

**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**

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of the  
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February 26, 2014  
JCX-14-14

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## INTRODUCTION

This document<sup>1</sup> provides a technical explanation of Title III of the Tax Reform Act of 2014, a discussion draft<sup>2</sup> prepared by the Chairman of the House Committee on Ways and Means that proposes to reform the Internal Revenue Code. Title III of the proposal addresses general business tax reform.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *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), February 26, 2014. This document can also be found on our website at [www.jct.gov](http://www.jct.gov).

<sup>2</sup> Statutory draft version Camp\_041.XML.

## 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:

<b>Taxable Income</b>	<b>Tax rate (percent)</b>
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.<sup>3</sup> 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.

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<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup>

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.<sup>8</sup> 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.<sup>9</sup> Similarly, a utility's adjusted basis of any property acquired with a contribution in aid of construction will be zero.<sup>10</sup>

#### **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.<sup>11</sup>

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<sup>4</sup> Sec. 118(a).

<sup>5</sup> Sec. 118(b).

<sup>6</sup> Sec. 118(c).

<sup>7</sup> Sec. 118(c)(4).

<sup>8</sup> Sec. 362(c)(1).

<sup>9</sup> Sec. 362(c)(2). See also Treas. Reg. sec. 1.362-2.

<sup>10</sup> Sec. 118(c)(4).

<sup>11</sup> 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.<sup>12</sup> However, section 162(e) denies a deduction for amounts paid or incurred in connection with (1) influencing legislation,<sup>13</sup> (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<sup>14</sup> 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.<sup>15</sup>

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<sup>12</sup> Sec. 162(a).

<sup>13</sup> 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).

<sup>14</sup> 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 Schedule 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).

<sup>15</sup> 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”).<sup>16</sup> 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.<sup>17</sup>

For purposes of this exception, legislation of an Indian tribal government is treated in the same manner as local legislation.<sup>18</sup>

### **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.<sup>19</sup>

## **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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<sup>16</sup> Sec. 162(e)(2).

<sup>17</sup> Sec. 162(e)(2)(B).

<sup>18</sup> Sec. 162(e)(7).

<sup>19</sup> 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.<sup>20</sup> The amount of any loss is limited to the adjusted basis of the property.<sup>21</sup> 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.<sup>22</sup> Personal casualty or theft losses for the taxable year are allowable only if they exceed a \$100 limitation per casualty or theft.<sup>23</sup> 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.<sup>24</sup> 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.<sup>25</sup>

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.<sup>26</sup> 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.<sup>27</sup> 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.<sup>28</sup> Amounts paid in excess of such limitation are analyzed under

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<sup>20</sup> Sec. 165(a).

<sup>21</sup> Sec. 165(b).

<sup>22</sup> Sec. 165(c)(3).

<sup>23</sup> Sec. 165(h)(1).

<sup>24</sup> Sec. 165(h)(2).

<sup>25</sup> Sec. 165(i).

<sup>26</sup> Treas. Reg. sec. 1.263(a)-3(k)(1), effective for taxable years beginning on or after January 1, 2014.

<sup>27</sup> Treas. Reg. sec. 1.263(a)-3(k)(1)(iii).

<sup>28</sup> 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).

the applicable provisions of the Internal Revenue Code and regulations<sup>29</sup> to determine if capitalization is required.<sup>30</sup>

### **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<sup>31</sup> 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.<sup>32</sup> 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.<sup>33</sup>

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<sup>29</sup> See, e.g., Treas. Reg. secs. 1.162-4, 1.263(a)-2, or 1.263(a)-3.

<sup>30</sup> Treas. Reg. sec. 1.263(a)-3(k)(4)(ii). See also, Treas. Reg. sec. 1.263(a)-3(k)(7), Example 5.

<sup>31</sup> See Treas. Reg. sec. 1.263(a)-3(j) for the rules governing the capitalization of amounts paid for abetterment to a unit of property.

<sup>32</sup> Sec. 167(a).

<sup>33</sup> 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.<sup>34</sup> 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,<sup>35</sup> 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 1 provides general rules for class lives and recovery periods as provided in sections 168(c) and (e).

**Table 1.—General Rules for Class Lives and Recovery Periods**

<b>Type of Property</b>	<b>General Rule-Class Life</b>	<b>MACRS Applicable Recovery Period</b>
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

<sup>34</sup> 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.

<sup>35</sup> 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

<b>Type of Property</b>	<b>General Rule-Class Life</b>	<b>MACRS Applicable Recovery Period</b>
10-year property	16 or more but less than 20 years	10 years
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.<sup>36</sup> 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.<sup>37</sup> 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.<sup>38</sup> 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,<sup>39</sup> 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.<sup>40</sup> An election to use ADS is available to taxpayers for any class of property

<sup>36</sup> Treas. Reg. sec. 1.167(a)-10(b).

<sup>37</sup> Secs. 168(d)(2) and (d)(4)(B).

<sup>38</sup> Secs. 168(d)(1) and (d)(4)(A).

<sup>39</sup> 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).

<sup>40</sup> Sec. 168(g).

for any taxable year.<sup>41</sup> Under ADS, all property is depreciated using the straight-line method, over recovery periods which generally are equal to the class life of the property, with certain exceptions.<sup>42</sup>

## **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.<sup>43</sup> 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 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);<sup>44</sup>
- 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);

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<sup>41</sup> Sec. 168(g)(7).

<sup>42</sup> Sec. 168(g)(2).

<sup>43</sup> See, *e.g.*, Rev. Proc. 87-56 (1987-2 C.B. 674) for class lives of certain property.

<sup>44</sup> 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).

- Water treatment and utility property (50 years);
- Clearing and grading improvements, and tunnel bore (50 years); and
- 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.<sup>45</sup> 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.<sup>46</sup> 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”)<sup>47</sup> 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.

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<sup>45</sup> Once elected, the taxpayer is required to apply the inflation adjustment percentage to such property for all subsequent taxable years.

<sup>46</sup> 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).

<sup>47</sup> 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.”

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.<sup>48</sup> 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.<sup>49</sup> 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.<sup>50</sup>

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.<sup>51</sup> In addition, a corporation must reduce the amount of basis otherwise eligible for the

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<sup>48</sup> 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.

<sup>49</sup> Sec. 169(d).

<sup>50</sup> Sec. 169(d)(5).

<sup>51</sup> 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.

60-month or 84-month recovery by 20 percent.<sup>52</sup> The amount of basis not eligible for 60-month or 84-month amortization is depreciable under the regular tax rules for depreciation.<sup>53</sup>

### **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.<sup>54</sup> NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.<sup>55</sup>

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.

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<sup>52</sup> Sec. 291(a)(4).

<sup>53</sup> 169(g).

<sup>54</sup> Sec. 172(b)(1)(A).

<sup>55</sup> Sec. 172(b)(2).

### **Effective Date**

The proposal limiting the NOL deduction for corporations applies to taxable years beginning after December 31, 2014.

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.<sup>56</sup> 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.<sup>57</sup>

### **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.

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<sup>56</sup> Secs. 167 and 263(a).

<sup>57</sup> 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.<sup>58</sup> 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.<sup>59</sup> 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.<sup>60</sup> Taxpayers, alternatively, may elect to amortize their research expenditures over a period of 10 years.<sup>61</sup>

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.<sup>62</sup> 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.<sup>63</sup> 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.<sup>64</sup> 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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<sup>58</sup> Secs. 167 and 263(a).

<sup>59</sup> Secs. 174(a) and (e).

<sup>60</sup> 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.

<sup>61</sup> 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.

<sup>62</sup> 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.

<sup>63</sup> Treas. Reg. sec. 1.174-2(a)(1).

<sup>64</sup> *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).<sup>65</sup> In addition, under administrative guidance, the costs of developing computer software have been accorded treatment similar to research expenditures.<sup>66</sup>

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.<sup>67</sup> 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.<sup>68</sup>

### **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<sup>69</sup> 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,<sup>70</sup> 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<sup>71</sup> paid or incurred during any taxable year beginning before 2021. For taxable years beginning in 2015, 60

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<sup>65</sup> 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).

<sup>66</sup> Rev. Proc. 2000-50, 2000-2 C.B. 601.

<sup>67</sup> Sec. 174(c).

<sup>68</sup> Sec. 174(d).

<sup>69</sup> For this purposes, the term "United States" includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States.

<sup>70</sup> See the description of section 2001 of the discussion draft, "Repeal of alternative minimum tax."

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<sup>72</sup> 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.<sup>73</sup> 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.<sup>74</sup>

#### **Effective Date**

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

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<sup>71</sup> 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.

<sup>72</sup> 16 U.S.C. sec. 1533(f)(B).

<sup>73</sup> Sec. 175.

<sup>74</sup> 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.<sup>75</sup> 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.<sup>76</sup>

### **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 or 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;<sup>77</sup> (4) any discount, coupon, rebate, slotting allowance,

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<sup>75</sup> See sec. 162 and Rev. Rul. 92-80, 1992-2 C.B. 57.

<sup>76</sup> See secs. 263, 167, and 168.

<sup>77</sup> 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;<sup>78</sup> (6) amounts paid or incurred for the creation of any logo, trademark, or trade name; (7) amounts paid or incurred for package design;<sup>79</sup> (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.<sup>80</sup>

### **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.

<sup>78</sup> 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.

<sup>79</sup> "Package design" is any amount to which new section 263A(i) applies.

<sup>80</sup> 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.<sup>81</sup> 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.<sup>82</sup> 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.<sup>83</sup> 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).<sup>84</sup> 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.<sup>85</sup>

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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<sup>81</sup> 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.

<sup>82</sup> 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).

<sup>83</sup> 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).

<sup>84</sup> Secs. 179(d)(1)(A)(ii) and (f).

<sup>85</sup> Sec. 179(f)(3).

without regard to this provision).<sup>86</sup> 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.<sup>87</sup> 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.<sup>88</sup>

No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.<sup>89</sup> An expensing election is made under rules prescribed by the Secretary.<sup>90</sup> 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 2013.<sup>91</sup>

### **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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<sup>86</sup> Sec. 179(b)(3).

<sup>87</sup> Section 179(f)(4) details the special rules that apply to disallowed amounts.

<sup>88</sup> 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 maximum 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).

<sup>89</sup> Sec. 179(d)(9).

<sup>90</sup> Sec. 179(c)(1).

<sup>91</sup> 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.<sup>92</sup> 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.<sup>93</sup> The deduction is limited to an amount equal to

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<sup>92</sup> See sec. 168.

<sup>93</sup> 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.<sup>94</sup> The deduction is allowed in the year in which the property is placed in service.<sup>95</sup>

If a deduction is allowed under this section, the basis of the property is reduced by the amount of the deduction.<sup>96</sup> The deduction is effective for property placed in service after December 31, 2005, and prior to January 1, 2014.<sup>97</sup>

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.<sup>98</sup>

### **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.<sup>99</sup> “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).

<sup>94</sup> Sec. 179D(b).

<sup>95</sup> Sec. 179D(a).

<sup>96</sup> Sec. 179D(e).

<sup>97</sup> Sec. 179D(h).

<sup>98</sup> Sec. 312(k)(3)(B).

<sup>99</sup> 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.<sup>100</sup>

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.<sup>101</sup>

### **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.<sup>102</sup>

### **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.<sup>103</sup>

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<sup>100</sup> Secs. 179E(c) and (g).

<sup>101</sup> Sec. 179E(d).

<sup>102</sup> Sec. 180.

<sup>103</sup> See, e.g., secs. 471 and 263A.

### **Effective Date**

The proposal applies to expenses paid or incurred in taxable year 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<sup>104</sup> 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.<sup>105</sup> Taxpayers may elect to deduct up to \$15 million of the aggregate cost of the film or television production under this section.<sup>106</sup> 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.<sup>107</sup>

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.<sup>108</sup> The term “compensation” does not include participations and residuals (as defined in section 167(g)(7)(B)).<sup>109</sup> 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.<sup>110</sup> Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.<sup>111</sup>

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<sup>104</sup> See Treas. Reg. section 1.181-2 for rules on making an election under this section.

<sup>105</sup> For this purpose, a production is treated as commencing on the first date of principal photography.

<sup>106</sup> Sec. 181(a)(2)(A).

<sup>107</sup> Sec. 181(a)(2)(B).

<sup>108</sup> Sec. 181(d)(3)(A).

<sup>109</sup> Sec. 181(d)(3)(B).

<sup>110</sup> Sec. 181(d)(2)(B).

<sup>111</sup> 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.<sup>112</sup>

### **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.<sup>113</sup>

### **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,<sup>114</sup> 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.<sup>115</sup>

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.<sup>116</sup> 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.<sup>117</sup>

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.<sup>118</sup> 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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<sup>112</sup> Sec. 1245(a)(2)(C).

<sup>113</sup> See secs. 167 and 263A. See also the description of section 3313 of the discussion draft, "Modification of income forecast method."

<sup>114</sup> 15 U.S.C. sec. 15.

<sup>115</sup> Sec. 186.

<sup>116</sup> Sec. 186(a).

<sup>117</sup> Sec. 186(b).

<sup>118</sup> 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.<sup>119</sup> 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.<sup>120</sup>

### **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.<sup>121</sup> The remaining expenditures are amortized over 84 months (seven years) subject to a mandatory half-year convention.<sup>122</sup> 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.<sup>123</sup>

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.<sup>124</sup> 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.<sup>125</sup>

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<sup>119</sup> Sec. 186(d).

<sup>120</sup> See secs. 61 and 451.

<sup>121</sup> Sec. 194.

<sup>122</sup> Sec. 194(a).

<sup>123</sup> Sec. 62(a)(11).

<sup>124</sup> Sec. 194(c)(3).

<sup>125</sup> Treas. Reg. sec. 1194-3(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.<sup>126</sup> 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.<sup>127</sup>

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.<sup>128</sup>

### **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<sup>129</sup> 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.<sup>130</sup>

### **Effective Date**

The proposal applies to expenditures paid or incurred in taxable years beginning after December 31, 2014.

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<sup>126</sup> Sec. 194(c)(1).

<sup>127</sup> Treas. Reg. sec. 1.194-3(a).

<sup>128</sup> Sec. 1245(b)(7).

<sup>129</sup> The present-law definition of reforestation expenditures is not changed.

<sup>130</sup> 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.<sup>131</sup> 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.<sup>132</sup> 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);<sup>133</sup> any covenant not to compete; and any franchise, trademark, or trade name.<sup>134</sup>

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.<sup>135</sup> Certain financial interests,<sup>136</sup> certain computer software readily available for purchase by the general public,<sup>137</sup> and certain rights acquired separately from the acquisition of assets constituting a trade or business (or substantial portion thereof)<sup>138</sup> are not subject to the 15-year amortization. Certain interests

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<sup>131</sup> 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).

<sup>132</sup> Sec. 197(d)(1).

<sup>133</sup> 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).

<sup>134</sup> Sec. 197(d)(1)(F).

<sup>135</sup> 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).

<sup>136</sup> Sec. 197(e)(1).

<sup>137</sup> Sec. 197(e)(3).

<sup>138</sup> Sec. 197(e)(4).

under leases and debt instruments,<sup>139</sup> 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”),<sup>140</sup> and certain transaction costs<sup>141</sup> 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.<sup>142</sup>

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.<sup>143</sup> Similarly, section 167 provides that computer software excluded from section 197 is depreciated using the straight-line method over a 36-month period.<sup>144</sup> 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.<sup>145</sup>

### **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.<sup>146</sup>

### **Effective Date**

The proposal applies to property acquired after December 31, 2014.

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<sup>139</sup> Sec. 197(e)(5).

<sup>140</sup> Sec. 197(e)(6)

<sup>141</sup> Sec. 197(e)(7).

<sup>142</sup> 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.

<sup>143</sup> Sec. 167(f)(3). Treas. Reg. sec. 1.167(a)-14(d).

<sup>144</sup> Sec. 167(f)(1). Treas. Reg. sec. 1.167(a)-14(b).

<sup>145</sup> Sec. 167(f)(2). Treas. Reg. sec. 1.167(a)-14(c).

<sup>146</sup> 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.<sup>147</sup> Treasury regulations provide that a taxpayer may the repair and maintenance costs of tangible property if such amounts are not otherwise required to be capitalized.<sup>148</sup> 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.<sup>149</sup> 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.<sup>150</sup> 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.<sup>151</sup> 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.<sup>152</sup> 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.*<sup>153</sup> and section 263A are treated as qualified environmental remediation expenditures.<sup>154</sup>

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.<sup>155</sup> Both urban and rural

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<sup>147</sup> Sec. 162.

<sup>148</sup> Treas. Reg. sec. 1.162-4(a).

<sup>149</sup> Treas. Reg. sec. 1.263(a)-3(d).

<sup>150</sup> Sec. 198.

<sup>151</sup> Sec. 198(b)(1).

<sup>152</sup> Sec. 198(b)(2).

