

## EXPLANATION OF THE BILL

### A. Individual Tax Reform

#### PART I – TAX RATE REFORM

##### 1. Temporary modification of rates (sec. 11001 of the bill and sec. 1 of the Code)

###### Present Law

###### In general

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

###### Tax rate schedules

Separate rate schedules apply based on an individual's filing status. For 2017, the regular individual income tax rate schedules are as follows:

**Table 1.–Federal Individual Income Tax Rates for 2017<sup>1</sup>**

<b>If taxable income is:</b>	<b>Then income tax equals:</b>
<i>Single Individuals</i>	
Not over \$9,325	10% of the taxable income
Over \$9,325 but not over \$37,950	\$932.50 plus 15% of the excess over \$9,325
Over \$37,950 but not over \$91,900	\$5,226.25 plus 25% of the excess over \$37,950
Over \$91,900 but not over \$191,650	\$18,713.75 plus 28% of the excess over \$91,900
Over \$191,650 but not over \$416,700	\$46,643.75 plus 33% of the excess over \$191,650
Over \$416,700 but not over \$418,400	\$120,910.25 plus 35% of the excess over \$416,700
Over \$418,400	\$121,505.25 plus 39.6% of the excess over \$418,400
<i>Heads of Households</i>	
Not over \$13,350	10% of the taxable income
Over \$13,350 but not over \$50,800	\$1,335 plus 15% of the excess over \$13,350
Over \$50,800 but not over \$131,200	\$6,952.50 plus 25% of the excess over \$50,800
Over \$131,200 but not over \$212,500	\$27,052.50 plus 28% of the excess over \$131,200
Over \$212,500 but not over \$416,700	\$49,816.50 plus 33% of the excess over \$212,500

<b>If taxable income is:</b>	<b>Then income tax equals:</b>
Over \$416,700 but not over \$444,550	\$117,202.50 plus 35% of the excess over \$416,700
Over \$444,550	\$126,950 plus 39.6% of the excess over \$444,550
<b><i>Married Individuals Filing Joint Returns and Surviving Spouses</i></b>	
Not over \$18,650	10% of the taxable income
Over \$18,650 but not over \$75,900	\$1,865 plus 15% of the excess over \$18,650
Over \$75,900 but not over \$153,100	\$10,452.50 plus 25% of the excess over \$75,900
Over \$153,100 but not over \$233,350	\$29,752.50 plus 28% of the excess over \$153,100
Over \$233,350 but not over \$416,700	\$52,222.50 plus 33% of the excess over \$233,350
Over \$416,700 but not over \$470,700	\$112,728 plus 35% of the excess over \$416,700
Over \$470,700	\$131,628 plus 39.6% of the excess over \$470,700
<b><i>Married Individuals Filing Separate Returns</i></b>	
Not over \$9,325	10% of the taxable income
Over \$9,325 but not over \$37,950	\$932.50 plus 15% of the excess over \$9,325
Over \$37,950 but not over \$76,550	\$5,226.25 plus 25% of the excess over \$37,950
Over \$76,550 but not over \$116,675	\$14,876.25 plus 28% of the excess over \$76,550
Over \$116,675 but not over \$208,350	\$26,111.25 plus 33% of the excess over \$116,675
Over \$208,350 but not over \$235,350	\$56,364 plus 35% of the excess over \$208,350
Over \$235,350	\$65,814 plus 39.6% of the excess over \$235,350
<b><i>Estates and Trusts</i></b>	
Not over \$2,550	15% of the taxable income
Over \$2,550 but not over \$6,000	\$382.50 plus 25% of the excess over \$2,550
Over \$6,000 but not over \$9,150	\$1,245 plus 28% of the excess over \$6,000
Over \$9,150 but not over \$12,500	\$2,127 plus 33% of the excess over \$9,150
Over \$12,500	\$3,232.50 plus 39.6% of the excess over \$12,500

<sup>1</sup> Rev. Proc. 2016-55, 2016-45 I.R.B. 707, sec. 3.01.

### **Unearned income of children**

Special rules (generally referred to as the “kiddie tax”) apply to the net unearned income of certain children.<sup>1</sup> Generally, the kiddie tax applies to a child if: (1) the child has not reached

<sup>1</sup> Sec. 1(g). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

the age of 19 by the close of the taxable year, or the child is a full-time student under the age of 24, and either of the child's parents is alive at such time; (2) the child's unearned income exceeds \$2,100 (for 2017); and (3) the child does not file a joint return.<sup>2</sup> The kiddie tax applies regardless of whether the child may be claimed as a dependent by either or both parents. For children above age 17, the kiddie tax applies only to children whose earned income does not exceed one-half of the amount of their support.

Under these rules, the net unearned income of a child (for 2017, unearned income over \$2,100) is taxed at the parents' tax rates if the parents' tax rates are higher than the tax rates of the child.<sup>3</sup> The remainder of a child's taxable income (i.e., earned income, plus unearned income up to \$2,100 (for 2017), less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child. For these purposes, unearned income is income other than wages, salaries, professional fees, other amounts received as compensation for personal services actually rendered, and distributions from qualified disability trusts.<sup>4</sup> In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.<sup>5</sup>

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents (\$1,050 for 2017<sup>6</sup>), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.<sup>7</sup>

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income.<sup>8</sup> If the child has net capital gains or qualified dividends, these items are allocated to the parent's hypothetical taxable income according to the ratio of net unearned income to the child's total unearned income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based upon the child's net unearned income relative to the aggregate net unearned income of all of the parent's children subject to the tax.

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<sup>2</sup> Sec. 1(g)(2).

<sup>3</sup> Special rules apply for determining which parent's rate applies where a joint return is not filed.

<sup>4</sup> Sec. 1(g)(4) and sec. 911(d)(2).

<sup>5</sup> Sec. 1(h).

<sup>6</sup> Sec. 3.02 of Rev. Proc. 2016-55, *supra*.

<sup>7</sup> Sec. 1(g)(4).

<sup>8</sup> Sec. 1(g)(3).

Generally, a child must file a separate return to report his or her income.<sup>9</sup> In such case, items on the parents' return are not affected by the child's income, and the total tax due from the child is the greater of:

1. The sum of (a) the tax payable by the child on the child's earned income and unearned income up to \$2,100 (for 2017), plus (b) the allocable parental tax on the child's unearned income, or
2. The tax on the child's income without regard to the kiddie tax provisions.<sup>10</sup>

Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return.<sup>11</sup>

## **Capital gains rates**

### In general

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

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

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

### Definitions

#### Net capital gain

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any

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<sup>9</sup> Sec. 1(g)(6). See IRS Form 8615, Tax for Certain Children Who Have Unearned Income.

<sup>10</sup> Sec. 1(g)(1).

