strategies the same and limits the amount of shifting to the extra-normal returns to IP.[2085]

[2084] Descriptions of the JCT conventional estimating models may be found in JCX-46-11, *Testimony of the Staff of the Joint Committee on Taxation before the House Committee on Ways and Means Regarding Economic Modeling*, September 21, 2011 and other documents at www.jct.gov under "Estimating Methodology."

[2085] The MNC modeling follows the work in M.P. Devereux and R. de Mooij in "An applied analysis of ACE and CBIT reforms in the EU," *International Tax and Public Finance*, 18(1), 2011, 93-120 and M.P. Devereux, L. Bettendorf, A. van der Horst, S. Loretz. And R. de Mooij, "Corporate tax harmonization in the EU," *Economic Policy*, 63, 2010, 537-590.

This analysis presents two OLG simulations that vary the degree of responsiveness of this MNC sector to changes in tax policy. In particular, we vary the responsiveness of MNCs to shifting intellectual property and profits. The "default IP elasticities" simulation reflects the calibration of the model to hit estimates for cross-border capital movements under present law, with the relatively mobile intellectual property estimated to be roughly 8.5 times more responsive than capital. Profit shifting is calibrated to be about 20 percent of the corporate tax base in 2013, consistent with the middle point of estimates of this shifting under present law. We present an additional simulation ("reduced IP elasticities") in which the IP responsiveness is assumed to be the same as that of capital, and the profit shifting elasticity is reduced by about one third.

One important difference between the MEG and OLG models is in their treatment of Federal fiscal policy. In the MEG model, it is possible to simulate structural Federal budget deficits as forecast in the CBO baseline and to allow for increases or decreases in the deficit in simulating proposals. In contrast, the OLG model cannot simulate either the present law fiscal baseline or policy proposals that incorporate unsustainable Federal budget deficits or surpluses. The MEG model assumes individuals cannot foresee future unsustainable Federal budget conditions, while the OLG model assumes that individuals have perfect foresight about the economy, including unsustainable Federal budget conditions. Thus, in the OLG model there is no equilibrium solution when Federal budget conditions appear unsustainable in the long run. It is necessary to create counterfactual stable ratios of debt to GDP within both the baseline and policy simulations of the OLG model.

Because both present-law fiscal conditions and the path of the budget deficit are necessarily modeled differently within the OLG and MEG models, it is difficult to compare the results between the two models directly, as they are essentially modeling different types of economies. Because the MEG model simulates the effects of the actual proposed law, its results are of interest. Because the MEG model assumes people are unable to foresee the probable effects of the proposed law change, while the OLG model assumes that people can foresee these effects, the OLG model provides a useful alternative perspective on the economy.

The OLG simulations presented here include an assumption in the base (present law) simulation that average tax rates are higher and transfer payments are lower than they actually are. To the extent that the policy simulation changes the path of debt growth, it is necessary to include a fiscal policy reaction function so that the debt to GDP ratio does not change significantly in the policy simulation. The specific changes in tax and spending that are used to provide fiscal balance can affect results. Because this proposal results in increased economic growth and decreasing deficits, the fiscal balance reaction to the policy requires either an increase in government outlays or a decrease in taxes. These simulations adjust transfer payments, thereby allowing us to analyze the specific tax policy in the proposal.

Following is a series of tables that show the effects of this proposal on real (inflation adjusted) gross domestic product, business capital stock, employment, and consumption. Results from each policy simulation for each variable are presented as percentage changes from the present-law baseline forecast values for the variables in each of Tables 11-15 below. The Joint Committee staff configures the present-law baseline forecasts for Federal government receipts and spending in the MEG model to approximate the February 2013 forecast of the CBO[2086] as closely as possible.

[2086] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013-2023*, February 5, 2013.

D. Effects on Economic Activity and Revenues

1. Effects on real gross domestic product and revenues

In the MEG model, economic growth responds to changes in average and effective marginal tax rates on labor, and changes in the after-tax return to capital. In the OLG model, economic growth also responds to changes in average and effective marginal tax rates on labor, as well as to changes in the anticipated after-tax value of firms. Changes in tax rates on interest, dividends, and capital gains income, as well as on business profits accruing to corporations and pass-through entities, affect the after-tax return to capital and the anticipated after-tax value of firms.

The level of economic activity also responds to changes in the after-tax income of individuals under certain assumptions about the current state of the baseline economy and Federal Reserve policy. During periods when the economy is operating below its full employment capacity - when not all available labor or capital is employed - increases in after-tax income increase demand for goods and services, leading to more economic growth.