<sup>153</sup> 418 U.S. 1 (1974).

<sup>154</sup> *Ibid.*

<sup>155</sup> 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”)<sup>156</sup> 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).<sup>157</sup>

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.<sup>158</sup> 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.<sup>159</sup>

### **Description of Proposal**

The proposal requires qualified environmental remediation expenditures<sup>160</sup> 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.<sup>161</sup> 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

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<sup>156</sup> Pub. L. No. 96-510 (1980).

<sup>157</sup> Sec. 198(d).

<sup>158</sup> Sec. 198(e).

<sup>159</sup> Sec. 198(f).

<sup>160</sup> The present-law definition of qualified environmental remediation expenditures is not changed.

<sup>161</sup> Sec. 198A.

account of a Federally declared disaster<sup>162</sup> 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.<sup>163</sup>

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.<sup>164</sup> 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.<sup>165</sup>

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.<sup>166</sup>

### **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<sup>167</sup>) that is equal to nine percent (six percent in the case of oil related

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<sup>162</sup> The term “Federally declared disaster” has the meaning given such term by section 165(h)(3)(C)(i).

<sup>163</sup> Sec. 198A(b).

<sup>164</sup> Sec. 198A(c)(1).

<sup>165</sup> Sec. 198A(d).

<sup>166</sup> Section 712 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343.

<sup>167</sup> 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.<sup>168</sup> 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.<sup>169</sup>

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.<sup>170</sup>

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<sup>171</sup> that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States;<sup>172</sup> (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film<sup>173</sup> 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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<sup>168</sup> 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).

<sup>169</sup> This example assumes the deduction does not exceed the wage limitation.

<sup>170</sup> 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.

<sup>171</sup> Qualifying production property generally includes any tangible personal property, computer software, and sound recordings. Sec. 199(c)(5).

<sup>172</sup> 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).

<sup>173</sup> 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.<sup>174</sup>

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.<sup>175</sup>

### **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.<sup>176</sup> 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.<sup>177</sup> 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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<sup>174</sup> Sec. 199(c)(4).

<sup>175</sup> 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, production 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.

<sup>176</sup> Sec. 195(b)(1)(A).

<sup>177</sup> Secs. 248(a)(1) and 709(b)(1)(A).

\$50,000.<sup>178</sup> 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.<sup>179</sup> 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.<sup>180</sup> Capitalized amounts are recovered when the business is sold, exchanged, or otherwise disposed.<sup>181</sup>

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.<sup>182</sup> 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.<sup>183</sup>

### **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.<sup>184</sup> 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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<sup>178</sup> 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).

<sup>179</sup> Secs. 195(b)(1)(B), 248(a)(2) and 709(b)(1)(B).

<sup>180</sup> Treas. Reg. secs. 1.195-1(b), 1.248-1(c), 1.709-1(b)(2).

<sup>181</sup> 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).

<sup>182</sup> Sec. 195(c)(1).

<sup>183</sup> Secs. 248(b) and 709(b)(3).

<sup>184</sup> 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.<sup>185</sup> 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.<sup>186</sup>

#### **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."<sup>187</sup> 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.<sup>188</sup> 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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<sup>185</sup> Sec. 265(a).

<sup>186</sup> See Rev. Proc. 72-18, 1972-1 C.B. 740.

<sup>187</sup> *Ibid.*

<sup>188</sup> 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.<sup>189</sup> 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).<sup>190</sup>

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.<sup>191</sup> 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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<sup>189</sup> 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.

<sup>190</sup> Special rules apply to bonds issued during 2009 and 2010. Secs. 265(b)(3)(G) and 265(b)(7).

<sup>191</sup> 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").<sup>192</sup> Miscellaneous itemized deductions<sup>193</sup> that are not investment expenses are disallowed first before any investment expenses are disallowed.<sup>194</sup>

## **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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<sup>192</sup> Sec. 67(a).

<sup>193</sup> 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.

<sup>194</sup> 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)<sup>195</sup> provides that if a loss has been disallowed under either of such provisions, the

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<sup>195</sup> 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,<sup>196</sup> 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.<sup>197</sup>

### **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.<sup>198</sup> 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.

<sup>196</sup> Sec. 267(f)(1).

<sup>197</sup> This rule in effect prevents a transferor from selectively realizing certain losses to offset gains in a transaction with a related party.

<sup>198</sup> 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.<sup>199</sup> 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.<sup>200</sup> Similarly, a deduction for any expense for food or beverages generally is limited to 50 percent of the amount otherwise deductible under the Code.<sup>201</sup> In

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<sup>199</sup> See sec. 274(a).

<sup>200</sup> Sec. 274(n).

<sup>201</sup> 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.<sup>202</sup>

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.<sup>203</sup> 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.<sup>204</sup> 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.<sup>205</sup>

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.<sup>206</sup> 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.<sup>207</sup> 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.<sup>208</sup>

### **Expenses treated as compensation**

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.<sup>209</sup> 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

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<sup>202</sup> Sec. 274(a)(3).

<sup>203</sup> Sec. 274(e)(2). See below for a discussion of the recent modification of this rule for certain individuals.

<sup>204</sup> Sec. 274(e)(9).

<sup>205</sup> Treas. Reg. sec. 1.162-25T.

<sup>206</sup> Sec. 274(e)(3).

<sup>207</sup> Sec. 274(e)(4).

<sup>208</sup> Sec. 274(n)(2)(E).

<sup>209</sup> Sec. 61(a)(1).

from gross income).<sup>210</sup> Treasury regulations provide rules regarding the valuation of fringe benefits, including flights on an employer-provided aircraft.<sup>211</sup> 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.”<sup>212</sup> 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.<sup>213</sup>

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.<sup>214</sup> 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.<sup>215</sup> 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).<sup>216</sup>

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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<sup>210</sup> Treas. Reg. sec. 1.61-21(b)(1).

<sup>211</sup> Treas. Reg. sec. 1.61-21.

<sup>212</sup> Treas. Reg. sec. 1.61-21(g)(5).

<sup>213</sup> Treas. Reg. sec. 1.61-21(b)(6).

<sup>214</sup> *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).

<sup>215</sup> Sec. 274(e)(2)(B). See also Treas. Reg. sec. 1.274-9.

<sup>216</sup> 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.<sup>217</sup>

### **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.<sup>218</sup> 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.<sup>219</sup> 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.<sup>220</sup>

### **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, taxpayer's 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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<sup>217</sup> See Treas. Reg. sec. 1.274-10(a)(2).

<sup>218</sup> Secs. 132(a), 3121(a)(20), 3231(e)(5), 3306(b)(16) and 3401(a)(19).

<sup>219</sup> 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.

<sup>220</sup> 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<sup>221</sup> 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<sup>222</sup> 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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<sup>221</sup> 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.

<sup>222</sup> 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)<sup>223</sup> 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.<sup>224</sup> 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.<sup>225</sup> 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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<sup>223</sup> 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, depreciation 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.

<sup>224</sup> Sec. 162(a).

<sup>225</sup> 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<sup>226</sup> 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.<sup>227</sup>

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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<sup>226</sup> 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.

<sup>227</sup> 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.<sup>228</sup> 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.<sup>229</sup>

### 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.<sup>230</sup>

### 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<sup>231</sup> 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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<sup>228</sup> Sec. 581.

<sup>229</sup> 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]”).

<sup>230</sup> Sec. 1361(b)(2).

<sup>231</sup> Tax Reform Act of 1986, Pub. L. No. 99-514.

## Credit unions

Credit unions are exempt from Federal income taxation.<sup>232</sup> 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.<sup>233</sup> 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.<sup>234</sup>

## **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.<sup>235</sup>

## **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.<sup>236</sup> 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.<sup>237</sup>

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<sup>232</sup> 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>.

<sup>233</sup> 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.

<sup>234</sup> 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>.

<sup>235</sup> Technical Advice Memorandum 199924060, March 5, 1999, and Rev. Rul. 80-230, 1980-2 C.B. 169, 1980.

<sup>236</sup> 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 and 613A of the Code)**

### **Present Law**

#### **In general**

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.<sup>238</sup> Certain costs incurred prior to drilling an oil or gas property or extracting minerals are recovered through the depletion deduction.<sup>239</sup> 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.<sup>240</sup>

Depletion is available to any person having an economic interest in a producing property.<sup>241</sup> 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.<sup>242</sup> 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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<sup>237</sup> Pub. L. No. 111-203.

<sup>238</sup> 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.

<sup>239</sup> Treas. Reg. sec. 1.612-4.

<sup>240</sup> Treas. Reg. sec. 1.612-1(b).

<sup>241</sup> Treas. Reg. sec. 1.611-1(b)(1).

<sup>242</sup> *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.<sup>243</sup>

Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.<sup>244</sup> 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.<sup>245</sup> Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.<sup>246</sup>

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.<sup>247</sup> The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.<sup>248</sup> Such producers and royalty owners generally may claim percentage depletion at a rate of 15 percent.<sup>249</sup>

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.<sup>250</sup> 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).<sup>251</sup> 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.<sup>252</sup>

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<sup>243</sup> *Ibid.*

<sup>244</sup> Secs. 611 - 613.

<sup>245</sup> Treas. Reg. sec. 1.611-2(a)(1).

<sup>246</sup> Treas. Reg. sec. 1.611-2(b)(2).

<sup>247</sup> Sec. 613.

<sup>248</sup> Sec. 613A(c).

<sup>249</sup> Sec. 613A(c)(1).

<sup>250</sup> 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.

<sup>251</sup> Sec. 613A(d)(1).

<sup>252</sup> 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.<sup>253</sup>

### **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.<sup>254</sup>

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.<sup>255</sup> 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.<sup>256</sup>

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.<sup>257</sup>

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.<sup>258</sup> 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,<sup>259</sup> each group is then treated as one producer in applying the 1,000-barrel limitation.

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<sup>253</sup> Sec. 613(a); Treas. Reg. sec. 1.611-1(a)(1).

<sup>254</sup> Sec. 613A(d)(2).

<sup>255</sup> *Ibid.*

<sup>256</sup> *Ibid.*

<sup>257</sup> Sec. 613A(d)(4).

<sup>258</sup> Sec. 613A(c).

<sup>259</sup> 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.<sup>260</sup> 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.<sup>261</sup> 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.<sup>262</sup> 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).<sup>263</sup>

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).<sup>264</sup> A stripper well property is any oil or gas property that produces a daily average of 15 or fewer

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<sup>260</sup> Pub. L. No. 101-508.

<sup>261</sup> Sec. 613A(c)(6).

<sup>262</sup> See Notice 2000-50, 2000-38 I.R.B. 291, September 18, 2000.

<sup>263</sup> See Notice 2013-53, 2013-36 I.R.B. 173, September 3, 2013.

<sup>264</sup> 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.<sup>265</sup>

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.<sup>266</sup>

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.<sup>267</sup> 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.<sup>268</sup> 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.<sup>269</sup> 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.<sup>270</sup>

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<sup>265</sup> Sec. 613A(c)(6)(E).

<sup>266</sup> 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.

<sup>267</sup> *Ibid.*

<sup>268</sup> Sec. 613A(c)(6)(G)(ii).

<sup>269</sup> Sec. 613(b)(4).

<sup>270</sup> 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).<sup>271</sup>

The excess of percentage depletion over cost depletion is a tax preference in computing a taxpayer's alternative minimum taxable income.<sup>272</sup>

### **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.<sup>273</sup> 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.<sup>274</sup> 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.<sup>275</sup> Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income.<sup>276</sup> 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.<sup>277</sup> The suspended losses from a passive activity are allowed in

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<sup>271</sup> Sec. 291(a)(2).

<sup>272</sup> Sec. 57(a)(1).

<sup>273</sup> Sec. 469. These rules were enacted in 1986 to curtail tax shelters. They apply to individuals, estates and trusts, and closely-held corporations.

<sup>274</sup> Sec. 469(c).

<sup>275</sup> Sec. 469(h). Regulations provide more detailed standards for material participation. See Treas. Reg. secs. 1.469-5 and -5T.

<sup>276</sup> Secs. 469(a) and (d).

<sup>277</sup> Sec. 469(b).

full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person.<sup>278</sup>

Losses from certain working interests in oil and gas property are not limited under the passive loss rule.<sup>279</sup> 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.<sup>280</sup> This rule applies without regard to whether the taxpayer materially participates in the activity.<sup>281</sup> 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.<sup>282</sup>

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.<sup>283</sup> 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.<sup>284</sup> 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.<sup>285</sup> The same

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<sup>278</sup> Sec. 469(g).

<sup>279</sup> 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.

<sup>280</sup> Sec. 469(c)(3)(A).

<sup>281</sup> Sec. 469(c)(4).

<sup>282</sup> Sec. 469(c)(3)(B).

<sup>283</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

<sup>284</sup> 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.

<sup>285</sup> 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.<sup>286</sup> 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.<sup>287</sup> 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.<sup>288</sup>

### **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.

<sup>286</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

<sup>287</sup> 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.

<sup>288</sup> 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 inventorable goods are taxed as ordinary income for Federal income tax purposes.<sup>289</sup> 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<sup>290</sup> or property used in the trade or business,<sup>291</sup> 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.<sup>292</sup> 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.<sup>293</sup>

#### **Coal or domestic iron ore**

Similar to proceeds from the sale of inventorable 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).<sup>294</sup> 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.<sup>295</sup>

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<sup>289</sup> Sec. 1221(a)(1).

<sup>290</sup> Sec. 1221.

<sup>291</sup> Sec. 1231.

<sup>292</sup> Sec. 631(b).

<sup>293</sup> 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.

<sup>294</sup> Secs. 631(c) and 1231(b)(2).

<sup>295</sup> 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.<sup>296</sup>

Section 1231 generally provides that if recognized gains on the sale or exchange of property used in a taxpayer's trade or business,<sup>297</sup> plus certain gains on involuntary conversions, exceed losses from such sales, exchanges, or conversions, the gain is long-term capital gain.<sup>298</sup> 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.<sup>299</sup>

### **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

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<sup>296</sup> Sec. 631(c).

<sup>297</sup> 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.

<sup>298</sup> Special recapture rules apply for non-recaptured section 1231 losses. See section 1231(d).

<sup>299</sup> 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.<sup>300</sup> 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.<sup>301</sup> Section 1031 also does not apply to certain exchanges involving livestock<sup>302</sup> or involving foreign property.<sup>303</sup>

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.<sup>304</sup> 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.<sup>305</sup> No losses may be recognized from a like-kind exchange.<sup>306</sup>

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange<sup>307</sup> 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.<sup>308</sup> The holding

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<sup>300</sup> Sec. 1031(a)(1).

<sup>301</sup> Sec. 1031(a)(2).

<sup>302</sup> Sec. 1031(e).

<sup>303</sup> Sec. 1031(h).

<sup>304</sup> 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.

<sup>305</sup> Secs. 1245(b)(4) and 1250(d)(4).

<sup>306</sup> Sec. 1031(c).

<sup>307</sup> 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).

<sup>308</sup> 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.<sup>309</sup>

### **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.<sup>310</sup> 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.<sup>311</sup> 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.<sup>312</sup> 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.<sup>313</sup>

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<sup>309</sup> Sec. 1223(1).

<sup>310</sup> Sec. 1001.

<sup>311</sup> Such a conversion may occur, for example, as a result of the property's destruction (in whole or in part). Sec. 1033(a).

<sup>312</sup> 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).

<sup>313</sup> 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”).<sup>314</sup>

Special rules extend the replacement period for certain real property<sup>315</sup> and principal residences damaged by a Federally declared disaster<sup>316</sup> 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.<sup>317</sup>

### **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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<sup>314</sup> Sec. 1033(a)(2)(B).

<sup>315</sup> Sec. 1033(g)(4).

<sup>316</sup> Sec. 1033(h)(1)(B).

<sup>317</sup> 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.<sup>318</sup> 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.<sup>319</sup> Seven percent of the excluded gain is an alternative minimum tax preference;<sup>320</sup> 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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<sup>318</sup> Sec. 1202.

<sup>319</sup> Sec. 1(h).

<sup>320</sup> 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.<sup>321</sup>

### **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.<sup>322</sup> 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),<sup>323</sup> 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.<sup>324</sup>

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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<sup>321</sup> 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 acquired at the time the replacement stock was purchased.

<sup>322</sup> Sec. 1221(a).

<sup>323</sup> 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).

<sup>324</sup> 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.<sup>325</sup> However, a taxpayer may elect to treat musical compositions and copyrights in musical works as capital assets.<sup>326</sup>

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.<sup>327</sup>

### **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<sup>328</sup> 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

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<sup>325</sup> Sec. 1221(a)(3).

<sup>326</sup> 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.

<sup>327</sup> *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 52 (1955).

<sup>328</sup> 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.<sup>329</sup>

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.<sup>330</sup>

### **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.<sup>331</sup>

### **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.<sup>332</sup> If the netting of gains and losses results in a loss, the loss is fully deductible against ordinary income.<sup>333</sup>

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<sup>329</sup> Sec. 1235(a).