<sup>11</sup> Sec. 1(g)(7).

gain generally is included in income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

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

#### Adjusted net capital gain

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

#### Qualified dividend income

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

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

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

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

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

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

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

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

#### 28-percent rate gain

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

#### Unrecaptured section 1250 gain

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

### **Reasons for Change**

The Committee believes that changing the individual rate structure by reducing certain rates and modifying the size of certain rate brackets creates a fairer Federal income tax. The Committee also aims to broaden the tax base to maintain necessary government revenues by repealing many existing tax incentives. The Committee further believes that a tax system with low rates will lead to efficient growth.

Under present law, the tax on the unearned income of children depends on the income of the child, parents, and when applicable, siblings. The Committee aims to simplify the taxation of unearned income of children, while continuing to minimize the benefit of tax-motivated income shifting, by subjecting this unearned income to rates applicable to estates and trusts.

### **Explanation of Provision**

#### **Temporary modification of rates**

The provision temporarily replaces the individual income tax rate structure with a new rate structure.

**Table 2.—Federal Individual Income Tax Rates for 2018 Under the Provision**

If taxable income is:	Then income tax equals:
<i>Single Individuals</i>	
Not over \$9,525	10% of the taxable income
Over \$9,525 but not over \$38,700	\$952.50 plus 12% of the excess over \$9,525
Over \$38,700 but not over \$70,000	\$4,453.50 plus 22% of the excess over \$38,700
Over \$70,000 but not over \$160,000	\$11,339.50 plus 24% of the excess over \$70,000
Over \$160,000 but not over \$200,000	\$32,939.50 plus 32% of the excess over \$160,000
Over \$200,000 but not over \$500,000	\$45,739.50 plus 35% of the excess over \$200,000
Over \$500,000	\$150,739.50 plus 38.5% of the excess over \$500,000
<i>Heads of Households</i>	
Not over \$13,600	10% of the taxable income
Over \$13,600 but not over \$51,800	\$1,360 plus 12% of the excess over \$13,600
Over \$51,800 but not over \$70,000	\$5,944 plus 22% of the excess over \$51,800
Over \$70,000 but not over \$160,000	\$9,948 plus 24% of the excess over \$70,000
Over \$160,000 but not over \$200,000	\$31,548 plus 32% of the excess over \$160,000
Over \$200,000 but not over \$500,000	\$44,348 plus 35% of the excess over \$200,000
Over \$500,000	\$149,348 plus 38.5% of the excess over \$500,000
<i>Married Individuals Filing Joint Returns and Surviving Spouses</i>	

<b>If taxable income is:</b>	<b>Then income tax equals:</b>
Not over \$19,050	10% of the taxable income
Over \$19,050 but not over \$77,400	\$1,905 plus 12% of the excess over \$19,050
Over \$77,400 but not over \$140,000	\$8,907 plus 22% of the excess over \$77,400
Over \$140,000 but not over \$320,000	\$22,679 plus 24% of the excess over \$140,000
Over \$320,000 but not over \$400,000	\$65,879 plus 32% of the excess over \$320,000
Over \$400,000 but not over \$1,000,000	\$91,479 plus 35% of the excess over \$400,000
Over \$1,000,000	\$301,479 plus 38.5% of the excess over \$1,000,000
<b><i>Married Individuals Filing Separate Returns</i></b>	
Not over \$9,525	10% of the taxable income
Over \$9,525 but not over \$38,700	\$952.50 plus 12% of the excess over \$9,525
Over \$38,700 but not over \$70,000	\$4,453.50 plus 22% of the excess over \$38,700
Over \$70,000 but not over \$160,000	\$11,339.50 plus 24% of the excess over \$70,000
Over \$160,000 but not over \$200,000	\$32,939.50 plus 32% of the excess over \$160,000
Over \$200,000 but not over \$500,000	\$45,739.50 plus 35% of the excess over \$200,000
Over \$500,000	\$150,739.50 plus 38.5% of the excess over \$500,000
<b><i>Estates and Trusts</i></b>	
Not over \$2,550	10% of the taxable income
Over \$2,550 but not over \$9,150	\$255 plus 24% of the excess over \$2,550
Over \$9,150 but not over \$12,500	\$1,839 plus 35% of the excess over \$9,150
Over \$12,500	\$3,011.50 plus 38.5% of the excess over \$12,500

Unlike present law (which uses a measure of the consumer price index for all-urban consumers), the new inflation adjustment uses the chained consumer price index for all-urban consumers.

The provision's rate structure does not apply to taxable years beginning after December 31, 2025.

### **Temporary simplification of tax on unearned income of children**

The provision temporarily simplifies the “kiddie tax” by effectively applying ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child. Thus, as under present law, taxable income attributable to earned income is taxed according to an unmarried taxpayers’ brackets and rates. Taxable income attributable to net unearned income is temporarily taxed according to the brackets applicable to trusts and estates, with respect to both ordinary income and income taxed at preferential rates. Thus, under the temporary provision, the



child's tax is unaffected by the tax situation of the child's parent or the unearned income of any siblings.

The simplification of tax on unearned income of children does not apply to taxable years beginning after December 31, 2025.

### **Maximum rates on capital gains and qualified dividends**

The provision generally retains the present-law maximum rates on net capital gain and qualified dividends. The breakpoints between the zero- and 15-percent rates ("15-percent breakpoint") and the 15- and 20-percent rates ("20-percent breakpoint") are based on the same amounts as the breakpoints under present law, except the breakpoints are indexed using the C-CPI-U in taxable years beginning after 2017. Thus, for 2018, the 15-percent breakpoint is \$77,200 for joint returns and surviving spouses (one-half of this amount for married taxpayers filing separately), \$51,700 for heads of household, \$2,600 for estates and trusts, and \$38,600 for other unmarried individuals. The 20-percent breakpoint is \$479,000 for joint returns and surviving spouses (one-half of this amount for married taxpayers filing separately), \$452,400 for heads of household, \$12,700 for estates and trusts, and \$425,800 for other unmarried individuals.

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

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

### **Paid preparer due diligence requirement for head of household status**

The provision directs the Secretary of the Treasury to promulgate due diligence requirements for paid preparers in determining eligibility for a taxpayer to file as head of household. A penalty of \$500 is imposed for each failure to meet these requirements.

The paid preparer due diligence requirement does not sunset.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **2. Inflation adjustments based on a closer approximation of cost-of-living increases (sec. 11002 of the bill and sec. 1 of the Code)**

## **Present Law**

Under present law, many parameters of the tax system are adjusted for inflation to protect taxpayers from the effects of rising prices. Most of the adjustments are based on annual changes in the level of the Consumer Price Index for all Urban Consumers (“CPI-U”).<sup>12</sup> The CPI-U is an index that measures prices paid by typical urban consumers on a broad range of products, and is developed and published by the Department of Labor.

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

## **Reasons for Change**

The Committee believes cost-of-living adjustments throughout the Code can be improved by indexing with the chained Consumer Price Index (“C-CPI-U”), which is designed by the Bureau of Labor Statistics to be a closer approximation to a cost-of-living index than other CPI measures.