This proposal reduces the overall effective marginal tax rate on labor, providing an incentive for people to work, supplying more labor to the economy. The importance of this effect depends on how responsive labor is to these changes. The proposal also increases the after-tax income of individuals by reducing individual tax rates overall, thus increasing demand for goods and services. Because the economy is currently operating below full employment levels, this increased demand can be expected to lead to an increase in economic output, to the extent that Federal Reserve policy does not take action to counteract this effect.

The proposal reduces effective marginal tax rates on interest and rental income and business profits of corporations and pass-through entities relative to present law, which increases the after-tax return to capital. But it also reduces a number of credits and deductions, the largest of which are inventory and depreciation deductions, which reduces the after-tax return to capital relative to present law. On net, the after-tax return to business capital is reduced relative to present law by these changes overall.

The proposal is projected to result in increases in economic activity relative to that projected under present law, as measured by changes in real GDP. The increase in projected economic activity is projected to increase revenues relative to the conventional revenue estimate by $50 to $700 billion, depending on which modeling assumptions are used, over the 10-year budget period.

Table 11.–Percent Change in Real GDP Relative to Present Law

		Fiscal Years 2014-2018	Fiscal Years 2019-2023	Fiscal Years 2014-2023
MEG				
High labor elasticity	Aggressive Fed	0.2%	0.2%	0.2%
	Neutral Fed	0.1%	0.8%	0.5%
Low Labor Elasticity	Aggressive Fed	0.2%	0.1%	0.1%
	Neutral Fed	0.1%	0.7%	0.4%
MEG, reduced investment response to taxation of multinationals				
High labor elasticity	Aggressive Fed	0.3%	0.3%	0.3%
	Neutral Fed	0.3%	0.8%	0.6%
OLG				
Default IP elasticities		1.8%	1.4%	1.5%
Reduced IP elasticities		1.8%	1.4%	1.6%

Table 11 (above) shows the predicted effects of this policy on real gross domestic product, relative to what is projected under present law for the proposal. These changes are shown for the first five years, second five years, and full 10 years of the standard budget window. GDP is projected to grow by 0.1 percent to 1.6 percent during the 10-year budget period. The positive growth effects of the proposal arise primarily from its effects on labor supply and consumption demand. In the following sections on capital stock, employment, and consumption effects, the influence of the proposal on each of these components of growth and the economy can be seen in more detail.

In the standard MEG model simulations, the larger growth effects occur in simulations that assume more labor response to reductions in effective marginal tax rates, and in which the Federal Reserve Board is assumed not to moderate increases in demand arising from higher after-tax income.

An additional modeling assumption affecting the projected effects of this proposal is the extent to which changes in the taxation of foreign income and income from intellectual property are expected to provide an incentive for more investment and profit reporting within the United States. The MEG model is not designed to model specifically the difference between IP and capital or the effects of shifting of reported profits between countries to take advantage of differences in relative tax rates. The conventional revenue estimate accounts for the effects of the latter behavior on revenues, but not on economic activity. In the OLG model, the ability to shift profits to minimize tax liability without shifting economic activity results in increased economic activity within the United States. To approximate the separate modeling of these effects using the MEG model, we assume that the various tax increasing portions of the changes on taxation of multinational corporations and intellectual property do not affect their investment incentives, as shown in the "MEG, reduced investment response to taxation of multinationals" simulations. In these simulations, anticipated GDP growth is higher than in the base MEG simulations.

2. Effects on the capital stock

The reduction in statutory tax rates on corporate and non-corporate business income increases the after-tax return to investment for some businesses that do not make use of many of the business deductions under present law. For those businesses that do make use of accelerated depreciation, expensing of research and experimentation expenses, or other business tax expenditures, the elimination of these provisions is expected to reduce the after-tax return on investment. Overall, the proposal is expected to increase the cost of capital for domestic firms, thus reducing the incentive for investment in domestic capital stock.

Table 12 shows the expected change in business capital relative to what was projected to occur under the present law baseline, but does not indicate a reduction in capital stock over time. In other words, the negative numbers in these tables result from a projected slower rate of growth in capital due to the proposal. Investment in capital is generally projected to increase slightly relative to present law in the first half of the budget period, and decrease relative to present law in the second half. The repeal of accelerated depreciation does not occur until 2016, thus delaying the negative influence of this provision, at the same time that reduced tax rates on income from capital are providing an incentive for increased investment. Over time, the cumulative effects of the repeal of MACRS and amortization of intellectual property begin to outweigh the positive incentives from reduced rates in standard MEG simulations.