<sup>330</sup> Sec. 1235(b).

<sup>331</sup> See also, section 3137 of the discussion draft, "Certain self-created property not treated as a capital asset."

<sup>332</sup> Sec. 1231(a)(1).

<sup>333</sup> 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.<sup>334</sup>

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.<sup>335</sup> 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.<sup>336</sup> 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.<sup>337</sup> 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.<sup>338</sup> 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.<sup>339</sup> 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.<sup>340</sup>

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<sup>334</sup> 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.

<sup>335</sup> Sec. 1245(a)(3).

<sup>336</sup> Sec. 1245(a)(1).

<sup>337</sup> Sec. 1250(c).

<sup>338</sup> Sec. 1250(a)(1).

<sup>339</sup> 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).

<sup>340</sup> 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 cellulosic biofuel producer credit. All but the cellulosic biofuel producer credit, expired on December 31, 2011. The cellulosic 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 cellulosic 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<sup>341</sup>) 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.<sup>342</sup> 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.<sup>343</sup>

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.<sup>344</sup> This separate credit computation commonly is referred to as the basic research credit.<sup>345</sup>

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.<sup>346</sup> This separate credit computation commonly is

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<sup>341</sup> See section 3201(b) of the discussion draft ("repeal of corresponding excise tax credits").

<sup>342</sup> Sec. 41(a)(1).

<sup>343</sup> Sec. 41(c)(5).

<sup>344</sup> Sec. 41(a)(2).

<sup>345</sup> Sec. 41(e).

<sup>346</sup> 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, expires for amounts paid or incurred after December 31, 2013.<sup>347</sup>

### **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).<sup>348</sup> 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.<sup>349</sup> 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.<sup>350</sup>

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<sup>347</sup> Sec. 41(h).

<sup>348</sup> 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).

<sup>349</sup> Sec. 41(f)(1).

<sup>350</sup> 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.<sup>351</sup> The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.<sup>352</sup> An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.<sup>353</sup>

## **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).<sup>354</sup> 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,<sup>355</sup> 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.<sup>356</sup> 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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<sup>351</sup> Sec. 41(c)(5)(A).

<sup>352</sup> Sec. 41(c)(5)(B).

<sup>353</sup> Sec. 41(c)(5)(C).

<sup>354</sup> 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).

<sup>355</sup> For a discussion of section 174, see section 3108 of the discussion draft, "Amortization of research and experimental expenditures."

<sup>356</sup> 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).<sup>357</sup>

### **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.<sup>358</sup> Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.<sup>359</sup>

### **Description of Proposal**

The proposal makes permanent the alternative simplified method<sup>360</sup> 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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<sup>357</sup> Sec. 41(d)(4).

<sup>358</sup> Sec. 280C(c).

<sup>359</sup> Sec. 280C(c)(3).

<sup>360</sup> 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.<sup>361</sup> 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

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<sup>361</sup> 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.<sup>362</sup> 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.

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<sup>362</sup> 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.<sup>363</sup> 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

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<sup>363</sup> 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.<sup>364</sup>

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.<sup>365</sup> Rehabilitation

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<sup>364</sup> This reflects the increased usage of the LIHTC by corporations rather than individuals since the creation of the credit.

<sup>365</sup> 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 expires for facilities the construction of which begins 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 begins 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.<sup>366</sup> 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<sup>367</sup> or section 4(10) of the Indian Child Welfare Act of 1978.<sup>368</sup> For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma"

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<sup>366</sup> Sec. 45A.

<sup>367</sup> Pub. L. No. 93-262.

<sup>368</sup> 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").<sup>369</sup> 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.<sup>370</sup> The credit applies

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<sup>369</sup> 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.

<sup>370</sup> 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 required to pay cash equal 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.”<sup>371</sup> 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.<sup>372</sup> 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.<sup>373</sup>

Amounts included in computing the credit under this section are excluded from the computation of the research credit under section 41.<sup>374</sup>

### **Description of Proposal**

This proposal repeals the credit for qualified clinical testing expenses.

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<sup>371</sup> Sec. 45C.

<sup>372</sup> Sec. 45C(b).

<sup>373</sup> Sec. 45C(d).

<sup>374</sup> 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;<sup>375</sup> (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.<sup>376</sup> 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.<sup>377</sup> 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.<sup>378</sup> 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.<sup>379</sup>

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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<sup>375</sup> 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.

<sup>376</sup> Secs. 45G(a) and (f).

<sup>377</sup> Sec. 45G(b)(1).

<sup>378</sup> Sec. 38(c)(4).

<sup>379</sup> 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).<sup>380</sup>

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.<sup>381</sup>

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.<sup>382</sup>

### **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

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<sup>380</sup> Sec. 45G(d).

<sup>381</sup> Sec. 45G(c).

<sup>382</sup> 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)<sup>383</sup> 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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<sup>383</sup> 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. 45I 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.<sup>384</sup> 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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<sup>384</sup> 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.<sup>385</sup>

An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States.<sup>386</sup> The term "wages" has the meaning given to such term by section 3306(b)<sup>387</sup> (determined without regard to any dollar limitation contained in that section).<sup>388</sup>

No deduction is allowed for the portion of the expenses otherwise deductible that is equal to the amount of the credit.<sup>389</sup> The credit does not apply to taxable years beginning after December 31, 2013.<sup>390</sup> Additionally, the credit is not allowable for purposes of computing the alternative minimum tax.<sup>391</sup>

### **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. 450 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.<sup>392</sup>

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<sup>385</sup> Sec. 45N(b).

<sup>386</sup> Sec. 45N(c).

<sup>387</sup> Section 3306(b) defines wages for purposes of Federal Unemployment Tax.

<sup>388</sup> Sec. 45N(d).

<sup>389</sup> Sec. 280C(e).

<sup>390</sup> Sec. 45N(e).

<sup>391</sup> Sec. 38(c).

<sup>392</sup> 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.<sup>393</sup> 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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<sup>393</sup> 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.<sup>394</sup> 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.<sup>395</sup> 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.<sup>396</sup> 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.<sup>397</sup>

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

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<sup>394</sup> 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.

<sup>395</sup> 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.

<sup>396</sup> Sec. 414(b), (c), (m) and (o).

<sup>397</sup> 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.<sup>398</sup>

### **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.<sup>399</sup>

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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<sup>398</sup> 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.

<sup>399</sup> 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.<sup>400</sup> Qualified

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<sup>400</sup> 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.<sup>401</sup> The Secretary, in consultation with the Secretary of Health and Human Services, awards certifications for qualified investments.<sup>402</sup> The credit is available only to companies having 250 or fewer employees.<sup>403</sup>

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.<sup>404</sup>

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.<sup>405</sup> 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.<sup>406</sup>

Companies must apply to the Secretary to obtain certification for qualifying investments.<sup>407</sup> 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.<sup>408</sup> 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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<sup>401</sup> Secs. 48D(b)(5) and (d)(1)(B).

<sup>402</sup> Sec. 48D(d)(1)(A).

<sup>403</sup> 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).

<sup>404</sup> Sec. 48D(c)(1).

<sup>405</sup> Sec. 48D(b)(1).

<sup>406</sup> Sec. 48D(b)(3).

<sup>407</sup> The Secretary must take action to approve or deny an application within 30 days of the submission of such application. Sec. 48D(d)(2).

<sup>408</sup> 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.<sup>409</sup>

Qualified therapeutic discovery project expenditures do not qualify for the research credit, orphan drug credit, or bonus depreciation.<sup>410</sup> 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.<sup>411</sup> 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.<sup>412</sup> 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.<sup>413</sup> 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.

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<sup>409</sup> Sec. 48D(d)(3)(B).

<sup>410</sup> Sec. 48D(e)(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.

<sup>411</sup> Sec. 48D(e)(1).

<sup>412</sup> Sec. 48D(f).

<sup>413</sup> 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)<sup>414</sup> 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 sec. 3306(b) (without regard to the dollar limitation therein contained). Special rules apply in the case of certain agricultural labor and certain railroad labor.

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<sup>414</sup> 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.<sup>415</sup> 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.<sup>416</sup>

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.<sup>417</sup>

#### **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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<sup>415</sup> Sec. 38.

<sup>416</sup> Sec. 39.

<sup>417</sup> 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.<sup>418</sup> 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.<sup>419</sup> An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.<sup>420</sup>

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.<sup>421</sup> Such taxpayers generally are required to keep inventories and use an accrual method of accounting with respect to inventory items.<sup>422</sup>

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.<sup>423</sup> Such farming businesses are not precluded from using the cash method regardless of whether they meet the gross receipts test.<sup>424</sup>

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<sup>418</sup> See, e.g., section 451.

<sup>419</sup> See, e.g., section 461.

<sup>420</sup> See, e.g., section 166.

<sup>421</sup> Treas. Reg. secs. 1.446-1(c)(2) and 1.471-1.

<sup>422</sup> Sec. 471; *Ibid.*

<sup>423</sup> Sec. 448(d)(1).

<sup>424</sup> 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”).<sup>425</sup> 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.<sup>426</sup>

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.

<sup>425</sup> Sec. 448(d)(5).

<sup>426</sup> 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<sup>427</sup> 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.<sup>428</sup> 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.<sup>429</sup> Examples of any one item for which an accounting method may be adopted include cost recovery,<sup>430</sup> revenue recognition,<sup>431</sup> and timing of deductions.<sup>432</sup> For each separate trade or business, a taxpayer is entitled to adopt any permissible method, subject to certain restrictions.<sup>433</sup>

A taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for such year.<sup>434</sup> Except as otherwise provided, section 446(e)

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<sup>427</sup> "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.

<sup>428</sup> Treas. Reg. sec. 1.446-1(a)(1).

<sup>429</sup> Sec. 446(c).

<sup>430</sup> See, *e.g.*, secs. 167 and 168.

<sup>431</sup> See, *e.g.*, secs. 451 and 460.

<sup>432</sup> See, *e.g.*, secs. 461 and 467.

<sup>433</sup> Sec. 446(d); Treas. Reg. sec. 1.446-1(d).

<sup>434</sup> 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.<sup>435</sup>

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.<sup>436</sup> 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.<sup>437</sup> 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.<sup>438</sup>

### **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.

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<sup>435</sup> Treas. Reg. sec. 1.446-1(e).

<sup>436</sup> Treas. Reg. sec. 1.446-1(e)(2)(ii)(a).

<sup>437</sup> Treas. Reg. sec. 1.446-1(e)(2)(ii)(b).

<sup>438</sup> 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.<sup>439</sup> 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.<sup>440</sup>

In general, for a cash basis taxpayer, an amount is included in income when actually or constructively received.<sup>441</sup> 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.<sup>442</sup>

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).<sup>443</sup>

##### 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.<sup>444</sup> 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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<sup>439</sup> Sec. 451(a).

<sup>440</sup> See Treas. Reg. sec. 1.451-2.

<sup>441</sup> See sec. 451 and Treas. Reg. sec. 1.451-1.

<sup>442</sup> *Ibid.*

<sup>443</sup> 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).

<sup>444</sup> 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.<sup>445</sup> 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<sup>446</sup> (the "reinvestment property").<sup>447</sup> 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.<sup>448</sup> 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<sup>449</sup>) with respect to the transmission

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<sup>445</sup> Sec. 451(e).

<sup>446</sup> 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.

<sup>447</sup> Sec. 451(i).

<sup>448</sup> Sec. 451(i)(3).

<sup>449</sup> 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<sup>450</sup>).<sup>451</sup>

In general, an independent transmission company is defined as: (1) an independent transmission provider<sup>452</sup> approved by the Federal Energy Regulatory Commission (“FERC”); (2) a person (i) who the FERC determines under section 203 of the Federal Power Act<sup>453</sup> (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).<sup>454</sup>

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).<sup>455</sup> Exempt utility property does not include any property that is located outside of the United States.<sup>456</sup>

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).<sup>457</sup>

### **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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<sup>450</sup> 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.

<sup>451</sup> Sec. 451(i)(6).

<sup>452</sup> For example, a regional transmission organization, an independent system operator, or an independent transmission company.

<sup>453</sup> 16 U.S.C. sec. 824b.

<sup>454</sup> Sec. 451(i)(4).

<sup>455</sup> Sec. 451(i)(5).

<sup>456</sup> Sec. 451(i)(5)(C).

<sup>457</sup> Sec. 451(i)(7).

statement under rules specified by the Secretary,<sup>458</sup> but provides an exception for long-term contract income to which section 460 applies.<sup>459</sup>

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.<sup>460</sup> 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.<sup>461</sup>

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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<sup>458</sup> 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.

<sup>459</sup> 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."

<sup>460</sup> 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).

<sup>461</sup> Thus, the proposal is intended to override the exception in Treasury Regulation section 1.451-5(c) for inventoriable goods.

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.<sup>462</sup> 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").<sup>463</sup> 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.<sup>464</sup>

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds<sup>465</sup> of such indebtedness are treated as a payment on the obligation, triggering the recognition of income.<sup>466</sup> 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,<sup>467</sup> 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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<sup>462</sup> See, e.g., sec. 451.

<sup>463</sup> Sec. 453.

<sup>464</sup> Sec. 453(l)(2).

<sup>465</sup> The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

<sup>466</sup> Sec. 453A(d).

<sup>467</sup> 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.<sup>468</sup> 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.<sup>469</sup> 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.<sup>470</sup> Another exception applies to obligations arising from sales of timeshares and residential lots; however, a separate interest charge applies as described above.<sup>471</sup>

### **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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<sup>468</sup> Sec. 453A(a)(1).

<sup>469</sup> 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.

<sup>470</sup> Sec. 453A(b)(3).

<sup>471</sup> 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.<sup>472</sup> However, eligible taxpayers using an accrual method of accounting for subscription income<sup>473</sup> may elect to recognize income associated with prepaid subscriptions<sup>474</sup> 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.<sup>475</sup> Thus, if elected,<sup>476</sup> 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.<sup>477</sup>

### **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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<sup>472</sup> See, e.g., sec. 451.

<sup>473</sup> See sec. 455(c)(1) and Treas. Reg. sec. 1.455-2(e).

<sup>474</sup> 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).

<sup>475</sup> For this purpose, “liability” means a liability to furnish or deliver a newspaper, magazine, or other periodical. Sec. 455(d)(2).

<sup>476</sup> 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.

<sup>477</sup> 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.<sup>478</sup> However, accrual method taxpayers<sup>479</sup> qualifying as membership organizations<sup>480</sup> may elect<sup>481</sup> to recognize income associated with prepaid dues<sup>482</sup> 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.<sup>483</sup> 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.<sup>484</sup>

### **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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<sup>478</sup> See, e.g., sec. 451.

<sup>479</sup> 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).

<sup>480</sup> 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).

<sup>481</sup> See sec. 456(c). See also Treas. Reg. secs. 1.456-2 and 1.456-6.

<sup>482</sup> 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).

<sup>483</sup> Sec. 456(e)(2).

<sup>484</sup> 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.<sup>485</sup> 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.<sup>486</sup>

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.<sup>487</sup> Deductions or exclusions based on estimates of future losses, expenses, or reductions in income ordinarily generally are not allowed for Federal income tax purposes.<sup>488</sup>

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.<sup>489</sup> 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.<sup>490</sup> 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.<sup>491</sup> Once an election is made, a taxpayer’s use of section 458 is treated as a method of

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<sup>485</sup> Sec. 451(a).

<sup>486</sup> See Treas. Reg. sec. 1.451-1(a).

<sup>487</sup> See sec. 461. See also Treas. Reg. secs. 1.461-1(a)(2)(i) and 1.461-4(g)(3).

<sup>488</sup> See, e.g., Treas. Reg. sec. 1.446-1(c)(1)(ii)(B).

<sup>489</sup> See also Treas. Reg. sec. 1.458-2.

<sup>490</sup> 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.

<sup>491</sup> 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<sup>492</sup> and must be continued until the taxpayer secures the consent of the Secretary to revoke such election.<sup>493</sup>

### **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.<sup>494</sup> 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.<sup>495</sup> 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.<sup>496</sup> 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.<sup>497</sup> The allocation of costs to a contract is made in accordance with regulations.<sup>498</sup> Costs incurred with

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<sup>492</sup> Sec. 458(c)(4).

<sup>493</sup> Sec. 458(c)(3).

<sup>494</sup> Sec. 460(a).

<sup>495</sup> 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.

<sup>496</sup> Sec. 460(b)(1).

<sup>497</sup> See sec. 460(c).

<sup>498</sup> 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.<sup>499</sup>

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.<sup>500</sup>

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.<sup>501</sup> 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.<sup>502</sup>

### **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.<sup>503</sup>

#### **Home and residential construction contracts**

One exception from the requirement to use the percentage-of-completion method is provided for home construction contracts.<sup>504</sup> 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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<sup>499</sup> Treas. Reg. secs. 1.460-4(b)(2)(iv) and 1.460-1(b)(8).