## **Explanation of Provision**

The provision requires the use of the C-CPI-U to index tax parameters currently indexed by the CPI-U. The C-CPI-U, like the CPI-U, is a measure of the average change over time in prices paid by urban consumers. It is developed and published by the Department of Labor, but differs from the CPI-U in accounting for the ability of individuals to alter their consumption patterns in response to relative price changes. The C-CPI-U accomplishes this by allowing for consumer substitution between item categories in the market basket of consumer goods and services that make up the index, while the CPI-U only allows for modest substitution within item categories.

Under the provision, indexed parameters in the Code switch from CPI-U indexing to C-CPI-U indexing going forward in taxable years beginning after December 31, 2017. Therefore, in the case of any existing tax parameters that are not temporarily reset for 2018, the provision indexes parameters as if CPI-U applies through 2017 and C-CPI-U applies for years thereafter; the provision does not index all existing tax parameters from their base years using the C-CPI-U. Tax parameters with cost-of-living adjustment base years of 2016 and later are indexed solely with C-CPI-U.

Tax values that are temporarily reset for 2018, such as bracket thresholds and the basic standard deduction, are indexed by the C-CPI-U in taxable years beginning after December 31, 2018.

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<sup>12</sup> Sec. 1(f)(5).

The provision requiring C-CPI-U indexing after 2017 is permanent. Thus, after certain temporary tax parameters sunset, such as bracket thresholds and the increased basic standard deduction, corresponding present law values in the Code are indexed appropriately with the C-CPI-U.

**Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **PART II – DEDUCTION FOR QUALIFIED BUSINESS INCOME OF PASS-THRU ENTITIES**

### **1. Allow temporary 17.4-percent deduction to certain pass-through income (sec. 11011 of the bill and new sec. 199A of the Code)**

#### **Present Law**

##### **Individual income tax rates**

To determine regular tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status (i.e., single, head of household, married filing jointly, or married filing separately). For 2017, the regular individual income tax rate schedule provides rates of 10, 15, 25, 28, 33, 35, and 39.6 percent.

##### **Partnerships**

Partnerships generally are treated for Federal income tax purposes as pass-through entities not subject to tax at the entity level.<sup>13</sup> Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account by the partners in computing their income tax liability (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners).<sup>14</sup> A partner's deduction for partnership losses is limited to the partner's adjusted basis in its partnership interest.<sup>15</sup> Losses not allowed as a result of that limitation generally are carried forward to the next year. A partner's adjusted basis in the partnership interest generally equals the sum of (1) the partner's capital contributions to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) the partner's distributive share of losses allowed as a deduction and certain nondeductible expenditures, and (2) any partnership distributions to the partner.<sup>16</sup> Partners generally may receive distributions of partnership property without recognition of gain or loss, subject to some exceptions.<sup>17</sup>

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<sup>13</sup> Sec. 701.

<sup>14</sup> Sec. 702(a).

<sup>15</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 deductions (sections 469 and 465). These limitations do not apply to corporate partners (except certain closely-held corporations) and may not be important to individual partners who have partner-level passive income from other investments.

<sup>16</sup> Sec. 705.

<sup>17</sup> Sec. 731. Gain or loss may nevertheless be recognized, for example, on the distribution of money or marketable securities, distributions with respect to contributed property, or in the case of disproportionate distributions (which can result in ordinary income).

Partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect.<sup>18</sup> In general, an allocation has substantial economic effect to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.<sup>19</sup>

State laws of every State provide for limited liability companies<sup>20</sup> (“LLCs”), which are neither partnerships nor corporations under applicable State law, but which are generally treated as partnerships for Federal tax purposes.<sup>21</sup>

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes.<sup>22</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>23</sup>

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.<sup>24</sup>

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<sup>18</sup> Sec. 704(b)(2).

<sup>19</sup> Treas. Reg. sec. 1.704-1(b)(2).

<sup>20</sup> The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute, though the tax treatment of LLCs for State tax purposes may differ.

<sup>21</sup> Under Treasury regulations promulgated in 1996, any domestic nonpublicly traded unincorporated entity with two or more members generally is treated as a partnership for federal income tax purposes, while any single-member domestic unincorporated entity generally is treated as disregarded for Federal income tax purposes (*i.e.*, treated as not separate from its owner). Instead of the applicable default treatment, however, an LLC may elect to be treated as a corporation for Federal income tax purposes. Treas. Reg. sec. 301.7701-3. These are known as the “check-the-box” regulations.

<sup>22</sup> Sec. 7704(a).

<sup>23</sup> Sec. 7704(b).

<sup>24</sup> Sec. 7704(c)(2). Qualifying income is defined to include 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. Sec. 7704(d). 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), industrial source carbon dioxide, or the transportation or storage of certain fuel mixtures, alternative fuel, alcohol fuel, or biodiesel fuel. 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) where a principal activity of the partnership is the buying and selling of such commodities, futures, options, or forward contracts. However, the exception for partnerships with qualifying income does not apply to any partnership resembling a mutual fund (*i.e.*, that would be described in section 851(a) if it were a domestic

## **S corporations**

For Federal income tax purposes, an S corporation<sup>25</sup> generally is not subject to tax at the corporate level.<sup>26</sup> Items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation are taken into account by the S corporation shareholders in computing their income tax liabilities (based on the S corporation's method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in its S corporation stock and the indebtedness of the S corporation to such shareholder. Losses not allowed as a result of that limitation generally are carried forward to the next year. A shareholder's adjusted basis in the S corporation stock generally equals the sum of (1) the shareholder's capital contributions to the S corporation and (2) the shareholder's pro rata share of S corporation income, less (1) the shareholder's pro rata share of losses allowed as a deduction and certain nondeductible expenditures, and (2) any S corporation distributions to the shareholder.<sup>27</sup>

In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation.

### **Electing S corporation status**

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.<sup>28</sup> Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders of an S corporation.

## **Sole proprietorships**

Unlike a C corporation, partnership, or S corporation, a business conducted as a sole proprietorship is not treated as an entity distinct from its owner for Federal income tax

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corporation), which includes a corporation registered under the Investment Company Act of 1940 (Pub. L. No. 76-768 (1940)) as a management company or unit investment trust (sec. 7704(c)(3)).

<sup>25</sup> An S corporation is so named because its Federal tax treatment is governed by subchapter S of the Code.

<sup>26</sup> Secs. 1363 and 1366.

<sup>27</sup> Sec. 1367. If any amount that would reduce the adjusted basis of a shareholder's S corporation stock exceeds the amount that would reduce that basis to zero, the excess is applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder. If, after a reduction in the basis of such indebtedness, there is an event that would increase the adjusted basis of the shareholder's S corporation stock, such increase is instead first applied to restore the reduction in the basis of the shareholder's indebtedness. Sec. 1367(b)(2).