As mentioned above, a crucial modeling assumption for analyzing this proposal is predicting the extent to which the changes in the taxation of foreign capital will provide an incentive for both U.S. multinational and foreign corporations to shift investment and profits to the United States. Because the proposal treats domestic investment in intellectual property less favorably and earnings on some foreign income more favorably than under present law, in the simulations with reduced sensitivity of the location of intellectual property to changes in taxation, the effects of reducing responsiveness to incentives for foreign-based capital investment, particularly in intellectual property, are shown to reverse or dampen (depending on the degree of responsiveness assumed) the negative effects on capital stock generated by the increased cost of domestic capital.

Table 12.–Percent Change in Business Capital Relative to Present Law

		Fiscal Years 2014-2018	Fiscal Years 2019-2023	Fiscal Years 2014-2023
MEG				
High labor elasticity	Aggressive Fed	0.1%	-1.0%	-0.5%
	Neutral Fed	0.0%	-0.5%	-0.3%
Low labor elasticity	Aggressive Fed	0.1%	-1.0%	-0.6%
	Neutral Fed	0.0%	-0.6%	-0.3%
MEG, reduced investment response to taxation of multinationals				
High labor elasticity	Aggressive Fed	0.3%	-0.6%	-0.2%
	Neutral Fed	0.2%	-0.2%	0.0%
OLG				
Default IP elasticities		0.2%	0.0%	0.1%
Reduced IP elasticities		0.0%	-0.3%	-0.2%

3. Effects on private sector employment

Reductions in effective marginal tax rates on labor - that is, increases in the portion of wages from additional work effort that a person keeps - provide an incentive for people to work more, supplying more labor to the economy. Somewhat offsetting that effect, reductions in total individual tax payments (as measured by changes in the average tax rate), increase peoples' total take home income, providing an incentive for people to work less. Policies that reduce effective marginal tax rates by more than average tax rates generally provide a net incentive for more labor to be supplied by the economy. This proposal reduces effective marginal and average tax rates on labor overall relative to present law. Table 13 below shows the predicted effects of these changes on peoples' willingness to work. As a result of this proposal, labor force participation is projected to increase relative to present law from 0.3 percent to 1.5 percent over the 10-year budget period. In the MEG model, labor force participation is affected by assumed labor force responsiveness parameters. Labor force response is higher in the OLG simulations than in the MEG simulations in part because the capital stock declines less in the OLG simulations, thus allowing for relatively less reduction or more increase in labor productivity and wages. In addition, labor is more responsive in the OLG model than in the MEG model.

Table 13.–Percent Change in Labor Force Participation Relative to Present Law

		Fiscal Years 2014-2018	Fiscal Years 2019-2023	Fiscal Years 2014-2023
MEG				
High labor elasticity	Aggressive Fed	0.3%	0.4%	0.3%
	Neutral Fed	0.3%	0.4%	0.3%
Low labor elasticity	Aggressive Fed	0.2%	0.3%	0.3%
	Neutral Fed	0.2%	0.3%	0.3%
MEG, reduced investment response to taxation of multinational				
High labor elasticity	Aggressive Fed	0.3%	0.4%	0.3%
	Neutral Fed	0.3%	0.4%	0.3%
OLG				
Default IP elasticities		1.4%	1.3%	1.3%
Reduced IP elasticities		1.5%	1.5%	1.5%

Table 14 shows changes in employment predicted to result from the proposal.

While the willingness of people to work at a given combination of wage rates and taxes on wages is an important component of total employment, changes in employment are also influenced by the amount of business demand for labor. Relative to present law, the proposal results in a net increase in after-tax income, leading consumers to demand more goods and services, and employers to increase output. Because the proposal reduces the after-tax return to capital relative to present law, businesses are expected to substitute some labor for capital. In some MEG simulations, employment is projected to increase by somewhat more than the labor force as a result of this increased demand for labor services, thereby reducing unemployment. As expected, the projected increase in labor force is more sensitive to assumptions about the elasticity of labor to marginal tax rates, while the projected increase in employment is also quite sensitive to actions of the Federal Reserve Board. In the OLG simulations, it is assumed there is no involuntary unemployment, and thus changes in employment are the same as changes in the labor force.