<sup>500</sup> 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).

<sup>501</sup> Sec. 460(f)(1). See also Treas. Reg. sec. 1.460-1(b)(1).

<sup>502</sup> Sec. 460(f)(2).

<sup>503</sup> Treas. Reg. sec. 1.460-4(c)(1).

<sup>504</sup> Secs. 460(e)(1)(A) and (e)(6).

of any integral component to, or improvements of, real property with respect to dwelling units<sup>505</sup> contained in buildings containing four or fewer dwelling units,<sup>506</sup> and improvements to real property directly related to (and located on the site of) such dwelling units.<sup>507</sup> 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").<sup>508</sup> Residential construction contracts are home construction contracts, as defined above, except that the building or buildings being constructed contain more than four dwelling units.<sup>509</sup> 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.<sup>510</sup> The exempt 30 percent of long-term contract income must be reported by consistently using the taxpayer's exempt contract method.<sup>511</sup>

#### 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.<sup>512</sup> Thus, long-term contract income from small construction contracts must be reported consistently using the taxpayer's exempt contract method.<sup>513</sup>

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<sup>505</sup> As defined in section 168(e)(2)(A)(ii).

<sup>506</sup> For this purpose, each townhouse or rowhouse is treated as a separate building. Sec. 460(e)(6)(A).

<sup>507</sup> Secs. 460(e)(4) and (e)(6). See also Treas. Reg. sec. 1.460-3(b)(2).

<sup>508</sup> Sec. 460(e)(5).

<sup>509</sup> Sec. 460(e)(6)(B). See also Treas. Reg. sec. 1.460-3(c).

<sup>510</sup> Treas. Reg. sec. 1.460-4(e).

<sup>511</sup> *Ibid.*

<sup>512</sup> Secs. 460(e)(1)(B) and (e)(4).

<sup>513</sup> 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.<sup>514</sup> 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.<sup>515</sup> 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.<sup>516</sup>

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<sup>517</sup> 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).<sup>518</sup>

### **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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<sup>514</sup> Treas. Reg. sec. 1.460-4(e).

<sup>515</sup> 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).

<sup>516</sup> 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).

<sup>517</sup> 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).

<sup>518</sup> 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.<sup>519</sup> However, the Deficit Reduction Act of 1984<sup>520</sup> contains an exception under which a taxpayer responsible for decommissioning a nuclear powerplant may elect<sup>521</sup> 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.<sup>522</sup> 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.<sup>523</sup> 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).<sup>524</sup>

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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<sup>519</sup> See, e.g., sec. 461 and Treas. Reg. sec. 1.461-1(a)(2).

<sup>520</sup> Sec. 91(c)(1) of Pub. L. No. 98-369 (1984).

<sup>521</sup> See Treas. Reg. sec. 1.468A-7 for election procedures.

<sup>522</sup> Sec. 468A.

<sup>523</sup> Sec. 468A(e)(1).

<sup>524</sup> 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").<sup>525</sup> 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.<sup>526</sup> 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).<sup>527</sup> 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.<sup>528</sup> 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.<sup>529</sup> 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.<sup>530</sup>

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.<sup>531</sup>

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<sup>525</sup> Sec. 468A(d).

<sup>526</sup> Taxpayers are required to include in gross income customer charges for decommissioning costs (sec. 88).

<sup>527</sup> 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.

<sup>528</sup> See sec. 468A(f)(3).

<sup>529</sup> 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).

<sup>530</sup> Sec. 468A(f)(2)(C).

<sup>531</sup> 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.<sup>532</sup> 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.<sup>533</sup>

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,<sup>534</sup> 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.<sup>535</sup> The transferee generally is required to obtain a new ruling amount from the IRS.<sup>536</sup>

### **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.<sup>537</sup> 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,<sup>538</sup> 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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<sup>532</sup> 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.

<sup>533</sup> Sec. 468A(c).

<sup>534</sup> Treas. Reg. sec. 1.468A-6(b).

<sup>535</sup> Treas. Reg. sec. 1.468A-6(c).

<sup>536</sup> Treas. Reg. sec. 1.468A-6(e)(2).

<sup>537</sup> These funds are generally referred to as "nonqualified funds."

<sup>538</sup> 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.<sup>539</sup> 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.<sup>540</sup> 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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<sup>539</sup> Sec. 471(a) and Treas. Reg. sec. 1.471-1.

<sup>540</sup> 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.<sup>541</sup>

### 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.<sup>542</sup> 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.<sup>543</sup>

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.<sup>544</sup> 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

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<sup>541</sup> 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.

<sup>542</sup> Sec. 474(a).

<sup>543</sup> 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.

<sup>544</sup> 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<sup>545</sup> 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.

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<sup>545</sup> "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.<sup>546</sup> 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.<sup>547</sup> Under the LCM method, the value of each article in ending inventory is written down if its market value is less than its cost.<sup>548</sup> 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.<sup>549</sup>

### **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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<sup>546</sup> Sec. 471(a) and Treas. Reg. sec. 1.471-1.

<sup>547</sup> 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.

<sup>548</sup> Treas. Reg. sec. 1.471-4(c).

<sup>549</sup> 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<sup>550</sup> 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)**

### **Present Law**

#### **In general**

The uniform capitalization (“UNICAP”) rules, which were enacted as part of the Tax Reform Act of 1986,<sup>551</sup> 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.<sup>552</sup> 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.

#### **Exceptions from UNICAP**

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;<sup>553</sup> such taxpayers are not required to include additional section 263A costs in inventory.

Another exception exists for taxpayers who raise, harvest, or grow trees.<sup>554</sup> 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

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<sup>550</sup> “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.

<sup>551</sup> Sec. 803(a) of Pub. L. No. 99-514 (1986).

<sup>552</sup> Sec. 263A.

<sup>553</sup> Sec. 263A(b)(2)(B).

<sup>554</sup> Sec. 263A(c)(5).

businesses (unless the taxpayer is required to use an accrual method of accounting under sec. 447 or 448(a)(3)).<sup>555</sup>

Freelance authors, photographers, and artists also are exempt from section 263A for any qualified creative expenses.<sup>556</sup> 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. The proposal also repeals the exception for farming businesses. 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

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<sup>555</sup> Sec. 263A(d).

<sup>556</sup> Sec. 263A(h).

intangible assets including the cost of motion picture films, sound recordings, copyrights, books, and patents.<sup>557</sup>

### **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,<sup>558</sup> 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.<sup>559</sup> For certain interests or rights with an undeterminable useful life, a 15-year safe harbor amortization period may be available.<sup>560</sup>

### **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.<sup>561</sup> 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).<sup>562</sup> 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.<sup>563</sup> 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.<sup>564</sup>

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<sup>557</sup> See secs. 167(g)(6), and 168(f)(3) and (4).

<sup>558</sup> Secs. 167(f)(2) and 197(e)(4)(B), (C), and (D).

<sup>559</sup> Treas. Reg. sec. 1.167(a)-3(a).

<sup>560</sup> 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.

<sup>561</sup> Sec. 167(g)(6).

<sup>562</sup> Sec. 167(g)(8).

<sup>563</sup> Sec. 167(g)(1).

<sup>564</sup> Sec. 167(g)(1)(C).

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).<sup>565</sup> An exception to this rule applies to participations and residuals.<sup>566</sup> Solely for 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.<sup>567</sup>

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*<sup>568</sup> decision.<sup>569</sup> This may be done on a property-by-property basis and must be applied consistently with respect to a given property thereafter.<sup>570</sup>

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.<sup>571</sup>

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<sup>565</sup> Sec. 167(g)(1)(B).

<sup>566</sup> 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.

<sup>567</sup> For example, in the case of participations or residuals to which sections 404(a)(5) or 404(b)(1) apply, such participations or residuals do not increase the taxpayer's basis until the amount is included in the gross income of the participant.

<sup>568</sup> *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945).

<sup>569</sup> Sec. 167(g)(7)(D).

<sup>570</sup> Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108<sup>th</sup> Congress* (JCS-5-05), May 2005.

<sup>571</sup> 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.

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. 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<sup>572</sup> engaged in a farming business<sup>573</sup> or fishing business.<sup>574</sup> Under section 1301, such an individual may elect to

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<sup>572</sup> The term “individual” does not include any estate or trust. Sec. 1301(b)(2).

<sup>573</sup> The term “farming business” has the meaning given such term by section 263A(e)(4). Sec. 1301(b)(3).

average the taxable income attributable to the farming or fishing business over a three-year period.

### **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.<sup>575</sup> 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.<sup>576</sup> Gross income does not, however, include return of capital (to the extent of the taxpayer's basis in such capital).<sup>577</sup>

#### **“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.”<sup>578</sup> 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

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<sup>574</sup> 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).

<sup>575</sup> Sec. 63.

<sup>576</sup> Sec. 61.

<sup>577</sup> Sec. 1001.

<sup>578</sup> *OKC Corp. v. Commissioner*, 82 T.C. 638, 649 (1984) (citing *Lyeth v. Hoey*, 305 U.S. 188 (1938)).

cash (often resulting in a reduction in the basis of the capital asset and/or capital gain treatment).<sup>579</sup> 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 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).<sup>580</sup>

In most infringement cases, the award is compensation for the taxpayer's loss of profits.<sup>581</sup> 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.”<sup>582</sup> 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.<sup>583</sup>

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.<sup>584</sup> 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.<sup>585</sup> 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.<sup>586</sup> The basis of the property then must be reduced (but not below zero) for any amounts excluded from income.<sup>587</sup> 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,<sup>588</sup> or as section 1231 gain, subject to the recapture provisions of section 1245.

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<sup>579</sup> *Freda v. Commissioner*, 656 F.2d 570 (7th Cir. 2011); *Messer v. Commissioner*, 438 F.2d 774 (3d Cir. 1971); *Durkee v. Commissioner*, 162 F.2d 184 (6th Cir. 1947).

<sup>580</sup> *Levens v. Commissioner*, 10 T.C.M. 1083 (1951).

<sup>581</sup> See *Mathy v. Commissioner*, 177 F.2d 259, 263 (1st Cir. 1949) (“*Mathy*”).

<sup>582</sup> *Ibid.* citing 3 *Walker on Patents* (Deller's Ed.) section 281.

<sup>583</sup> 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.

<sup>584</sup> *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).

<sup>585</sup> *Kurlan v. Commissioner*, 343 F.2d 625, 629-30 (2d Cir. 1965); Sec 1231(a)(3).

<sup>586</sup> See Rev. Rul. 81-277, 1981-2 C.B. 14.

<sup>587</sup> *Ibid.*

<sup>588</sup> See *Fawick v. Commissioner*, 52 T.C. 104 (1969), rev'd 436 F.2d 655 (6th Cir. 1971).

## 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 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.<sup>589</sup>

Section 266 permits a taxpayer to elect to charge certain taxes and carrying charges to capital account.<sup>590</sup> 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.<sup>591</sup> Such items chargeable to capital account include: (1) in the case of unimproved and unproductive real

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<sup>589</sup> Sec. 263(a)(2).

<sup>590</sup> See Treas. Reg. sec. 1.266-1(c) for the rules governing the making of an election under section 266.

<sup>591</sup> See Treas. Reg. sec. 1.266-1.

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 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.<sup>592</sup>

### **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.<sup>593</sup> 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.<sup>594</sup> For liabilities arising out of the use of property by a taxpayer, economic performance occurs ratably over the period of

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<sup>592</sup> Treas. Reg. sec. 1.266-1(b)(1).

<sup>593</sup> See, e.g., section 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).

<sup>594</sup> Sec. 461(h)(2)(A)(i) and (ii).

time during which the taxpayer is entitled to use the property.<sup>595</sup> For liabilities arising out of goods or services provided by a taxpayer to another person, economic performance occurs as the taxpayer incurs costs in connection with the satisfaction of the liability.<sup>596</sup> For liabilities arising out of workers compensation, tort, breach of contract, and other liabilities designated in regulations,<sup>597</sup> economic performance occurs when and to the extent that payment is made to the person to whom the liability is owed.<sup>598</sup>

There is an exception for recurring items generally expected to be incurred from one taxable year to the next.<sup>599</sup> 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 15<sup>th</sup> day of the ninth calendar month following the close of such taxable year.<sup>600</sup> 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.<sup>601</sup> The exception generally is not available to tax shelters.<sup>602</sup>

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 90<sup>th</sup> day following the close of the taxable year.<sup>603</sup> 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.<sup>604</sup>

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<sup>595</sup> Sec. 461(h)(2)(A)(iii); Treas. Reg. sec. 1.461-4(d)(3)(i).

<sup>596</sup> Sec. 461(h)(2)(B); Treas. Reg. sec. 1.461-4(d)(4)(i).

<sup>597</sup> Treas. Reg. sec. 1.461-4(g)(2)-(7).

<sup>598</sup> Sec. 461(h)(2)(C) and (D); Treas. Reg. sec. 1.461-4(g)(1).

<sup>599</sup> Sec. 461(h)(3).

<sup>600</sup> Treas. Reg. sec. 1.461-5(b).

<sup>601</sup> Treas. Reg. 1.461-5(b)(1)(iv).

<sup>602</sup> Sec. 461(i)(1).

<sup>603</sup> Sec. 461(i)(2)(A).

<sup>604</sup> Secs. 461(i)(2)(B) and (C).

### **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).

### **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,<sup>605</sup> 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

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<sup>605</sup> This discussion does not address options granted in connection with the performance of services.

premium payment in income.<sup>606</sup> 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.<sup>607</sup> 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.<sup>608</sup> A seller of an option has ordinary income if the option is not exercised,<sup>609</sup> but if the option is with respect to "property," any gain or loss from closing or lapse is short term capital gain.<sup>610</sup> For this purpose, "property" includes stocks, securities, commodities, and commodity futures.<sup>611</sup> 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.<sup>612</sup> 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.<sup>613</sup> 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.<sup>614</sup>

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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<sup>606</sup> 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 F.2d 919 (4th Cir. 1938), cert. denied, 307 U.S. 630 (1939).

<sup>607</sup> Sec. 1234(a).

<sup>608</sup> Sec. 1234(a)(2).

<sup>609</sup> Treas. Reg. sec. 1.1234-1(b).

<sup>610</sup> Sec. 1234(b).

<sup>611</sup> Sec. 1234(b)(2)(B).

<sup>612</sup> Rev. Rul. 88-31, 1988-1 C.B. 302.

<sup>613</sup> *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).

<sup>614</sup> 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.<sup>615</sup> 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.<sup>616</sup>

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.<sup>617</sup> 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.<sup>618</sup> 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.<sup>619</sup> 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.<sup>620</sup> Cash settlement of a forward is treated as a sale or exchange.<sup>621</sup>

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<sup>615</sup> See Notice 2008-2, 2008-1 C.B. 252.

<sup>616</sup> See, for example, *Anschutz Co. v. Commissioner*, 664 F.3d 313 (10th Cir. 2011).

<sup>617</sup> 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).

<sup>618</sup> Sec. 1001.

<sup>619</sup> Sec. 1234A and Prop. Treas. Reg. sec. 1.1234A-1(c)(1).

<sup>620</sup> *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.

<sup>621</sup> *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,<sup>622</sup> the long party's holding period of the underlying includes the period in which the party held the contract.<sup>623</sup> 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.<sup>624</sup> For short parties to physically settled securities forwards and commodities futures, section 1233 and the accompanying regulations provide rules regarding holding period determinations,<sup>625</sup> 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.<sup>626</sup> 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.<sup>627</sup>

Forwards for the sale of a single security or a narrow-based security index<sup>628</sup> 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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<sup>622</sup> The scope of section 1256 is discussed in detail below.

<sup>623</sup> 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).

<sup>624</sup> 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).

<sup>625</sup> 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).

<sup>626</sup> Sec. 1233(a)-(b).

<sup>627</sup> General Counsel Memorandum 39304, November 5, 1984.

<sup>628</sup> 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.<sup>629</sup> 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.<sup>630</sup> 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.<sup>631</sup> 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)).<sup>632</sup> 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.<sup>633</sup> A swap with a significant<sup>634</sup> nonperiodic payment is treated as two transactions: an on-market level payment swap and a loan.<sup>635</sup> The loan must be accounted for independently of the swap. Treasury regulations

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<sup>629</sup> 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.

<sup>630</sup> Treas. Reg. sec. 1.446-3(c)(1)(i).

<sup>631</sup> Treas. Reg. sec. 1.446-3(c)(1)(i).

<sup>632</sup> Treas. Reg. sec. 1.446-3(e), (f) and (h).

<sup>633</sup> *Ibid.*

<sup>634</sup> A term defined only indirectly through examples that leave a large area of uncertainty as to what constitutes a “significant” nonperiodic payment.