<sup>28</sup> Sec. 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. Sec. 1361(c)(1).

purposes.<sup>29</sup> Rather, the business owner is taxed directly on business income, and files Schedule C (sole proprietorships generally), Schedule E (rental real estate and royalties), or Schedule F (farms) with his or her individual tax return. Furthermore, transfer of a sole proprietorship is treated as a transfer of each individual asset of the business. Nonetheless, a sole proprietorship is treated as an entity separate from its owner for employment tax purposes,<sup>30</sup> for certain excise taxes,<sup>31</sup> and certain information reporting requirements.<sup>32</sup>

### **Reasons for Change**

The Committee believes that a reduction in the corporate income tax rate to 20 percent provided by the bill does not completely address the income tax rate on business income. Many businesses are conducted in the form of pass-through entities, namely partnerships and S corporations. Further, businesses are frequently conducted as sole proprietorships, rather than through a legal entity that is treated for tax purposes as separate from the individual who owns the business. The income of businesses conducted in pass-through form or in sole proprietorship form is subject to tax in the hands of their individual owners at the income tax rates of individuals. To treat corporate and noncorporate business income more similarly under the income tax, the bill provides a 17.4-percent deduction for qualified business income of individuals.

### **Explanation of Provision**

#### **In general**

For taxable years beginning after December 31, 2017, and before January 1, 2026, an individual taxpayer generally may deduct 17.4 percent of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 17.4 percent of aggregate qualified REIT dividends and qualified cooperative dividends. A limitation based on W-2 wages paid is phased in above a threshold amount of taxable income. A disallowance of the deduction with respect to specified service trades or businesses is also phased in above the threshold amount of taxable income.<sup>33</sup>

#### **Qualified business income**

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<sup>29</sup> A single-member unincorporated entity is disregarded for Federal income tax purposes, unless its owner elects to be treated as a C corporation. Treas. Reg. sec. 301.7701-3(b)(1)(ii). Sole proprietorships often are conducted through legal entities for nontax reasons. While sole proprietorships generally may have no more than one owner, a married couple that files a joint return and jointly owns and operates a business may elect to have that business treated as a sole proprietorship under section 761(f).

<sup>30</sup> Treas. Reg. sec. 301.7701-2(c)(2)(iv).

<sup>31</sup> Treas. Reg. sec. 301.7701-2(c)(2)(v).

<sup>32</sup> Treas. Reg. sec. 301.7701-2(c)(2)(vi).

<sup>33</sup> For purposes of this provision, taxable income is computed without regard to the 17.4 percent deduction.

Qualified business income is determined for each qualified trade or business of the taxpayer. For any taxable year, qualified business income means the net amount of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business of the taxpayer. The determination of qualified items of income, gain, deduction, and loss takes into account these items only to the extent included or allowed in the determination of taxable income for the year. For example, if in a taxable year, a qualified business has \$100,000 of ordinary income from inventory sales, and makes an expenditure of \$25,000 that is required to be capitalized and amortized over 5 years under applicable tax rules, the qualified business income is \$100,000 minus \$5,000 (current-year ordinary amortization deduction), or \$95,000. The qualified business income is not reduced by the entire amount of the capital expenditure, only by the amount deductible in determining taxable income for the year.

If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year. Similar to a qualified trade or business that has a qualified business loss for the current taxable year, any deduction allowed in a subsequent year is reduced (but not below zero) by 17.4 percent of any carryover qualified business loss. For example, Taxpayer has qualified business income of \$20,000 from qualified business A and a qualified business loss of \$50,000 from qualified business B in Year 1. Taxpayer is not permitted a deduction for Year 1 and has a carryover qualified business loss of \$30,000 to Year 2. In Year 2, Taxpayer has qualified business income of \$20,000 from qualified business A and qualified business income of \$50,000 from qualified business B. To determine the deduction for Year 2, Taxpayer reduces the 17.4 percent deductible amount determined for the qualified business income of \$70,000 from qualified businesses A and B by 17.4 percent of the \$30,000 carryover qualified business loss.

#### Domestic business

Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States.<sup>34</sup> In the case of a taxpayer who is an individual with otherwise qualified business income from sources within the commonwealth of Puerto Rico, if all the income is taxable under section 1 (income tax rates for individuals) for the taxable year, the "United States" is considered to include Puerto Rico for purposes of determining the individual's qualified business income.

#### Treatment of investment income

Qualified items do not include specified investment-related income, deductions, or loss. Specifically, qualified items of income, gain, deduction and loss do not include (1) any item taken into account in determining net long-term capital gain or net long-term capital loss, (2) dividends, income equivalent to a dividend, or payments in lieu of dividends, (3) interest income other than that which is properly allocable to a trade or business, (4) the excess of gain over loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the

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<sup>34</sup> For this purpose, section 864(c) is applied substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or "a foreign corporation."



ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business, (5) the excess of foreign currency gains over foreign currency losses from section 988 transactions, other than transactions directly related to the business needs of the business activity, (6) net income from notional principal contracts, other than clearly identified hedging transactions that are treated as ordinary (i.e., not treated as capital assets), and (7) any amount received from an annuity that is not used in the trade or business of the business activity. Qualified items under this provision do not include any item of deduction or loss properly allocable to such income.

#### Reasonable compensation and guaranteed payments

Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. Similarly, qualified business income does not include any guaranteed payment for services rendered with respect to the trade or business,<sup>35</sup> and to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.<sup>36</sup>

#### Qualified trade or business

A qualified trade or business means any trade or business other than a specified service trade or business.

#### Specified service business

A specified service trade or business means any trade or business involving the performance of services in the fields of health,<sup>37</sup> law, engineering, architecture, accounting, actuarial science, performing arts,<sup>38</sup> consulting,<sup>39</sup> athletics, financial services, brokerage services,

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<sup>35</sup> Described in sec. 707(c).

<sup>36</sup> Described in sec. 707(a).

<sup>37</sup> A similar list of service trades or business is provided in section 448(d)(2)(A) and Treas. Reg. sec. 1.448-1T(e)(4)(i). For purposes of section 448, Treasury regulations provide that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers. See Treas. Reg. sec. 1.448-1T(e)(4)(ii).

<sup>38</sup> For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (e.g., persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performance of such artists to members of the public (e.g., employees of a radio station that broadcasts the performances of musicians and singers). See Treas. Reg. sec. 1.448-1T(e)(4)(iii).

including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. For this purpose a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities (sections 475(c)(2) and 475(e)(2), respectively).

#### Phase-in of specified service business limitation

The exclusion from the definition of a qualified business for specified service trades or businesses phases in for a taxpayer with taxable income in excess of a threshold amount. The threshold amount is \$250,000 (200 percent of that amount, or \$500,000, in the case of a joint return) (the “threshold amount”). The threshold amount is indexed for inflation. The exclusion from the definition of a qualified business for specified service trades or businesses is fully phased in for a taxpayer with taxable income in excess of the threshold amount plus \$50,000 (\$100,000 in the case of a joint return). For a taxpayer with taxable income within the phase-in range, the exclusion applies as follows.

In computing the qualified business income with respect to a specified service trade or business, the taxpayer takes into account only the applicable percentage of qualified items of income, gain, deduction, or loss, and of allocable W-2 wages. The applicable percentage with respect to any taxable year is 100 percent reduced by the percentage equal to the ratio of the excess of the taxable income of the taxpayer over the threshold amount bears to \$50,000 (\$100,000 in the case of a joint return).