Table 14.–Percent Change in Private Sector Employment Relative to Present Law

		Fiscal Years 2014-2018	Fiscal Years 2019-2023	Fiscal Years 2014-2023
MEG				
High labor elasticity	Aggressive Fed	0.3%	0.6%	0.5%
	Neutral Fed	0.2%	1.3%	0.7%
Low labor elasticity	Aggressive Fed	0.3%	0.5%	0.4%
	Neutral Fed	0.2%	1.2%	0.7%
MEG, reduced investment response to taxation of multinationals				
High labor elasticity	Aggressive Fed	0.4%	0.6%	0.5%
	Neutral Fed	0.4%	1.2%	0.8%
OLG				
Default IP elasticities		1.4%	1.3%	1.3%
Reduced IP elasticities		1.5%	1.5%	1.5%

4. Effects on consumption

Table 15 shows how the proposal affects consumption relative to present law. In addition to the interaction between consumption demand and short-term economic growth, consumption is often of interest as an indicator of individuals' well-being. Generally, increased growth and employment facilitate more consumption, with consumption increasing relative to present law by between 0.4 percent and 2.1 percent over the 10-year budget window. The increased labor supply due to reduced marginal rates, and increase in after-tax income relative to present law allow for a substantial increase in consumption, consistent with the increasing pressures on demand described above. Consumption is also increased because the slightly reduced after-tax return to capital reduces incentives to save. Those simulations that predict higher employment generally also predict higher consumption.

Table 15.—Percent Change in Consumption Relative to Present Law (base proposal)

		Fiscal Years 2014-2018	Fiscal Years 2019-2023	Fiscal Years 2014-2023
MEG				
High labor elasticity	Aggressive Fed	0.3%	0.6%	0.5%
	Neutral Fed	0.2%	1.1%	0.7%
Low labor elasticity	Aggressive Fed	0.2%	0.6%	0.4%
	Neutral Fed	0.1%	1.0%	0.6%
MEG, reduced investment response to taxation of multinationals				
High labor elasticity	Aggressive Fed	0.2%	0.7%	0.5%
	Neutral Fed	0.2%	1.1%	0.7%
OLG				
Default IP elasticities		2.3%	1.9%	2.1%
Reduced IP elasticities		2.2%	1.9%	2.0%

5. Conclusion

Broadening of the individual and corporate income tax bases through elimination of many preferences in the form of deductions, exemptions, and tax credits allows for a reduction in average and effective marginal tax rates for most individual taxpayers, which provides both an incentive for increased labor effort, and an increase in demand for goods and services. These changes also reduce the after-tax return to investment under many modeling assumptions, providing an incentive for a reduction in the U.S. domestic capital stock. On net, these changes are expected to result in an increase in economic output relative to present law.

E. Appendix – Key Parameter Assumptions

The amount of taxpayer response to changes in fiscal policy is governed by how sensitive their work, consumption and savings decisions are to changes in their disposable income, and to changes in the after-tax rate of return to additional work or investment. Tables A-1 and A-2 below show the parameters used to model the degree of responsiveness for the MEG and OLG models respectively.

Table A.1.–Key Parameter Assumptions in the MEG Model

Labor supply elasticities in disaggregated labor supply	Income	High Elasticity Substitution	Low Elasticity Substitution
Low income primary	-0.1	0.2	0.15
Other primary	-0.1	0.1	0.1
Low income secondary	-0.3	0.8	0.4
Other secondary	-0.2	0.6	0.3
Wage-weighted population average with baseline rates	-0.1	0.2	0.1
Savings/consumption parameters			
Rate of time preference	0.015		
Intertemporal elasticity of substitution	0.35		
Derived long-run savings elasticity to the after-tax rate of return on capital	0.25		

Table A.2.–Key Parameter Assumptions in the OLG Model

Description	Value
Time preference	0.015
Intertemporal elasticity of substitution	0.4
Intratemporal elasticity of substitution between consumption and leisure	0.6
Leisure share of time endowment	0.4
Population growth rate	0.015
Technological growth rate	0.019
Capital share for	
Corporate	0.2
Multinational (not including IP)	0.15
Non-corporate	0.3
Housing	0.985
Adjustment cost*	5.0
Debt-to-capital ratio (average)	0.35
Substitution elasticity between capital and labor in	
Non-housing†	1.0
Housing†	1.0
Substitution elasticity for intellectual property‡	
Default elasticity	8.6
Low elasticity	1.0

**Quadratic adjustment cost function*

†Cobb-Douglas production function

‡Substitution elasticity between foreign and domestic after-tax profits attributable to intellectual property