<sup>635</sup> 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.<sup>636</sup> The amount of a taxpayer's accrual is redetermined periodically as more information becomes available.<sup>637</sup>

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.<sup>638</sup> 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.<sup>639</sup>

### **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.<sup>640</sup> The character of gain or loss on the mark to market, or if the contract is terminated or transferred,<sup>641</sup> 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.<sup>642</sup> Different character rules apply to foreign currency contracts that come within both sections 1256 and 988.<sup>643</sup>

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<sup>636</sup> Notional Principal Contracts; Contingent Nonperiodic Payments: Notice of Proposed Rulemaking, Fed. Reg. vol. 69, 38, February 26, 2004, p. 8886 (the "2004 proposed regulations").

<sup>637</sup> *Ibid.*

<sup>638</sup> Prop. Treas. Reg. sec. 1.1234A-1.

<sup>639</sup> Prop. Treas. Reg. sec. 1.1234A-1(b).

<sup>640</sup> Sec. 1256(a)(1).

<sup>641</sup> Sec. 1256(c)(1).

<sup>642</sup> 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.

<sup>643</sup> 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,<sup>644</sup> (2) a foreign currency contract, (3) a nonequity option traded on or subject to the rules of a qualified board or exchange,<sup>645</sup> (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,<sup>646</sup> 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.<sup>647</sup>

### **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.<sup>648</sup> 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.<sup>649</sup>

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.<sup>650</sup> 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.

<sup>644</sup> 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).

<sup>645</sup> An option on a narrow-based security index is treated as an equity option and therefore not a section 1256 contract.

<sup>646</sup> Sec. 1256(g)(4).

<sup>647</sup> Sec. 1256(b)(2).

<sup>648</sup> Sec. 475(c)(2).

<sup>649</sup> Sec. 475(f).

<sup>650</sup> 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).<sup>651</sup>

## **Straddles**

Section 1092 defines a “straddle” as offsetting positions with respect to actively traded property.<sup>652</sup> 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.<sup>653</sup> 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.<sup>654</sup>

Exceptions from the straddle rules are provided for hedging transactions,<sup>655</sup> straddles composed entirely of section 1256 contracts,<sup>656</sup> and qualified covered calls.<sup>657</sup> Special rules apply for mixed straddles (generally, straddles comprised of both section 1256 contracts and non-section 1256 contracts)<sup>658</sup> and for identified straddles.<sup>659</sup>

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<sup>651</sup> Sec. 475(b)(1).

<sup>652</sup> Sec. 1092(c)(1) and (d)(1).

<sup>653</sup> 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.

<sup>654</sup> Sec. 1092(a)(1).

<sup>655</sup> 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).

<sup>656</sup> Sec. 1256(a)(4).

<sup>657</sup> Sec. 1092(c)(4); Treas. Reg. sec. 1.1092(c)1(b).

<sup>658</sup> 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 regulations 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.

<sup>659</sup> 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.<sup>660</sup> Likewise, the mark to market requirement under section 1256 does not apply to a transaction that the taxpayer identifies as a hedging transaction.<sup>661</sup>

Hedges must be identified by the close of the day on which a taxpayer enters into the hedging transaction.<sup>662</sup> The identification must be made on, and retained as part of, the taxpayer’s books and records.<sup>663</sup> 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.<sup>664</sup>

## **Treatment of convertible debt instruments**

Treasury Regulations provide for the treatment of debt instruments with contingent payments.<sup>665</sup> In the case of debt instruments issued for money or publicly traded property, the noncontingent bond method applies for accruing original issue discount (“OID”).<sup>666</sup> 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.”<sup>667</sup> 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.

<sup>660</sup> Sec. 475(b)(1)(C), (2).

<sup>661</sup> Sec. 1256(e).

<sup>662</sup> Treas. Reg. sec. 1.1221-2(f)(1).

<sup>663</sup> Treas. Reg. sec. 1.1221-2(f)(4)(i).

<sup>664</sup> Treas. Reg. sec. 1.1221-2(f)(4)(ii).

<sup>665</sup> Treas. Reg. sec. 1.1275-4.

<sup>666</sup> For a discussion of OID, see section 3413 of this discussion draft, “Coordination with rules for inclusion not later than for financial accounting purposes.”

<sup>667</sup> Treas. Reg. sec. 1.1275-4(b)(4)(i).

or debt.<sup>668</sup> It does apply to a debt instrument that is convertible into the corporation's stock and provides for one or more cash contingent payments.<sup>669</sup>

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.<sup>670</sup>

## **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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<sup>668</sup> Treas. Reg. sec. 1.1275-4(a)(4).

<sup>669</sup> Rev. Rul. 2002-31, 2002-1 C. B. 1023.

<sup>670</sup> 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.<sup>671</sup>

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

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<sup>671</sup> 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 or 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).<sup>672</sup> Gain or loss on property that is part of an identified hedging transaction generally is treated as ordinary, rather than capital.<sup>673</sup>

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.<sup>674</sup>

#### 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<sup>675</sup> identify the item, items, or aggregate risk being hedged.<sup>676</sup> Identification of an item being hedged generally involves indentifying a transaction that creates risk and the type of risk that the transaction creates.<sup>677</sup> Additional information is required for certain types of hedging transactions.<sup>678</sup> The regulations also specify that the identification of a

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<sup>672</sup> Sec. 1221(a)(7).

<sup>673</sup> 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).

<sup>674</sup> Sec. 1221(b)(2)(A).

<sup>675</sup> Treas. Reg. sec. 1.1221-2(f)(1).

<sup>676</sup> Treas. Reg. sec. 1.1221-2(f)(2).

<sup>677</sup> *Ibid.*

<sup>678</sup> 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.<sup>679</sup>

### **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.<sup>680</sup> 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,<sup>681</sup> 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.<sup>682</sup> This treatment of commodities gains as foreign personal holding company income does not, however, apply to income that arises out of commodity hedging transactions.<sup>683</sup> 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 primarily to

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<sup>679</sup> Treas. Reg. sec. 1.1221-2(f)(4)(ii).

<sup>680</sup> Financial Accounting 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.

<sup>681</sup> 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."

<sup>682</sup> Sec. 954(c)(1)(C).

<sup>683</sup> Sec. 954(c)(1)(C)(i).

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.<sup>684</sup>

### **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.<sup>685</sup>

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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<sup>684</sup> Sec. 954(c)(5)(A).

<sup>685</sup> 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.<sup>686</sup> 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.<sup>687</sup>

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.<sup>688</sup> 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.<sup>689</sup> To the extent any interest expense has been previously disallowed, it is allowed at the time the market discount is recognized.<sup>690</sup>

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<sup>686</sup> Sec. 1276.

<sup>687</sup> Sec. 1278(a)(2)(C).

<sup>688</sup> Sec. 1277.

<sup>689</sup> Sec. 1277(b)(1).

<sup>690</sup> Sec. 1277(b)(2).

A taxpayer may elect to include market discount in income as it accrues.<sup>691</sup> 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.<sup>692</sup> 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.<sup>693</sup> 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.<sup>694</sup> 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.<sup>695</sup>

## **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

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<sup>691</sup> Sec. 1278(b).

<sup>692</sup> Sec. 1272(a).

<sup>693</sup> 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."

<sup>694</sup> 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.

<sup>695</sup> 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.<sup>696</sup>

#### 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 (sections 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.

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<sup>696</sup> 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.<sup>697</sup> 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.<sup>698</sup>

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.<sup>699</sup> XYZ Corporation deducts

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<sup>697</sup> Sec. 1283(c).

<sup>698</sup> Sec. 1271(a)(4).

<sup>699</sup> 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.<sup>700</sup>

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<sup>701</sup> and \$16.37 of market discount.

The table below summarizes the 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.

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<sup>700</sup> 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.

<sup>701</sup> 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”).<sup>702</sup> The amount of COD income is generally the difference between the adjusted issue price<sup>703</sup> of the debt being cancelled and the amount used to satisfy the debt.<sup>704</sup> 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.<sup>705</sup> 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.<sup>706</sup>

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.<sup>707</sup>

##### **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).<sup>708</sup> The issue price of the new debt obligation generally determines the amount realized by the holder of the old debt.<sup>709</sup> In the case of a corporate reorganization and certain corporate distributions, gain on

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<sup>702</sup> 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.

<sup>703</sup> 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.

<sup>704</sup> Treas. Reg. sec. 1.61-12(c)(2).

<sup>705</sup> See Treas. Reg. sec. 1.1001-3(a).

<sup>706</sup> Sec. 108(e)(10).

<sup>707</sup> Treas. Reg. sec. 1.163-7(c).

<sup>708</sup> Sec. 1001 and Treas. Reg. sec. 1.1001-1.

<sup>709</sup> 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<sup>710</sup> and loss on the exchange is not recognized.<sup>711</sup>

### **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.<sup>712</sup> 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”),<sup>713</sup> 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 than the adjusted issue price of the old debt instrument. The 1990 Act repealed the special rule.<sup>714</sup>

### **Certain exchange of government obligations**

Present law provides that United States obligations may be exchanged without recognition of gain or loss.<sup>715</sup> 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.<sup>716</sup>

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<sup>710</sup> Sec. 356(d)(2)(B) and (C).

<sup>711</sup> Sec. 356(b).

<sup>712</sup> Secs. 1273(b) and 1274.

<sup>713</sup> Pub.L. No. 101-508.

<sup>714</sup> Sec. 1275(a)(4) was repealed by section 11325(a)(2) of the Omnibus Budget Reconciliation Act of 1990.

<sup>715</sup> Sec. 1037.

<sup>716</sup> 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)<sup>717</sup> 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.

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<sup>717</sup> See Treas. Reg. sec. 1.001-3 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.<sup>718</sup> 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.<sup>719</sup>

In general, for a cash basis taxpayer, an amount is included in income when actually or constructively received.<sup>720</sup> 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.<sup>721</sup>

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<sup>718</sup> Sec. 451(a).

<sup>719</sup> See. Treas. Reg. sec. 1.451-2.

<sup>720</sup> *Ibid.*

<sup>721</sup> 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.<sup>722</sup>

## **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.<sup>723</sup>

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.<sup>724</sup> The stated redemption price at maturity includes all amounts payable at maturity.<sup>725</sup> 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.<sup>726</sup> 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.<sup>727</sup>

## **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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<sup>722</sup> Secs. 61(a)(4) and 451.

<sup>723</sup> Sec. 1272.

<sup>724</sup> Sec. 1273(a)(1).

<sup>725</sup> Sec. 1273(a)(2).

<sup>726</sup> See sec. 1272.

<sup>727</sup> Sec. 163(e).

determined by taking into account an assumption regarding the prepayment of principal for such instruments.<sup>728</sup>

The Taxpayer Relief Act of 1997<sup>729</sup> extended these rules to any pool of debt instruments the payments on which may be accelerated by reason of prepayments.<sup>730</sup> 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,<sup>731</sup> cash-advance fees,<sup>732</sup> and interchange fees,<sup>733</sup> have been determined to create OID or increase the amount of OID on the pool of credit card receivables to which the amounts relate.<sup>734</sup>

### **Description of Proposal**

The proposal modifies the proposed rules under section 451.<sup>735</sup> 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.

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<sup>728</sup> Sec. 1272(a)(6).

<sup>729</sup> Pub. L. No. 105-34, sec. 1004(a).

<sup>730</sup> Sec. 1272(a)(6)(C)(iii).

<sup>731</sup> Revenue Procedure 2004-33, 2004-1 C.B. 989.

<sup>732</sup> Revenue Procedure 2005-47, 2005-2 C.B. 269.

<sup>733</sup> *Capital One Financial Corp. v. Commissioner*, 133 T.C. 8, September 31, 2009; IRS Chief Counsel Notice CC-2010-018, September 27, 2010.

<sup>734</sup> See also Rev. Proc. 2013-26, 2013-22 I.R.B. 1160, May 28, 2013 for a safe harbor method of accounting for OID on a pool of credit card receivables for purposes of section 1272(a)(6).

<sup>735</sup> 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.<sup>736</sup>

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.<sup>737</sup> 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.<sup>738</sup>

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.<sup>739</sup>

### **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.

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<sup>736</sup> Sec. 454(a).

<sup>737</sup> Sec. 454(b).

<sup>738</sup> Sec. 1281(a).

<sup>739</sup> 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.<sup>740</sup>

To compute adjusted basis, a taxpayer must first determine the property's unadjusted or original basis and then make adjustments prescribed by the Code.<sup>741</sup> 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").<sup>742</sup> 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.<sup>743</sup> 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").<sup>744</sup>

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.<sup>745</sup> To facilitate the determination of the cost of RIC stock under the average basis

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<sup>740</sup> Sec. 1001.

<sup>741</sup> Sec. 1016.

<sup>742</sup> Treas. Reg. sec. 1.1012-1(c)(1).

<sup>743</sup> Treas. Reg. sec. 1.1012-1(c).

<sup>744</sup> Treas. Reg. sec. 1.1012-1(e).

<sup>745</sup> 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.<sup>746</sup>

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.<sup>747</sup>

### **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.<sup>748</sup>

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.<sup>749</sup>

### **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.

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<sup>746</sup> Sec. 1012(c)(2).

<sup>747</sup> Sec. 1012(d)(1). Other special rules apply to DRP stock. See sec. 1012(d)(2) and (3).

<sup>748</sup> Sec. 6045(g); Treas. Reg. sec. 1.6045-1(d).

<sup>749</sup> 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”).<sup>750</sup> 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.<sup>751</sup> 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.<sup>752</sup>

#### **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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<sup>750</sup> Sec. 1091.

<sup>751</sup> Internal Revenue Service, *Investment Income and Expenses (Including Capital Gains and Losses)*, Publication 550, October 16, 2012, p. 59.

<sup>752</sup> 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.<sup>753</sup> 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.<sup>754</sup>

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<sup>753</sup> 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,<sup>755</sup> 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.<sup>756</sup>

### **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.

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<sup>754</sup> The second sentence of sec. 1032(a).

<sup>755</sup> See section 3401 of the discussion draft, relating to revision of treatment of contributions to capital.

<sup>756</sup> See section 3401 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.<sup>757</sup> 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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<sup>757</sup> 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).<sup>758</sup>

#### 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.<sup>759</sup>

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<sup>758</sup> Sec. 141(b)(4).

<sup>759</sup> 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.<sup>760</sup> 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.<sup>761</sup>

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.<sup>762</sup>

### **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").<sup>763</sup> 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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<sup>760</sup> Sec. 141(e).

<sup>761</sup> Sec. 142(a).

<sup>762</sup> Rev. Proc. 2013-35, 2013-47 I.R.B. 537 (November 18, 2013).

<sup>763</sup> 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.<sup>764</sup>

### **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).<sup>765</sup> 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.<sup>766</sup> 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

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<sup>764</sup> Sec. 143.

<sup>765</sup> Sec. 141.

<sup>766</sup> Sec. 149(d)(5).

and qualified 501(c)(3) bonds may be advance refunded one time.<sup>767</sup> Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all.<sup>768</sup> 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”).<sup>769</sup>

### **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**<sup>770</sup>

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

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<sup>767</sup> 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.

<sup>768</sup> Sec. 149(d)(2).

<sup>769</sup> 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.

<sup>770</sup> 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.<sup>771</sup> 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.

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<sup>771</sup> 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.<sup>772</sup> 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.<sup>773</sup>

#### 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,<sup>774</sup>

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<sup>772</sup> Sec. 54C.

<sup>773</sup> 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.

<sup>774</sup> 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 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.

rural development involving the production of electricity from 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.<sup>775</sup>

#### 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.

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.

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<sup>775</sup> 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.

### 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<sup>776</sup> (“inside buildup”).<sup>777</sup> 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.<sup>778</sup>

##### 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.<sup>779</sup>

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<sup>776</sup> 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)).

<sup>777</sup> 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).

<sup>778</sup> Sec. 101(a).

<sup>779</sup> Sec. 264(a)(1).

### Interest paid or accrued with respect to the contract<sup>780</sup>

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,<sup>781</sup> with a key person insurance exception.<sup>782</sup> 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.<sup>783</sup> 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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<sup>780</sup> 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 such debt.

<sup>781</sup> Sec. 264(a)(4).

<sup>782</sup> 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.

<sup>783</sup> Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 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<sup>784</sup> (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.<sup>785</sup>

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.<sup>786</sup>

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<sup>784</sup> Sec. 101(j).

<sup>785</sup> Sec. 172(b)(2).

<sup>786</sup> 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.<sup>787</sup> 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.<sup>788</sup>

### **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.

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<sup>787</sup> Secs. 810, 805(a)(5).

<sup>788</sup> 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.<sup>789</sup> 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 used in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning of 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.

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<sup>789</sup> 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.<sup>790</sup>

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.

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<sup>790</sup> 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.<sup>791</sup> 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.<sup>792</sup> 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.

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<sup>791</sup> Sec. 807.

<sup>792</sup> Sec. 807(f).