For example, Taxpayer has taxable income of \$280,000, of which \$200,000 is attributable to an accounting sole proprietorship after paying wages of \$100,000 to employees. Taxpayer has an applicable percentage of 40 percent.<sup>40</sup> In determining includible qualified business income, Taxpayer takes into account 40 percent of \$200,000, or \$80,000. In determining the includible W-2 wages, Taxpayer takes into account 40 percent of \$100,000, or \$40,000. Taxpayer calculates the deduction by taking the lesser of 17.4 percent of \$80,000 (\$13,920) or 50 percent of \$40,000 (\$20,000). Taxpayer takes a deduction for \$13,920.

#### **REIT dividends and cooperative dividends**

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<sup>39</sup> For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person’s services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person’s business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.*, whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect). See Treas. Reg. sec. 1.448-1T(e)(4)(iv).

<sup>40</sup>  $1 - (\$280,000 - \$250,000)/(\$50,000) = 1 - 30,000/50,000 = 1 - .6 = 40$  percent.

A deduction is allowed under the provision for 17.4 percent of the taxpayer's aggregate amount of qualified REIT dividends and qualified cooperative dividends for the taxable year. Qualified REIT dividends do not include any portion of a dividend received from a REIT that is a capital gain dividend<sup>41</sup> or a qualified dividend.<sup>42</sup> A qualified cooperative dividend means a patronage dividend,<sup>43</sup> per-unit retain allocation,<sup>44</sup> qualified written notice of allocation,<sup>45</sup> or any similar amount, provided it is includible in gross income and is received from either (1) a tax-exempt benevolent life insurance association, mutual ditch or irrigation company, cooperative telephone company, like cooperative organization,<sup>46</sup> or a taxable or tax-exempt cooperative that is described in section 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the Code in 1962.

### **Tentative deductible amount for a qualified trade or business**

#### In general

For each qualified trade or business, the taxpayer is allowed a deductible amount equal to the lesser of 17.4 percent of the qualified business income with respect to such trade or business or 50 percent of the W-2 wages with respect to such business (the "wage limit"). However, if the taxpayer's taxable income is below the threshold amount, the deductible amount for each qualified trade or business is equal to 17.4 percent of the qualified business income with respect to each respective trade or business.

#### W-2 wages

W-2 wages are the total wages<sup>47</sup> subject to wage withholding, elective deferrals,<sup>48</sup> and deferred compensation<sup>49</sup> paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the taxable year of the taxpayer.<sup>50</sup> W-2 wages

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<sup>41</sup> Defined in sec. 857(b)(3).

<sup>42</sup> Defined in sec. 1(h)(11).

<sup>43</sup> Defined in sec. 1388(a).

<sup>44</sup> Defined in sec. 1388(f).

<sup>45</sup> Defined in sec. 1388(c).

<sup>46</sup> Described in sec. 501(c)(12).

<sup>47</sup> Defined in sec. 3401(a).

<sup>48</sup> Within the meaning of sec. 402(g)(3).

<sup>49</sup> Deferred compensation includes compensation deferred under section 457, as well as the amount of any designated Roth contributions (as defined in section 402A).

<sup>50</sup> In the case of a taxpayer with a short taxable year that does not contain a calendar year ending during such short taxable year, the Committee intends that the following amounts shall be treated as the W-2 wages of the

do not include any amount which is not properly allocable to the qualified business income as a qualified item of deduction. In addition, W-2 wages do not include any amount which was not properly included in a return filed with the Social Security Administration on or before the 60<sup>th</sup> day after the due date (including extensions) for such return.

In the case of a taxpayer who is an individual with otherwise qualified business income from sources within the commonwealth of Puerto Rico, if all the income is taxable under section 1 (income tax rates for individuals) for the taxable year, the determination of W-2 wages with respect to the taxpayer's trade or business conducted in Puerto Rico is made without regard to any exclusion under the wage withholding rules<sup>51</sup> for remuneration paid for services in Puerto Rico.

#### Phase-in of wage limit

The application of the wage limit phases in for a taxpayer with taxable income in excess of the threshold amount. The wage limit applies fully for a taxpayer with taxable income in excess of the threshold amount plus \$50,000 (\$100,000 in the case of a joint return). For a taxpayer with taxable income within the phase-in range, the wage limit applies as follows.

With respect to any qualified trade or business, the taxpayer compares (1) 17.4 percent of the taxpayer's qualified business income with respect to the qualified trade or business with (2) 50 percent of the W-2 wages with respect to the qualified trade or business. If the amount determined under (2) is less than the amount determined (1), (that is, if the wage limit is binding), the taxpayer's deductible amount is the amount determined under (1) reduced by the same proportion of the difference between the two amounts as the excess of the taxable income of the taxpayer over the threshold amount bears to \$50,000 (\$100,000 in the case of a joint return).

For example, H and W file a joint return on which they report taxable income of \$520,000. W has a qualified trade or business that is not a specified service business, such that 17.4 percent of the qualified business income with respect to the business is \$15,000. W's share of wages paid by the business is \$20,000, such that 50 percent of the W-2 wages with respect to the business is \$10,000. The \$15,000 amount is reduced by 20 percent<sup>52</sup> of the difference between \$15,000 and \$10,000, or \$1,000. H and W take a deduction for \$14,000.

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taxpayer for the short taxable year: (1) only those wages paid during the short taxable year to employees of the qualified trade or business, (2) only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the qualified trade or business, and (3) only compensation actually deferred under section 457 during the short taxable year with respect to employees of the qualified trade or business. The Committee intends that amounts that are treated as W-2 wages for a taxable year shall not be treated as W-2 wages of any other taxable year.

<sup>51</sup> As provided in sec. 3401(a)(8).

<sup>52</sup>  $(\$520,000 - \$500,000) / \$100,000 = 20$  percent.

## **Determination of the taxpayer's deduction**

The taxpayer's deduction for qualified business income is equal to the lesser of the combined qualified business income amount for the taxable year or an amount equal to 17.4 percent of the taxpayer's taxable income (reduced by any net capital gain<sup>53</sup>) for the taxable year. The combined qualified business income amount is the sum of the deductible amounts determined for each qualified trade or business for the taxable year and 17.4 percent of the qualified REIT dividends and qualified cooperative dividends received by the taxpayer for the taxable year.

## **Special rules and definitions**

For purposes of the provision, taxable income is determined without regard to the deduction allowable under the provision.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner takes into account the partner's allocable share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the taxable year equal to the partner's allocable share of W-2 wages of the partnership. The partner's allocable share of W-2 wages is required to be determined in the same manner as the partner's share of wage expenses. For example, if a partner is allocated a deductible amount of 10 percent of wages paid by the partnership to employees for the taxable year, the partner is required to be allocated 10 percent of the W-2 wages of the partnership for purposes of calculating the wage limit under this deduction. Similarly, each shareholder of an S corporation takes into account the shareholder's pro rata share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the taxable year equal to the shareholder's pro rata share of W-2 wages of the S corporation.