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 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.<sup>793</sup>

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,<sup>794</sup> 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.<sup>795</sup> 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.<sup>796</sup>

Gross investment income includes specified items.<sup>797</sup> 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

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<sup>793</sup> Secs. 807(a)(2)(B) and (b)(1)(B).

<sup>794</sup> Secs. 805(a)(4), 812.

<sup>795</sup> Sec. 812(a).

<sup>796</sup> Sec. 812(c).

<sup>797</sup> Sec. 812(d).

taxable year and (b) a portion of policyholder dividends.<sup>798</sup> Policy interest is defined to include 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.<sup>799</sup>

In 2007, the IRS issued Rev. Rul. 2007-54,<sup>800</sup> 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.<sup>801</sup> 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.<sup>802</sup> 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.<sup>803</sup> Methods for determining

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<sup>798</sup> Sec. 812(b)(1). This portion is defined as gross investment income’s share of policyholder dividends.

<sup>799</sup> 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.

<sup>800</sup> 2007-38 I.R.B. 604.

<sup>801</sup> 2007-42 I.R.B. 799.

<sup>802</sup> Section 817(d) provides a more detailed definition of a variable contract.

<sup>803</sup> Sec. 807.

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.

For purposes of determining the amount of the tax reserves for variable contracts, however, a special rule eliminates gains and losses. Under this rule,<sup>804</sup> 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.<sup>805</sup> 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.<sup>806</sup> The taxpayer's holding period is reduced for periods during which its risk of loss is reduced.<sup>807</sup>

### **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.

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<sup>804</sup> Sec. 817.

<sup>805</sup> Sec. 243 *et seq.* Conceptually, dividends received by a corporation are retained in corporate solution; these amounts are taxed when distributed to noncorporate shareholders.

<sup>806</sup> Sec. 246(c).

<sup>807</sup> 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.

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 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<sup>808</sup> 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

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<sup>808</sup> Pub. L. No. 98-369.

thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.

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.<sup>809</sup> This proration rule reflects the fact that reserves are

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<sup>809</sup> Sec. 832(b)(5).

generally funded in part from tax-exempt interest, from deductible dividends, and from other untaxed amounts.

### **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.<sup>810</sup> 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.<sup>811</sup>

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.<sup>812</sup> When this rule was enacted in 1986,<sup>813</sup> special rules were

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<sup>810</sup> Sec. 832.

<sup>811</sup> Sec. 832(b)(4)(B).

<sup>812</sup> Sec. 501(m).

<sup>813</sup> See H. Rep. 99-426, Tax Reform Act of 1985, December 7, 1985, p. 664. The Committee 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

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).<sup>814</sup>

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.<sup>815</sup>

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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.

<sup>814</sup> 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.

<sup>815</sup> 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

## 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.

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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 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.

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, 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.<sup>816</sup> 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.<sup>817</sup> 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

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<sup>816</sup> 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.

<sup>817</sup> 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.

determine a 24-month average for the 24 months preceding the first month of the calendar year for which the determination is made.

### **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.<sup>818</sup>

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

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<sup>818</sup> 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<sup>819</sup> 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

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<sup>819</sup> 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.<sup>820</sup>

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

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<sup>820</sup> 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.<sup>821</sup>

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<sup>821</sup> 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.<sup>822</sup> 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,<sup>823</sup> 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.<sup>824</sup>

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,<sup>825</sup> 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,<sup>826</sup> 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).

<sup>822</sup> Sec. 101(a)(2).

<sup>823</sup> Sec. 101(a)(2)(A).

<sup>824</sup> Sec. 101(a)(2)(B).

<sup>825</sup> 2009-21 I.R.B. 1029.

<sup>826</sup> 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.<sup>827</sup>

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.<sup>828</sup> 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.<sup>829</sup> 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

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<sup>827</sup> Sec. 1366.

<sup>828</sup> Certain built-in income items are treated as recognized built-in gain for this purpose. Sec. 1374(d)(5).

<sup>829</sup> 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).<sup>830</sup>

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.<sup>831</sup> 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.<sup>832</sup> 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.<sup>833</sup>

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.<sup>834</sup>

### **Reduced period for taxable years beginning in 2009 thru 2013**

The 10-year period during which the built-in gains tax applies has been shortened on a temporary basis.<sup>835</sup> 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.<sup>836</sup>

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<sup>830</sup> Sec. 1374(d)(2).

<sup>831</sup> Treas. Reg. sec. 1.1374-4(h).

<sup>832</sup> Sec. 1374(d)(8).

<sup>833</sup> Sec. 1374(d)(8)(B).

<sup>834</sup> Sec. 1366(f)(2).

<sup>835</sup> Sec. 1374(d)(7)(B) and (C).

<sup>836</sup> 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.<sup>837</sup>

### 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.<sup>838</sup>

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.<sup>839</sup> Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income.<sup>840</sup> Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, and annuities.<sup>841</sup> 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

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<sup>837</sup> See section 3647 of the bill for provisions relating to RICs and REITs.

<sup>838</sup> Sec. 1375(a).

<sup>839</sup> Sec. 1375(b)(1).

<sup>840</sup> Sec. 1375(b)(2).

<sup>841</sup> Sec. 1375(b)(3).

gross receipts for each of those years more than 25 percent of which are passive investment income.<sup>842</sup>

### **Description of Proposal**

The provisions 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.<sup>843</sup> 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.<sup>844</sup>

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.

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<sup>842</sup> Sec. 1362(d)(3).

<sup>843</sup> Sec. 1361(c)(2)(A)(v).

<sup>844</sup> 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.<sup>845</sup> 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,<sup>846</sup> rather than the deduction applicable to individuals,<sup>847</sup> 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

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<sup>845</sup> Sec. 1361(c)(2)(A)(v).

<sup>846</sup> Sec. 642(c).

<sup>847</sup> Sec. 170.

income tax liability.<sup>848</sup> A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.<sup>849</sup>

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.<sup>850</sup> An election continues in effect for subsequent taxable years until it is terminated.<sup>851</sup>

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.<sup>852</sup>

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

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<sup>848</sup> Sec. 1366(a)(1)(A).

<sup>849</sup> Sec. 1367(a)(2)(B).

<sup>850</sup> Sec. 1362(b)(1).

<sup>851</sup> Sec. 1362(c).

<sup>852</sup> Sec. 1362(a)(2).

(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.

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.<sup>853</sup>

The due date for filing a return on or before the 15th day of the third month following the close of the taxable year.<sup>854</sup>

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.

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<sup>853</sup> Sec. 1361(d)(1).

<sup>854</sup> 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) of the Code. The term “C corporation” is defined in section 1361(a)(2) of the Code (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.<sup>855</sup> 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.<sup>856</sup> 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.<sup>857</sup> A partner's deduction for partnership losses is limited to the adjusted basis of the partnership interest.<sup>858</sup> 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.<sup>859</sup> Guaranteed payments are distinct from a partnership distribution of income or capital,<sup>860</sup> and from payments by the partnership to a partner not acting in its capacity as a partner.<sup>861</sup>

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<sup>855</sup> Sec. 701.

<sup>856</sup> 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.

<sup>857</sup> Sec. 705.

<sup>858</sup> 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.

<sup>859</sup> Sec. 707(c).

<sup>860</sup> Secs. 731 and 733.

<sup>861</sup> 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.<sup>862</sup> The provision has created a great deal of uncertainty, confusion, and controversy since its enactment.<sup>863</sup>

### **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.<sup>864</sup> 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.

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<sup>862</sup> 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).

<sup>863</sup> See, for example, L. Steinberg, "Fun and Games with Guaranteed Payments," *Tax Lawyer*, Vol 57, Winter 2004, p. 533.

<sup>864</sup> 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<sup>865</sup> or (2) payments in exchange for the partner's interest in partnership property.<sup>866</sup>

Payments for goodwill generally are amortized over a period of 15 years.<sup>867</sup> However, under section 736(a), if a retiring general partner of a service partnership<sup>868</sup> 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.<sup>869</sup>

#### Income in respect of a decedent

Under present law, the receipt of income in respect of a decedent is includible in gross income,<sup>870</sup> 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.<sup>871</sup> 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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<sup>865</sup> Sec. 736(a).

<sup>866</sup> Sec. 736(b).

<sup>867</sup> Sec. 197.

<sup>868</sup> A service partnership refers to a partnership in which capital is not a material income-producing factor.

<sup>869</sup> Sec. 736(b)(2).

<sup>870</sup> Sec. 691.

<sup>871</sup> Sec. 1014(c).

decedent.<sup>872</sup> 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.<sup>873</sup>

### **Description of Proposal**

The proposal repeals section 736 and correspondingly repeals section 753 as obsolete.<sup>874</sup> 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<sup>875</sup> governing income in respect of a decedent.<sup>876</sup>

### **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.<sup>877</sup>

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.<sup>878</sup> These adjustments are to account for the difference between the

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<sup>872</sup> 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.

<sup>873</sup> *Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), aff'd per curiam, 444 F.2d 90 (8th Cir. 1971).

<sup>874</sup> 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.

<sup>875</sup> Secs. 691 and 1014(c).

<sup>876</sup> See P. Postlewaite and Rosenzweig, "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.

<sup>877</sup> Sec. 743(a).

<sup>878</sup> 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.<sup>879</sup> 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.<sup>880</sup> 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.<sup>881</sup> 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).<sup>882</sup> In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is

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<sup>879</sup> Sec. 743(d).

<sup>880</sup> See sec. 743(e) (alternative rules for electing investment partnerships) and sec. 743(f) (exception for securitization partnerships).

<sup>881</sup> 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).

<sup>882</sup> 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).<sup>883</sup>

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.<sup>884</sup>

### **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.<sup>885</sup> 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).<sup>886</sup>

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<sup>883</sup> Sec. 732(a).

<sup>884</sup> 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)).

<sup>885</sup> Sec. 734(a).

<sup>886</sup> 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 liquidation of a partner's interest.

Basis allocations among properties generally are allocated to reduce the difference between the fair market values and adjusted basis of 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.<sup>887</sup>

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.<sup>888</sup>

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<sup>887</sup> 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.

<sup>888</sup> 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.<sup>889</sup> 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.<sup>890</sup> 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)<sup>891</sup> and the basis in A's partnership interest is reduced to zero.<sup>892</sup>

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

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<sup>889</sup> Sec. 732(c)(3).

<sup>890</sup> Sec. 732(c)(2).

<sup>891</sup> Sec. 731(a)(1).

<sup>892</sup> 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).<sup>893</sup> 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).<sup>894</sup> 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<sup>895</sup> so that if A immediately sells Y it will recognize gain of \$20. A's basis in its partnership interest is reduced to zero.<sup>896</sup>

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).<sup>897</sup>

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.

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<sup>893</sup> 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 be apply solely with respect to A (present law sec. 734(b)(1)(A)).

<sup>894</sup> Sec. 705.

<sup>895</sup> Sec. 732(a)(2).

<sup>896</sup> Sec. 733.

<sup>897</sup> 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.<sup>898</sup>

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.<sup>899</sup>

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 if 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.

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<sup>898</sup> 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.

<sup>899</sup> 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<sup>900</sup> or by the transfer of an interest in the partnership by sale, exchange, or upon the death of a partner.<sup>901</sup> Under present law, certain of these adjustments are not mandatory.<sup>902</sup>

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.

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<sup>900</sup> Sec. 734.

<sup>901</sup> Sec. 743. For purposes of section 743, any distribution of an interest in a partnership is treated as an exchange. Sec. 761(e)(2).

<sup>902</sup> 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).<sup>903</sup>

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.<sup>904</sup> 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.<sup>905</sup>

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.<sup>906</sup> 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.<sup>907</sup>

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."<sup>908</sup> 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).

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<sup>903</sup> Sec. 704(d) and Treas. Reg. sec. 1.704-1(d)(1).

<sup>904</sup> Sec. 705(a).

<sup>905</sup> Rev. Rul. 96-11, 1996-1 C. B. 140.

<sup>906</sup> 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.

<sup>907</sup> Sec. 702.

<sup>908</sup> 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.<sup>909</sup>

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.<sup>910</sup>

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).<sup>911</sup>

### **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.

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<sup>909</sup> PLR 8405084. And see William S. McKee, William F. Nelson and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, WG&L, 4<sup>th</sup> 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.").

<sup>910</sup> Sec. 901.

<sup>911</sup> 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.<sup>912</sup> 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.<sup>913</sup>

Certain distributions are treated as sales or exchanges where a partnership holds unrealized receivables or substantially appreciated inventory.<sup>914</sup> 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<sup>915</sup> 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.

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<sup>912</sup> Sec. 741.

<sup>913</sup> The last sentence of sec. 741 and sec. 751(a).

<sup>914</sup> Sec. 751(b).

<sup>915</sup> 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.<sup>916</sup>

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.<sup>917</sup>

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.<sup>918</sup>

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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<sup>916</sup> 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.

<sup>917</sup> Sec. 704(c)(1)(A).

<sup>918</sup> 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.<sup>919</sup>

### **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.<sup>920</sup> 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.”<sup>921</sup> A partner means a member of a partnership.<sup>922</sup>

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.<sup>923</sup> 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

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<sup>919</sup> Sec. 737.

<sup>920</sup> Sec. 761(a). See also sec. 7701(a)(2).

<sup>921</sup> *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949).

<sup>922</sup> Sec. 761(b).

<sup>923</sup> Sec. 704(e)(1).

whether the business benefitted from the entrance of the new partner.”<sup>924</sup> In enacting this provision, Congress intended to override the intent test established by the Supreme Court.<sup>925</sup>

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.<sup>926</sup> 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.<sup>927</sup>

### **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.

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<sup>924</sup> See S. Rep. No. 781, 82d Cong., 1st Sess., 38, 39 (1951); H.R. Rep. No. 586, 82d Cong., 1st Sess., 32 (1951).

<sup>925</sup> See McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners*, 4<sup>th</sup> ed., para. 3.02[3], pages 3-21 thru 3-25.

<sup>926</sup> See 4 Bittker and Lokken, *Federal Taxation of Income, Estates, and Gifts*, para. 86.3.1, pages 86-29 (3<sup>rd</sup> 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.”

<sup>927</sup> See *TIFD III-E v. United States*, 459 F.3d 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.<sup>928</sup> Rules are also provided for the merger, consolidation, or division of a partnership.<sup>929</sup>

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.<sup>930</sup>

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.<sup>931</sup> 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.<sup>932</sup>

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.<sup>933</sup> Partnership-level elections generally cease to apply following a technical termination.<sup>934</sup> A technical termination generally results in the restart of partnership depreciation recovery periods.<sup>935</sup>

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<sup>928</sup> Sec. 708(b)(1).

<sup>929</sup> 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).

<sup>930</sup> Sec. 708(b)(1)(A).

<sup>931</sup> Sec. 708(b)(1)(B).

<sup>932</sup> Treas. Reg. sec. 1.708-1(b)(4).

<sup>933</sup> Sec. 706(c)(1); Treas. Reg. sec. 1.708-1(b)(3).

<sup>934</sup> 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*, 4<sup>th</sup> edition, para. 9.01[7], pages 9-42 - 9-44.

<sup>935</sup> Although sec. 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. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, 4<sup>th</sup> edition, para. 13.05[2][k], pages 13-33 - 13-37.

## **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.<sup>936</sup> The character of partnership items passes through to the partners, as if the items were realized directly by the partners.<sup>937</sup>

#### **Publicly traded partnerships**

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes.<sup>938</sup> A corporation is subject to tax at the corporate level on its taxable income.<sup>939</sup> 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).<sup>940</sup> 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 exchange for the stock of the corporation, and distributing the stock to its partners in liquidation of their partnership interests.<sup>941</sup>

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<sup>936</sup> Sec. 701.

<sup>937</sup> Sec. 702.

<sup>938</sup> Sec. 7704(a).

<sup>939</sup> Sec. 11(a).

<sup>940</sup> Sec. 7704(b).

<sup>941</sup> Sec. 7704(f).

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.<sup>942</sup> 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.

## **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

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<sup>942</sup> Sec. 7704(c)(2).

(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.<sup>943</sup>

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.<sup>944</sup> 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<sup>945</sup> 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.<sup>946</sup>

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.<sup>947</sup> A partnership capital interest for this purpose is an interest that 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.<sup>948</sup>

## **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

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<sup>943</sup> 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)).

<sup>944</sup> Rev. Proc. 93-27 (1993-2 C.B. 343) citing the *Diamond* and *Campbell* cases, *supra*.

<sup>945</sup> 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.

<sup>946</sup> 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).

<sup>947</sup> 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).

<sup>948</sup> Rev. Proc. 93-27, 1993-2 C.B. 343.

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.<sup>949</sup> 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.<sup>950</sup> The proposed regulations 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,

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<sup>949</sup> Sec. 83(h).

<sup>950</sup> 70 Fed. Reg. 29675 (May 24, 2005).