Qualified business income is determined without regard to any adjustments prescribed under the rules of the alternative minimum tax.

The provision does not apply to a trust or estate.

The deduction under the provision is allowed only for Federal income tax purposes.

For purposes of determining a substantial underpayment of income tax under the accuracy related penalty,<sup>54</sup> a substantial underpayment exists if the amount of the understatement exceeds the greater of five percent (not 10 percent) of the tax required to be shown on the return or \$5,000.

Authority is provided to promulgate regulations needed to carry out the purposes of the provision, including regulations requiring, or restricting, the allocation of items of income, gain,

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<sup>53</sup> Defined in sec. 1(h).

<sup>54</sup> Sec. 6662(d)(1)(A).

loss, or deduction, or of wages under the provision. In addition, regulatory authority is provided to address reporting requirements appropriate under the provision, and the application of the provision in the case of tiered entities.

The provision does not apply to taxable years beginning after December 31, 2025.

### **Additional examples**

The following examples provide a comprehensive illustration of the provision.

#### Example 1

H and W file a joint return on which they report taxable income of \$520,000 (determined without regard to this provision). H is a partner in a qualified trade or business that is not a specified service business (“qualified business A”). W has a sole proprietorship qualified trade or business that is a specified service business (“qualified business B”). H and W also received \$10,000 in qualified REIT dividends during the tax year.

H’s allocable share of qualified business income from qualified business A is \$300,000, such that 17.4 percent of the qualified business income with respect to the business is \$52,200.<sup>55</sup> H’s allocable share of wages paid by qualified business A is \$100,000, such that 50 percent of the W-2 wages with respect to the business is \$50,000.<sup>56</sup> As H and W’s taxable income is above the threshold amount for a joint return, the application of the wage limit for qualified business A is phased in. Accordingly, the \$52,200 amount is reduced by 20 percent<sup>57</sup> of the difference between \$52,200 and \$50,000, or \$440.<sup>58</sup> H’s deductible amount for qualified business A is \$51,760.<sup>59</sup>

W’s qualified business income and W-2 wages from qualified business B, which is a specified service business, are \$325,000 and \$150,000, respectively. H and W’s taxable income is above the threshold amount for a joint return. Thus, the exclusion of qualified business income and W-2 wages from the specified service business are phased in. W has an applicable percentage of 80 percent.<sup>60</sup> In determining includible qualified business income, W takes into account 80 percent of \$325,000, or \$260,000. In determining includible W-2 wages, W takes into account 80 percent of \$150,000, or \$120,000. W calculates the deductible amount for qualified business B by taking the lesser of 17.4 percent of \$260,000 (\$45,240) or 50 percent of

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<sup>55</sup>  $\$300,000 \times .174 = \$52,200$ .

<sup>56</sup>  $\$100,000 \times .5 = \$50,000$ .

<sup>57</sup>  $(\$520,000 - \$500,000) / \$100,000 = 20$  percent.

<sup>58</sup>  $(\$52,200 - \$50,000) \times .2 = \$440$ .

<sup>59</sup>  $\$52,200 - \$440 = \$51,760$ .

<sup>60</sup>  $1 - (\$520,000 - \$500,000) / \$100,000 = 1 - \$20,000 / \$100,000 = 1 - .2 = 80$  percent.

includible W-2 wages of \$120,000 (\$60,000).<sup>61</sup> W's deductible amount for qualified business B is \$45,240.

H and W's combined qualified business income amount of \$96,980 is comprised of the deductible amount for qualified business A of \$51,760, the deductible amount for qualified business B of \$45,240, and 17.4 percent of the \$10,000 qualified REIT dividends (\$1,740). H and W's deduction is limited to 17.4 percent of their taxable income for the year (\$520,000), or \$90,480. Accordingly, H and W's deduction for the taxable year is \$90,480.

### Example 2

H and W file a joint return on which they report taxable income of \$200,000 (determined without regard to this provision). H has a sole proprietorship qualified trade or business that is not a specified service business ("qualified business A"). W is a partner in a qualified trade or business that is not a specified service business ("qualified business B"). H and W have a carryover qualified business loss of \$50,000.

H's qualified business income from qualified business A is \$150,000, such that 17.4 percent of the qualified business income with respect to the business is \$26,100. As H and W's taxable income is below the threshold amount for a joint return, the wage limit does not apply to qualified business A. H's deductible amount for qualified business A is \$26,100.

W's allocable share of qualified business loss is \$40,000, such that 17.4 percent of the qualified business loss with respect to the business is \$6,960. As H and W's taxable income is below the threshold amount for a joint return, the wage limit does not apply to qualified business B. W's deductible amount for qualified business B is a reduction to the deduction of \$6,960.

H and W's combined qualified business income amount of \$10,440 is comprised of the deductible amount for qualified business A of \$26,100, the reduction to the deduction for qualified business B of \$6,960, and the reduction to the deduction of \$8,700 attributable to the carryover qualified business loss. H and W's deduction is limited to 17.4 percent of their taxable income for the year (\$200,000), or \$34,800. Accordingly, H and W's deduction for the taxable year is \$10,440.

### Effective Date

The provision is effective for taxable years beginning after December 31, 2017.

## **2. Temporary limitation on losses for taxpayers other than corporations (sec. 11012 of the bill and sec. 461 of the Code)**

### Present Law

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<sup>61</sup> Although H and W's taxable income is above the threshold amount for a joint return, the wage limit is not binding as the 17.4 percent of includible qualified business income of qualified business B (\$45,240) is less than 50 percent of includible W-2 wages of qualified business B (\$60,000).

## **Loss limitation rules applicable to individuals**

### **Passive loss rules**

The passive loss rules limit deductions and credits from passive trade or business activities.<sup>62</sup> The passive loss rules apply to individuals, estates and trusts, and closely held corporations. 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. 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>63</sup> Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. 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. The suspended losses from a passive activity are allowed in full when a taxpayer makes a taxable disposition of his entire interest in the passive activity to an unrelated person.

### **Excess farm loss rules**

A limitation on excess farm losses applies to taxpayers other than C corporations.<sup>64</sup> If a taxpayer other than a C corporation receives an applicable subsidy for the taxable year, the amount of the excess farm loss is not allowed for the taxable year, and is carried forward and treated as a deduction attributable to farming businesses in the next taxable year. An excess farm loss for a taxable year means the excess of aggregate deductions that are attributable to farming businesses over the sum of aggregate gross income or gain attributable to farming businesses plus the threshold amount. The threshold amount is the greater of (1) \$300,000 (\$150,000 for married individuals filing separately), or (2) for the five-consecutive-year period preceding the taxable year, the excess of the aggregate gross income or gain attributable to the taxpayer's farming businesses over the aggregate deductions attributable to the taxpayer's farming businesses.

## **Reasons for Change**

The Committee notes the net operating loss rules for C corporations have been significantly limited under this bill. Carrybacks would be eliminated and the taxable income limitation on carryforwards would be tightened. In addition, non-business losses of individuals have been reformed with respect to personal casualty losses. The Committee believes that excess business losses of taxpayers other than corporations should be carried forward rather than

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<sup>62</sup> Sec. 469.

<sup>63</sup> Regulations provide more detailed standards for material participation. See Treas. Reg. sec. 1.469-5 and -5T.

<sup>64</sup> Sec. 461(j).



bunched in the year of loss. The provision is based on, and operates in a manner that is somewhat similar to, the current rule for excess farm losses.

### **Explanation of Provision**

For taxable years beginning after December 31, 2017, and before January 1, 2026, excess business losses of a taxpayer other than a corporation are not allowed for the taxable year. Such losses are carried forward and treated as part of the taxpayer's net operating loss ("NOL") carryforward in subsequent taxable years. Under the bill, NOL carryovers generally are allowed for a taxable year up to the lesser of the carryover amount or 90 percent (80 percent for taxable years beginning after December 31, 2022) of taxable income determined without regard to the deduction for NOLs.

An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. The threshold amount for a taxable year is \$250,000 (or twice the otherwise applicable threshold amount in the case of a joint return). The threshold amount is indexed for inflation.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner's distributive share and each S corporation shareholder's pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation are taken into account in applying the limitation under the provision for the taxable year of the partner or S corporation shareholder. Regulatory authority is provided to apply the provision to any other pass-through entity to the extent necessary to carry out the provision. Regulatory authority is also provided to require any additional reporting as the Secretary determines is appropriate to carry out the purposes of the provision.

The provision applies after the application of the passive loss rules.<sup>65</sup>

For taxable years beginning after December 31, 2017 and before January 1, 2026, the present-law limitation relating to excess farm losses does not apply.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

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<sup>65</sup> Sec. 469.

## **PART III – TAX BENEFITS FOR FAMILIES AND INDIVIDUALS**

### **1. Temporary increase in standard deduction (sec. 11021 of the bill and sec. 63 of the Code)**

#### **Present Law**

Under present law, an individual who does not elect to itemize deductions may reduce his adjusted gross income (“AGI”) by the amount of the applicable standard deduction in arriving at his taxable income. The standard deduction is the sum of the basic standard deduction and, if applicable, the additional standard deduction. The basic standard deduction varies depending upon a taxpayer’s filing status. For 2017, the amount of the basic standard deduction is \$6,350 for single individuals and married individuals filing separate returns, \$9,350 for heads of households, and \$12,700 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.<sup>66</sup> The amount of the standard deduction is indexed annually for inflation.

In the case of a dependent for whom a deduction for a personal exemption is allowed to another taxpayer, the standard deduction may not exceed the greater of (i) \$1,050 (in 2017) or (ii) the sum of \$350 (in 2017) plus the individual’s earned income.

#### **Reasons for Change**

The Committee believes that consolidating the basic standard deduction and personal exemptions for a taxpayer and his or her spouse into a larger standard deduction simplifies the Code while still allowing a minimum level of income to be exempt from Federal income taxation.

#### **Explanation of Provision**

The provision temporarily increases the basic standard deduction for individuals across all filing statuses. Under the provision, the amount of the standard deduction is temporarily increased to \$24,000 for married individuals filing a joint return, \$18,000 for head-of-household filers, and \$12,000 for all other individuals. The amount of the standard deduction is indexed for inflation using the chained consumer price index for all-urban consumers for taxable years beginning after December 31, 2018.

The additional standard deduction for the elderly and the blind is not changed by the provision.

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<sup>66</sup> For 2017, the additional amount is \$1,250 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is \$1,550. An individual who qualifies as both blind and elderly is entitled to two additional standard deductions, for a total additional amount (for 2017) of \$2,500 or \$3,100, as applicable.

The increase of the basic standard deduction does not apply to taxable years beginning after December 31, 2025.<sup>67</sup>

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **2. Temporary increase in and modification of child tax credit (sec. 11022 of the bill and sec. 24 of the Code)**

### **Present Law**

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

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

The credit is allowable against both the regular tax and the alternative minimum tax (“AMT”). To the extent the child credit exceeds the taxpayer’s tax liability, the taxpayer is eligible for a refundable credit<sup>68</sup> (the “additional child tax credit”) equal to 15 percent of earned income in excess of \$3,000 (the “earned income” formula).

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

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. At the taxpayer’s election, combat pay may be treated as earned income for these purposes. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers’ parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income

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<sup>67</sup> The standard deduction continues to be indexed with the C-CPI-U after this sunset.

<sup>68</sup> The refundable credit may not exceed the maximum credit per child of \$1,000.

for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

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

### **Reasons for Change**

The Committee believes that it is important to provide an increased tax benefit for families with children, as well as to ensure that all dependents of a household are accounted for in determining families' ability to pay income tax. The Committee believes that an expanded child tax credit is the most equitable means of achieving this goal.

### **Explanation of Provision**

The provision temporarily increases the child tax credit to \$2,000 per qualifying child. Additionally, the age limit for a qualifying child is temporarily increased by one year, such that a taxpayer may claim the credit with respect to any qualifying child under the age of 18.

The credit is further modified to temporarily provide for a \$500 nonrefundable credit for qualifying dependents other than qualifying children. The provision generally retains the present-law definition of dependent.

Under the temporary provision, beginning in 2018, the threshold at which the credit begins to phase out is increased to \$500,000 for all taxpayers. These amounts are not indexed for inflation.

The provision temporarily lowers the earned income threshold for the refundable child tax credit to \$2,500. As under present law, the maximum amount refundable may not exceed \$1,000 per qualifying child. Under the provision, this \$1,000 threshold is indexed for inflation with a base year of 2017, rounding up to the nearest \$100 (such that the threshold is \$1,100 in 2018). A temporary rule provides that, for the taxable years for which the above-described changes are in effect, in order to receive the refundable portion of the child tax credit, a taxpayer must include a Social Security number for each qualifying child for whom the credit is claimed on the tax return.

The temporary provision expires for taxable years beginning after December 31, 2025.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

### **3. Temporary increase in percentage limit for charitable contributions of cash to public charities (sec. 11023 of the bill and sec. 170 of the Code)**

#### **Present Law**

##### **In general**

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

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (i.e., an organization or entity described in section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (i.e., not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.<sup>69</sup> Fourth, the transfer must be of money or property—contributions of services are not deductible. Finally, the transfer must be substantiated and in the proper form.

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

##### **Percentage limits on charitable contributions**

###### **Individual taxpayers**

Charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's adjusted gross income ("AGI") for a taxable year, disregarding any net operating loss carryback to the year under section 172.<sup>70</sup> In general, more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

More specifically, the deduction for charitable contributions by an individual taxpayer of cash and property that is not appreciated to a charitable organization described in section 170(b)(1)(A) (public charities, private foundations other than nonoperating private foundations,

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<sup>69</sup> Sec. 170(a)(1).