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.<sup>951</sup> 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").<sup>952</sup> A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").<sup>953</sup>

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.<sup>954</sup> 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.<sup>955</sup> The amount of wages subject to the HI component of the tax is not

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<sup>951</sup> Sec. 702.

<sup>952</sup> See Chapter 21 of the Code.

<sup>953</sup> Sec. 1401.

<sup>954</sup> Secs. 3101 and 3111.

<sup>955</sup> 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

capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.<sup>956</sup>

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,<sup>957</sup> 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.<sup>958</sup> 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.<sup>959</sup>

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.

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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 (unmarried individual or head of household).

<sup>956</sup> 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 (8<sup>th</sup> Cir. 2012); *Radtke v. U.S.*, 895 F.2d 1196 (7<sup>th</sup> Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9<sup>th</sup> 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. Commissioner*, 356 F.3d 290 (3d Cir. 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 employment tax.

<sup>957</sup> Sec. 1401; an additional 0.9 percent tax applies for remuneration received in taxable years beginning after December 31, 2012 (sec. 1401(b)(2)).

<sup>958</sup> 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).

<sup>959</sup> Secs. 1402(a)(1), (2), and (3).

A special rule applies for limited partners of a partnership.<sup>960</sup> 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.<sup>961</sup>

For taxable years beginning after 2012, in the case of an individual, estate, or trust, an unearned income Medicare contribution tax is imposed.<sup>962</sup> 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<sup>963</sup> 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.

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<sup>964</sup> not apply to the transfer of a partnership interest to which the proposal applies.

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<sup>960</sup> Sec. 1402(a)(13).

<sup>961</sup> 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.

<sup>962</sup> Sec. 1411.

<sup>963</sup> 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.

<sup>964</sup> 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.

## **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 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 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<sup>965</sup> subject to an initial hurdle rate of return to investor partners, except that partner 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

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<sup>965</sup> The possibility that the partnership in which investors hold interests may be a lower-tier partnership is ignored for purposes of this simplified example.

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,<sup>966</sup> 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.<sup>967</sup> Finally, for partnerships with 10 or fewer partners, that does not elect to be governed by TEFRA rules,<sup>968</sup> adjustments to items of income, gain, loss, deduction, or credit of 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.<sup>969</sup>

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<sup>966</sup> 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.

<sup>967</sup> Secs. 6240-6256.

<sup>968</sup> Prior to 1982, these rules applied regardless of the number of partners in the partnership.

<sup>969</sup> Secs. 6231 and 6201 *et seq.*

## **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."<sup>970</sup>

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.<sup>971</sup>

### 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 impractical to apply the largest profits interest rule, the IRS may select any partner as the Tax Matters Partner.

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<sup>970</sup> 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.

<sup>971</sup> Sec. 6224(c).

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.<sup>972</sup>

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.<sup>973</sup> 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 a settlement is reached with respect to partnership items, all partners are entitled to consistent treatment.<sup>974</sup>

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<sup>972</sup> Sec. 6229(d) and (g).

<sup>973</sup> Secs. 6222 and 6230(b).

<sup>974</sup> Sec. 6224.

## Electing large partnership audit rules

### Definition of electing large partnership

In 1997, a new audit system was enacted for electing large partnerships.<sup>975</sup> The 1997 legislation also enacted specific simplified reporting rules for electing large partnerships.<sup>976</sup> 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.<sup>977</sup>

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.”<sup>978</sup>

### 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 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

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<sup>975</sup> The Taxpayer Relief Act of 1997, Pub. L. No. 105-34.

<sup>976</sup> Secs. 771-777.

<sup>977</sup> Sec. 775.

<sup>978</sup> See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, p. 363.

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).

#### Partners cannot request refunds separately

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).<sup>979</sup> 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

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<sup>979</sup> Sec. 6031(b).

to file the partnership return and the Schedule K-1 (to September 15 in the foregoing example).<sup>980</sup>

## **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

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<sup>980</sup> 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;<sup>981</sup> 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.<sup>982</sup>

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).<sup>983</sup> 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.<sup>984</sup>

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.<sup>985</sup> In this manner, capital gain also is taxed only once, whether or not distributed, rather than at both the entity and investor level.

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<sup>981</sup> 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.

<sup>982</sup> Secs. 856 and 857.

<sup>983</sup> 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).

<sup>984</sup> 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.

<sup>985</sup> 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”).<sup>986</sup> 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,<sup>987</sup> 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.<sup>988</sup> 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.<sup>989</sup>

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<sup>986</sup> 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.

<sup>987</sup> Secs. 856(d)(1)(A) and (B).

<sup>988</sup> 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).

<sup>989</sup> 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”).<sup>990</sup>

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.<sup>991</sup>

### **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<sup>992</sup> (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.<sup>993</sup> No more than 25 percent of a REIT’s assets may be securities other than such real estate assets.<sup>994</sup>

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.<sup>995</sup> 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.<sup>996</sup>

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<sup>990</sup> Sec. 856(c)(3).

<sup>991</sup> See Rev. Rul. 74-191, 1974-1 C.B. 170.

<sup>992</sup> 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.

<sup>993</sup> 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).

<sup>994</sup> Sec. 856(c)(4)(B)(i).

<sup>995</sup> Sec. 856(c)(4)(B)(iii).

<sup>996</sup> 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.<sup>997</sup>

### **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.<sup>998</sup>

However, a TRS may rent a lodging facility or health care facility from its parent REIT and is permitted to hire an independent contractor<sup>999</sup> 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

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<sup>997</sup> 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.

<sup>998</sup> 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.

<sup>999</sup> 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.<sup>1000</sup>

### **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))<sup>1001</sup> 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.<sup>1002</sup> 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.<sup>1003</sup> However, a REIT is

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<sup>1000</sup> Sec. 857(b)(7).

<sup>1001</sup> 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).

<sup>1002</sup> 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.

<sup>1003</sup> 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.<sup>1004</sup> Such a dividend is treated as capital gain to the shareholders.<sup>1005</sup>

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”)<sup>1006</sup> 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

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<sup>1004</sup> 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.

<sup>1005</sup> 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.

<sup>1006</sup> 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.<sup>1007</sup> 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").<sup>1008</sup> 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.<sup>1009</sup> 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

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<sup>1007</sup> 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.

<sup>1008</sup> Sec. 355(b).

<sup>1009</sup> 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)),<sup>1010</sup> 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.<sup>1011</sup> 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.<sup>1012</sup>

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.<sup>1013</sup>

The IRS has ruled that a REIT may satisfy the active business requirement though its rental activities.<sup>1014</sup> 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.<sup>1015</sup> 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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<sup>1010</sup> 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.

<sup>1011</sup> Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113.

<sup>1012</sup> 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.

<sup>1013</sup> Sec. 355(g).

<sup>1014</sup> Rev. Rul. 2001-29, 2001-1 C.B. 1348.

<sup>1015</sup> PLR 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).<sup>1016</sup>

### **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.<sup>1017</sup>

### **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.

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<sup>1016</sup> 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.

<sup>1017</sup> 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.<sup>1018</sup>

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).<sup>1019</sup>

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.”<sup>1020</sup>

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

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<sup>1018</sup> See, overview of present law, *supra*, for a discussion of the specific income and asset requirements.

<sup>1019</sup> 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); PLR 200937006 (gas pipeline system); PLR 201037005 (data center); PLR 20119007 (wireless and broadcast communication towers, sites, and generators); PLR 2011430011 (billboards attached to building and also free standing tower structure billboards); PLR 201204006 (sign superstructures on façade of building); PLR 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.

<sup>1020</sup> Treas. Reg. sec. 1.856-3(d).

permanent structure.<sup>1021</sup> 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.<sup>1022</sup> 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.<sup>1023</sup>

### **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.<sup>1024</sup>

### **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.<sup>1025</sup>

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<sup>1021</sup> 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.

<sup>1022</sup> 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)).

<sup>1023</sup> PLR 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.* ).

<sup>1024</sup> For a discussion of a proposal concerning depreciation, see section 3104, Reform of accelerated cost recovery system.

<sup>1025</sup> 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., PLR 200052021, see also PLR 199945055, PLR 199927021, PLR 8838016. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued. However,

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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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 PLR 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 PLR 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.<sup>1026</sup>

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.<sup>1027</sup> 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.

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<sup>1026</sup> Sec. 856(d)(2)(A).

<sup>1027</sup> Sec. 856(f)(1). Income from a shared appreciation provision of a mortgage 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 draft and sec. 562 of the Code)**

**Present Law**

A REIT is allowed a deduction for dividends paid to its shareholders.<sup>1028</sup> In order to qualify for the deduction, a dividend must not be a “preferential dividend.”<sup>1029</sup> 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 apply 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)).<sup>1030</sup>

**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.<sup>1031</sup> A capital gain dividend is

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<sup>1028</sup> Sec. 857(b)(2)(B).

<sup>1029</sup> Sec. 562(c).

<sup>1030</sup> Secs. 852(b), 562(c).

<sup>1031</sup> 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.<sup>1032</sup> 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.<sup>1033</sup> 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.<sup>1034</sup>

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.<sup>1035</sup> 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.<sup>1036</sup> 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.

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<sup>1032</sup> Sec. 857(c)(2).

<sup>1033</sup> Sec. 1(h)(11) enacted in Pub. L. No. 105-34.

<sup>1034</sup> Rev. Rul 2005-31, 2005-1 C.B.1084.

<sup>1035</sup> Rev. Rul. 89-81, 1989-1 C.B.226.

<sup>1036</sup> 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.<sup>1037</sup> 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.<sup>1038</sup> 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.<sup>1039</sup> 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.<sup>1040</sup>

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

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<sup>1037</sup> There is an exception for any REIT that has continually been a REIT for all taxable years beginning after February 28, 1986.

<sup>1038</sup> 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).

<sup>1039</sup> Treas. Reg. sec. 1.857-11.

<sup>1040</sup> 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.<sup>1041</sup>

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.<sup>1042</sup>

### **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.

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<sup>1041</sup> See, e.g., PLRs 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., PLR 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.

<sup>1042</sup> 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").<sup>1043</sup> 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.<sup>1044</sup> No more than 25 percent of a REIT's assets may be securities other than such real estate assets.<sup>1045</sup>

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.<sup>1046</sup> No more than 25 percent of the value of a REIT's assets may be securities of one or more taxable REIT subsidiaries.<sup>1047</sup>

The asset tests must be met as of the close of each quarter of a REIT's taxable year.<sup>1048</sup>

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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<sup>1043</sup> Sec. 856(c)(4)(A).

<sup>1044</sup> 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).

<sup>1045</sup> Sec. 856(c)(4)(B)(i).

<sup>1046</sup> Sec. 856(c)(4)(B)(iii).

<sup>1047</sup> Sec. 856(c)(4)(B)(ii).

<sup>1048</sup> Sec. 856(4)(B)(ii).

<sup>1048</sup> 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.<sup>1049</sup>

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,

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<sup>1049</sup> 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.<sup>1050</sup> 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.<sup>1051</sup>

### **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)(1)(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.<sup>1052</sup> 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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<sup>1050</sup> 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).

<sup>1051</sup> Special rules apply to construction loans. Treas. Reg. sec. 1.856-5(c)(2).

<sup>1052</sup> 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).<sup>1053</sup>

### **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<sup>1054</sup>, 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

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<sup>1053</sup> Sec. 856(c)(5)(G).

<sup>1054</sup> 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.<sup>1055</sup> 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.<sup>1056</sup>

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.<sup>1057</sup>

These rules can be 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)<sup>1058</sup> and without regard to any deduction for dividends paid).

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<sup>1055</sup> 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.

<sup>1056</sup> Sec. 562(e).

<sup>1057</sup> Sec. 312(k)(3) and (n)(5).

<sup>1058</sup> Sec. 179D.

Assume that in 2013 (the first of the five years)<sup>1059</sup>, 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.

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<sup>1059</sup> 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.<sup>1060</sup> 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.<sup>1061</sup>

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.

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<sup>1060</sup> Sec. 856(c)(4)(b)(iii).

<sup>1061</sup> 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.<sup>1062</sup> 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<sup>1063</sup> during the taxable year, or (B) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property<sup>1064</sup> sold during the

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<sup>1062</sup> Sec. 857(b)(6).

<sup>1063</sup> Sales of foreclosure property or sales to which section 1033 applies are excluded.

<sup>1064</sup> 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<sup>1065</sup> 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<sup>1066</sup> during the taxable year, or (B) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property<sup>1067</sup> 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<sup>1068</sup> 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.

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<sup>1065</sup> Sales of foreclosure property or sales to which section 1033 applies are excluded.

<sup>1066</sup> Sales of foreclosure property or sales to which section 1033 applies are excluded.

<sup>1067</sup> Sales of foreclosure property or sales to which section 1033 applies are excluded.

<sup>1068</sup> 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.<sup>1069</sup>

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

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<sup>1069</sup> 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.<sup>1070</sup> 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.<sup>1071</sup> Treasury conducted and published a study of returns for 2001, the first year for which the legislation was in effect.<sup>1072</sup> A follow-up study was conducted, covering the period 2001-2004.<sup>1073</sup> 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.

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<sup>1070</sup> 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).

<sup>1071</sup> Ticket to Work and Work Incentives Improvement Act, Pub. L. No. 106-170 (1999).

<sup>1072</sup> Thornton Matheson, "Taxable REIT Subsidiaries: Analysis of the First Year's Returns 2001," available at <http://www.irs.gov/pub/irs-soi/01reit.pdf>.

<sup>1073</sup> 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.<sup>1074</sup>

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<sup>1075</sup> 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.<sup>1076</sup>

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.<sup>1077</sup>

### Section 337 and regulations relating to REITs and RICs

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.<sup>1078</sup>

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 it 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.<sup>1079</sup>

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<sup>1074</sup> Sec. 1366.

<sup>1075</sup> Certain built-in income items are treated as recognized built-in gain for this purpose. Sec. 1374(d)(5).

<sup>1076</sup> 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.

<sup>1077</sup> Sec. 1374(d)(7)(C).

<sup>1078</sup> Sec. 337(b)(2); Treas. Reg. sec. 1.337(d)-4.

<sup>1079</sup> 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.<sup>1080</sup>

### **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.<sup>1081</sup>

However, the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”)<sup>1082</sup> 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<sup>1083</sup> of a domestic U.S. real property holding company (“USRPHC”), generally

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<sup>1080</sup> Treas. Reg. sec. 1.337(d)-6(c).

<sup>1081</sup> 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 of 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)).

<sup>1082</sup> 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).

<sup>1083</sup> 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.<sup>1084</sup>

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.<sup>1085</sup>

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.<sup>1086</sup> 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.<sup>1087</sup>

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).<sup>1088</sup> 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.

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<sup>1084</sup> 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).

<sup>1085</sup> 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.

<sup>1086</sup> Secs. 851-855 (RICs) and Secs. 856-859 (REITs).

<sup>1087</sup> Sec. 562.

<sup>1088</sup> 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.<sup>1089</sup>

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

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<sup>1089</sup> Sec. 243.

percent of their income annually (except for net capital gains).<sup>1090</sup> REITs generally must invest in real estate related assets. RICs generally must invest in stocks and securities.<sup>1091</sup>

Dividends from REITs are not eligible for the corporate dividends received deduction.<sup>1092</sup> 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.<sup>1093</sup>

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.<sup>1094</sup> 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.<sup>1095</sup>

### **Description of Proposal**

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.

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<sup>1090</sup> 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.

<sup>1091</sup> Secs. 851-860.

<sup>1092</sup> Secs. 243(d)(3) and 857(c)(1).

<sup>1093</sup> Secs. 243(d)(2) and 854(b)(1)(A) and (C).

<sup>1094</sup> Sec. 245.

<sup>1095</sup> IRS CCA 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.<sup>1096</sup> 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.<sup>1097</sup> Personal holding company income includes dividends, interest, certain rents, and other generally passive investment income.<sup>1098</sup>

### 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.<sup>1099</sup>

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<sup>1096</sup> Sec. 541.

<sup>1097</sup> Sec. 542.

<sup>1098</sup> Sec. 543.

<sup>1099</sup> 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.<sup>1100</sup>

### **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.

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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)).

<sup>1100</sup> 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.<sup>1101</sup>

##### 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.<sup>1102</sup> 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.<sup>1103</sup>

##### 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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<sup>1101</sup> Sec. 816(a).

<sup>1102</sup> Sec. 807.

<sup>1103</sup> 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.<sup>1104</sup>

### **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.<sup>1105</sup> 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.<sup>1106</sup>

#### **Deduction for unpaid loss reserves**

Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred.<sup>1107</sup> 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.<sup>1108</sup> 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.<sup>1109</sup>

#### **Unearned premiums**

Further, the company deducts from gross premiums the increase in unearned premiums for the year.<sup>1110</sup> The company is required to reduce the deduction for increases in unearned

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<sup>1104</sup> Sec. 812.

<sup>1105</sup> Sec. 832.

<sup>1106</sup> Sec. 832(b)(1)(A).

<sup>1107</sup> Sec. 832(b)(3).

<sup>1108</sup> Sec. 846.

<sup>1109</sup> 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.<sup>1111</sup> 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.<sup>1112</sup>

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.<sup>1113</sup> 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."<sup>1114</sup>

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

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<sup>1110</sup> Sec. 832(b)(4)(B). Unearned premiums are generally those premiums received for insurance coverage in a future taxable year of the insurance company.

<sup>1111</sup> Sec. 832(b)(5).

<sup>1112</sup> 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.

<sup>1113</sup> Section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

<sup>1114</sup> 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.<sup>1115</sup>

#### 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.<sup>1116</sup> 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.<sup>1117</sup> 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

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<sup>1115</sup> 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.

<sup>1116</sup> Secs. 901-909.

<sup>1117</sup> 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.<sup>1118</sup>

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.<sup>1119</sup> Special rules apply to calculate the minimum effectively connected net investment income for this purpose.<sup>1120</sup>

#### 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.<sup>1121</sup>

#### 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.<sup>1122</sup> 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.

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<sup>1118</sup> Sec. 881.

<sup>1119</sup> Sec. 842.

<sup>1120</sup> 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).

<sup>1121</sup> Treas. Reg. sec. 1.1441-2(a)(7); see also Treas. Reg. sec. 1.881-2(b).

<sup>1122</sup> 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.<sup>1123</sup> Original issue discount on obligations maturing in six months or less is also exempt from tax.<sup>1124</sup> An additional exception is provided for certain interest paid on portfolio obligations.<sup>1125</sup> 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.<sup>1126</sup> 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.<sup>1127</sup> Moreover, this exception is not available for certain contingent interest payments.<sup>1128</sup>

### Subpart F

Under the subpart F rules,<sup>1129</sup> 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

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<sup>1123</sup> Secs. 871(i)(2)(A), 881(d).

<sup>1124</sup> Sec. 871(g)(1)(B)(i).

<sup>1125</sup> Secs. 871(h), 881(c).

<sup>1126</sup> Sec. 871(h).

<sup>1127</sup> Sec. 881(c)(3).

<sup>1128</sup> Sec. 871(h)(4).

<sup>1129</sup> Secs. 951-965.

of an insurance business (so-called “active financing income”).<sup>1130</sup> 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.<sup>1131</sup> 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.”<sup>1132</sup> 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.<sup>1133</sup> 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.

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<sup>1130</sup> Secs. 953(e) and 954(h) and (i), which expires December 31, 2011.

<sup>1131</sup> Sec. 953(c).

<sup>1132</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, May 4, 1987, p. 968.

<sup>1133</sup> Sec. 884.

## **Insurance and reinsurance excise tax**

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.<sup>1134</sup> 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.<sup>1135</sup>

Certain U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Switzerland, and the United Kingdom.<sup>1136</sup> 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).<sup>1137</sup>

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<sup>1134</sup> Secs. 4371-4374.

<sup>1135</sup> 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.

<sup>1136</sup> 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.

<sup>1137</sup> 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 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.

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.<sup>1138</sup> 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.<sup>1139</sup>

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).<sup>1140</sup> 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.

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<sup>1138</sup> Pub. L. No. 100-647.

<sup>1139</sup> 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.

<sup>1140</sup> 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.<sup>1141</sup> 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

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<sup>1141</sup> 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).<sup>1142</sup> 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.

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<sup>1142</sup> 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.<sup>1143</sup> Although the United States taxes U.S. persons<sup>1144</sup> 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<sup>1145</sup> 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.<sup>1146</sup> With respect to income from shipping, the gross basis tax potentially applicable is four percent,<sup>1147</sup> 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.<sup>1148</sup> 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.

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<sup>1143</sup> 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.

<sup>1144</sup> 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).

<sup>1145</sup> Secs. 871(a) and 881.

<sup>1146</sup> Secs. 871(b) and 882.

<sup>1147</sup> Sec. 887.

<sup>1148</sup> 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 countries 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.<sup>1149</sup> 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.<sup>1150</sup> Transportation income attributable to transportation that begins and ends in the United States is treated as wholly derived from sources in the United States,<sup>1151</sup> 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.<sup>1152</sup> 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.<sup>1153</sup>

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

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<sup>1149</sup> Sec. 4471. The tax is imposed either at the time of first embarkation or disembarkation in the United States, but not both.

<sup>1150</sup> Sec. 863(c)(3). The term “vessel or aircraft” includes any container used in connection with a vessel or aircraft.

<sup>1151</sup> Sec. 863(c)(1).

<sup>1152</sup> Sec. 863(c)(2).

<sup>1153</sup> Treas. Reg. sec. 1.863-4(a), *et seq.*

of such income of the foreign person is attributable to regularly scheduled transportation.<sup>1154</sup> 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.<sup>1155</sup> 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.<sup>1156</sup> 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.<sup>1157</sup> 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

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<sup>1154</sup> Sec. 887(b)(4).

<sup>1155</sup> Sec. 872(b)(1).

<sup>1156</sup> 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).

<sup>1157</sup> Rev. Rul. 2008-17, 2008-1 C.B. 626, modified by Ann. 2008-57, 2008-C.B. 1192, 2008.

under treaties vary in scope.<sup>1158</sup> 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).<sup>1159</sup>

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.<sup>1160</sup> 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

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<sup>1158</sup> 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.

<sup>1159</sup> Treas. Reg. Sec. 1.883-1(e)(3).

<sup>1160</sup> 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.<sup>1161</sup> 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.<sup>1162</sup> 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.<sup>1163</sup>

### **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

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<sup>1161</sup> Rev. Proc. 91-12, 1991-1 C.B. 473.

<sup>1162</sup> Sec. 6114.

<sup>1163</sup> 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.<sup>1164</sup> 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.<sup>1165</sup> 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.<sup>1166</sup> 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

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<sup>1164</sup> Sec. 1297.

<sup>1165</sup> Secs. 1293-1295.

<sup>1166</sup> Sec. 1291.

and their adjusted basis in such stock (subject to certain limitations), often referred to as “marking to market.”<sup>1167</sup>

### **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.<sup>1168</sup>

### **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 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.

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<sup>1167</sup> Sec. 1296.

<sup>1168</sup> 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."<sup>1169</sup> Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;<sup>1170</sup> 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.

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<sup>1169</sup> Sec. 163(j).

<sup>1170</sup> 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,<sup>1171</sup> 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

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<sup>1171</sup> 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)<sup>1172</sup> 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.<sup>1173</sup>

Under general tax principles, unfunded nonqualified deferred compensation generally is not included in income until actually or constructively received.<sup>1174</sup> 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.<sup>1175</sup> Absent a specific exception, these requirements apply in addition to any special rules for particular types of nonqualified deferred compensation plans.

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<sup>1172</sup> 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.

<sup>1173</sup> 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.

<sup>1174</sup> Treas. Reg. secs. 1.451-1(a) and 1.451-2; Rev. Rul. 60-31, 1960-1 C.B. 174.

<sup>1175</sup> 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.<sup>1176</sup> 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.<sup>1177</sup> 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.<sup>1178</sup>

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<sup>1176</sup> 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.

<sup>1177</sup> 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.

<sup>1178</sup> 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.<sup>1179</sup> 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.<sup>1180</sup>

Under Treasury regulations, certain other types of arrangements are not considered a deferral of compensation and thus are not subject to these rules.<sup>1181</sup> 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”).<sup>1182</sup> 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.”<sup>1183</sup> 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

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<sup>1179</sup> Sec. 409A(d)(1).

<sup>1180</sup> Secs. 401(a) and 403(a), 403(b), 408(k), 408(p), 457(b), 501(c)(18), and 415(m).

<sup>1181</sup> 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.

<sup>1182</sup> Treas. Reg. sec. 1.409A-1(b)(4).

<sup>1183</sup> 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”).<sup>1184</sup>

### 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.<sup>1185</sup> 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.<sup>1186</sup>

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

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<sup>1184</sup> Secs. 421-424.

<sup>1185</sup> Treas. Reg. sec. 1.409A-1(f).

<sup>1186</sup> 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.<sup>1187</sup>

### **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.<sup>1188</sup> 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.<sup>1189</sup> 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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<sup>1187</sup> Sec. 457(f)(3)(B).

<sup>1188</sup> Section 457A, generally effective for deferred amounts attributable to services performed after December 31, 2008.

<sup>1189</sup> 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.<sup>1190</sup> However, IRS guidance provides some exceptions.<sup>1191</sup> 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).

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<sup>1190</sup> 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.

<sup>1191</sup> 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.<sup>1192</sup>

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

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<sup>1192</sup> 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<sup>1193</sup> is limited to no more than \$1 million per year.<sup>1194</sup> 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

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<sup>1193</sup> 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.

<sup>1194</sup> 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).<sup>1195</sup> 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.<sup>1196</sup>

### **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<sup>1197</sup>); 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.

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<sup>1195</sup> Notice 2007-49, 2007-25 I.R.B. 1429.

<sup>1196</sup> Treas. Reg. sec. 1.162-27(c)(2).

<sup>1197</sup> 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,<sup>1198</sup> (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

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<sup>1198</sup> 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.<sup>1199</sup> 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").<sup>1200</sup>

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").<sup>1201</sup> 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

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<sup>1199</sup> Sec. 162(a)(1).

<sup>1200</sup> Sec. 162(m)(1). Under section 162(m)(6), limits apply to deductions for compensation of individuals performing services for certain health insurance providers.

<sup>1201</sup> Sec. 280G.

payments under a qualified retirement plan, a simplified employee pension plan or a simple retirement account.<sup>1202</sup>

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,<sup>1203</sup> an exempt farmers' cooperative,<sup>1204</sup> or a Federal, State or local governmental entity with excludable income.<sup>1205</sup>

Remuneration means wages as defined for income tax withholding purposes,<sup>1206</sup> but does not include any designated Roth contribution.<sup>1207</sup> 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<sup>1208</sup> during the taxable year with respect to the organization, (4) is a supporting organization<sup>1209</sup> during the taxable year

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<sup>1202</sup> Secs. 401(a) and 403(a), 408(k) and 408(p).

<sup>1203</sup> Sec. 501(a).

<sup>1204</sup> Sec. 521(b).

<sup>1205</sup> Sec. 115(1).

<sup>1206</sup> Sec. 3401(a).

<sup>1207</sup> 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.

<sup>1208</sup> Sec. 509(f)(3).

<sup>1209</sup> Sec. 509(a)(3).

with respect to the organization, or (5) in the case of a voluntary employees' beneficiary association ("VEBA"),<sup>1210</sup> 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,<sup>1211</sup> or an eligible deferred compensation plan of a State or local government employer.<sup>1212</sup>

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.<sup>1213</sup>

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

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<sup>1210</sup> Sec. 501(c)(9).

<sup>1211</sup> Sec. 403(b).

<sup>1212</sup> Sec. 457(b).

<sup>1213</sup> 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.<sup>1214</sup> 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.<sup>1215</sup> 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.<sup>1216</sup>

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<sup>1217</sup> and concludes that the rules relating to statutory options do not permit such a deduction.<sup>1218</sup>

### **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.

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<sup>1214</sup> 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.

<sup>1215</sup> Sec. 421(a)(2), referring to trade or business expenses deductible under section 162.

<sup>1216</sup> Sec. 421(b).

<sup>1217</sup> Sec. 174.

<sup>1218</sup> 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.<sup>1219</sup> 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.<sup>1220</sup> 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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<sup>1219</sup> 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.

<sup>1220</sup> Treas. Reg. secs. 31.3121(d)-1(c)(1), 31.3306(i)-1(a), and 31.3401(c)-1.

exists.<sup>1221</sup> 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.<sup>1222</sup> 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<sup>1223</sup> ("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.

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<sup>1221</sup> 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.

<sup>1222</sup> 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.

<sup>1223</sup> 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.<sup>1224</sup>

### **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.<sup>1225</sup> 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,<sup>1226</sup> and certain other salesmen are treated as employees for social security and Medicare tax purposes.<sup>1227</sup>

### **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

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<sup>1224</sup> 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.

<sup>1225</sup> Sec. 3508.

<sup>1226</sup> Sec. 3121(d)(3)(B) and 7701(a)(20).

<sup>1227</sup> 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),<sup>1228</sup> 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<sup>1229</sup> 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.

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<sup>1228</sup> 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.

<sup>1229</sup> 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”)<sup>1230</sup> authorized the designation of nine empowerment zones (“Round I empowerment zones”) to provide tax incentives for businesses to locate within certain targeted areas<sup>1231</sup> 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<sup>1232</sup> 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”)<sup>1233</sup> authorized a total of ten new empowerment zones (“Round III empowerment zones”), bringing the total number of authorized empowerment zones to 40.<sup>1234</sup> 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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<sup>1230</sup> Pub. L. No. 103-66.

<sup>1231</sup> 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.

<sup>1232</sup> Pub. L. No. 105-34.

<sup>1233</sup> Pub. L. No. 106-554.

<sup>1234</sup> 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.<sup>1235</sup> 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.<sup>1236</sup> 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 additional years, through December 31, 2013.<sup>1237</sup> 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.<sup>1238</sup>

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

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<sup>1235</sup> 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.

<sup>1236</sup> 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.

<sup>1237</sup> Pub. L. No. 112-240, sec. 327 (2013).

<sup>1238</sup> 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.”<sup>1239</sup>

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.<sup>1240</sup> 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.<sup>1241</sup> 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.<sup>1242</sup> The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.<sup>1243</sup>

### **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)<sup>1244</sup> for qualified zone property placed in service before January 1, 2012.<sup>1245</sup> 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.<sup>1246</sup> 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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<sup>1239</sup> 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.

<sup>1240</sup> Sec. 280C(a).

<sup>1241</sup> Secs. 1396(c)(3)(A) and 51A(d)(2).

<sup>1242</sup> Secs. 1396(c)(3)(B) and 51A(d)(2).

<sup>1243</sup> Sec. 38(c)(2).

<sup>1244</sup> The Small Business Jobs Act of 2010, Pub. L. No. 111-240, sec. 2021.

<sup>1245</sup> Secs. 1397A, 1397D.

<sup>1246</sup> Sec. 1397A(a)(2), 179(b)(2). For 2012 the limit is \$500,000. For taxable years beginning after 2012, 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.<sup>1247</sup>

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.<sup>1248</sup>

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.<sup>1249</sup> 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.

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<sup>1247</sup> Sec. 1397C(b).

<sup>1248</sup> Sec. 1397C(c).

<sup>1249</sup> 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.<sup>1250</sup> 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).<sup>1251</sup>

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<sup>1252</sup> held for more than one year and replaced within 60 days by another qualified

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<sup>1250</sup> Sec. 1394.

<sup>1251</sup> Sec. 1394(b)(3).

<sup>1252</sup> 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.<sup>1253</sup> 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.<sup>1254</sup> 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.

<sup>1253</sup> Sec. 1397B.

<sup>1254</sup> 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<sup>1255</sup> 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;<sup>1256</sup> (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).<sup>1257</sup>

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).<sup>1258</sup> 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

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<sup>1255</sup> Pub. L. No. 105-34.

<sup>1256</sup> 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).

<sup>1257</sup> These bonds could only be issued while the DC Zone designation was in effect.

<sup>1258</sup> Sec. 1400B.

qualified DC Zone business.<sup>1259</sup> 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.

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<sup>1259</sup> 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<sup>1260</sup> 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.<sup>1261</sup>

#### 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.<sup>1262</sup>

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

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<sup>1260</sup> 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.

<sup>1261</sup> If a renewal community designation is terminated prior to December 31, 2009, the tax incentives cease to be available as of the termination date.

<sup>1262</sup> 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.”<sup>1263</sup>

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.<sup>1264</sup> 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.<sup>1265</sup> 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.<sup>1266</sup> The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.<sup>1267</sup>

#### 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.<sup>1268</sup> 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.<sup>1269</sup>

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.<sup>1270</sup> Special rules are provided in the case of property that is substantially renovated by the taxpayer.

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<sup>1263</sup> 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.

<sup>1264</sup> Sec. 280C(a).

<sup>1265</sup> Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).

<sup>1266</sup> Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).

<sup>1267</sup> Sec. 38(c)(2).

<sup>1268</sup> Sec. 1400J.

<sup>1269</sup> Sec. 1400J, 179(b)(2), 179(b)(7). For 2008 and 2009, the limit is \$800,000.

<sup>1270</sup> 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.<sup>1271</sup>

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.<sup>1272</sup> 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.<sup>1273</sup> 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.

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<sup>1271</sup> Sec. 1400I.

<sup>1272</sup> Sec. 1400I.

<sup>1273</sup> 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<sup>1274</sup> 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,

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<sup>1274</sup> 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 designation, 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.