<sup>70</sup> Sec. 170(b)(1)(G).

and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to nonoperating private foundations generally may be deducted up to the lesser of 30 percent of the taxpayer's contribution base or the excess of (i) 50 percent of the contribution base over (ii) the amount of contributions subject to the 50 percent limitation.

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

Finally, contributions that are for the use of (not to) the donee charity get less favorable percentage limits. Contributions of capital gain property for the use of public charities and other organizations described in section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's contribution base. Property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization.<sup>71</sup> Charitable contributions of income interests (where deductible) also generally are treated as contributions for the use of the donee organization.

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<sup>71</sup> *Rockefeller v. Commissioner*, 676 F.2d 35, 39 (2d Cir. 1982).

**Table 3.—Charitable Contribution Percentage Limits For Individual Taxpayers<sup>1</sup>**

	Ordinary Income Property and Cash	Capital Gain Property to the Recipient <sup>2</sup>	Capital Gain Property for the use of the Recipient
Public Charities, Private Operating Foundations, and Private Distributing Foundations	50%	30% <sup>3</sup>	20%
Nonoperating Private Foundations	30%	20%	20%

<sup>1</sup> Percentages shown are the percentage of an individual's contribution base.

<sup>2</sup> Capital gain property contributed to public charities, private operating foundations, or private distributing foundations will be subject to the 50-percent limitation if the donor elects to reduce the fair market value of the property by the amount that would have been long-term capital gain if the property had been sold.

<sup>3</sup> Certain qualified conservation contributions to public charities (generally, conservation easements), qualify for more generous contribution limits. In general, the 30-percent limit applicable to contributions of capital gain property is increased to 100 percent if the individual making the qualified conservation contribution is a qualified farmer or rancher or to 50 percent if the individual is not a qualified farmer or rancher.

#### Corporate taxpayers

A corporation generally may deduct charitable contributions up to 10 percent of the corporation's taxable income for the year.<sup>72</sup> For this purpose, taxable income is determined without regard to: (1) the charitable contributions deduction; (2) any net operating loss carryback to the taxable year; (3) deductions for dividends received; (4) deductions for dividends paid on certain preferred stock of public utilities; and (5) any capital loss carryback to the taxable year.<sup>73</sup>

#### Carryforwards of excess contributions

Charitable contributions that exceed the applicable percentage limit generally may be carried forward for up to five years.<sup>74</sup> In general, contributions carried over from a prior year are taken into account after contributions for the current year that are subject to the same percentage limit. Excess contributions made for the use of (rather than to) an organization generally may not be carried forward.

<sup>72</sup> Sec. 170(b)(2)(A).

<sup>73</sup> Sec. 170(b)(2)(C).

<sup>74</sup> Sec. 170(d).

## Qualified conservation contributions

Preferential percentage limits and carryforward rules apply for qualified conservation contributions.<sup>75</sup> In general, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions. Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) (generally, public charities) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions. Individuals are allowed to carry forward any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.<sup>76</sup>

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

### **Reasons for Change**

The Committee believes that a robust charitable sector is vital to our economy and that charitable giving is critical to ensuring that the sector thrives. For this reason, the Committee believes that it is desirable to provide additional incentives for taxpayers to provide monetary support to charities. Increasing the charitable percentage limit for cash contributions to public charities will encourage taxpayers to provide essential monetary support to front-line charities.

### **Explanation of Provision**

For contributions in taxable years beginning after December 31, 2017, and before January 1, 2026, the provision increases the income-based percentage limit described in section 170(b)(1)(A) for charitable contributions of cash by an individual taxpayer to public charities and certain other organizations from 50 percent to 60 percent.

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<sup>75</sup> Sec. 170(b)(1)(E).

<sup>76</sup> Sec. 170(b)(2)(B).



### Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 2017.

#### **4. Temporarily allow increased contributions to ABLE accounts, and allow contributions to be eligible for saver's credit (sec. 11024 of the bill and sec. 529A of the Code)**

### Present Law

#### Qualified ABLE programs

The Code provides for a tax-favored savings program intended to benefit disabled individuals, known as qualified ABLE programs.<sup>77</sup> A qualified ABLE program is a program established and maintained by a State or agency or instrumentality thereof. A qualified ABLE program must meet the following conditions: (1) under the provisions of the program, contributions may be made to an account (an "ABLE account"), established for the purpose of meeting the qualified disability expenses of the designated beneficiary of the account; (2) the program must limit a designated beneficiary to one ABLE account; and (3) the program must meet certain other requirements discussed below. A qualified ABLE program is generally exempt from income tax, but is otherwise subject to the taxes imposed on the unrelated business income of tax-exempt organizations.

A designated beneficiary of an ABLE account is the owner of the ABLE account. A designated beneficiary must be an eligible individual (defined below) who established the ABLE account and who is designated at the commencement of participation in the qualified ABLE program as the beneficiary of amounts paid (or to be paid) into and from the program.

Contributions to an ABLE account must be made in cash and are not deductible for Federal income tax purposes. Except in the case of a rollover contribution from another ABLE account, an ABLE account must provide that it may not receive aggregate contributions during a taxable year in excess of the amount under section 2503(b) of the Code (the annual gift tax exemption). For 2017, this is \$14,000.<sup>78</sup> Additionally, a qualified ABLE program must provide adequate safeguards to ensure that ABLE account contributions do not exceed the limit imposed on accounts under the qualified tuition program of the State maintaining the qualified ABLE program. Amounts in the account accumulate on a tax-deferred basis (i.e., income on accounts under the program is not subject to current income tax).

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<sup>77</sup> Sec. 529A.

<sup>78</sup> This amount is indexed for inflation. In the case that contributions to an ABLE account exceed the annual limit, an excise tax in the amount of six percent of the excess contribution to such account is imposed on the designated beneficiary. Such tax does not apply in the event that the trustee of such account makes a corrective distribution of such excess amounts by the due date (including extensions) of the individual's tax return for the year within the taxable year.

A qualified ABLE program may permit a designated beneficiary to direct (directly or indirectly) the investment of any contributions (or earnings thereon) no more than two times in any calendar year and must provide separate accounting for each designated beneficiary. A qualified ABLE program may not allow any interest in the program (or any portion thereof) to be used as security for a loan.

Distributions from an ABLE account are generally includible in the distributee's income to the extent consisting of earnings on the account.<sup>79</sup> Distributions from an ABLE account are excludable from income to the extent that the total distribution does not exceed the qualified disability expenses of the designated beneficiary during the taxable year. If a distribution from an ABLE account exceeds the qualified disability expenses of the designated beneficiary, a pro rata portion of the distribution is excludable from income. The portion of any distribution that is includible in income is subject to an additional 10-percent tax unless the distribution is made after the death of the beneficiary. Amounts in an ABLE account may be rolled over without income tax liability to another ABLE account for the same beneficiary<sup>80</sup> or another ABLE account for the designated beneficiary's brother, sister, stepbrother or stepsister who is also an eligible individual.

Except in the case of an ABLE account established in a different ABLE program for purposes of transferring ABLE accounts,<sup>81</sup> no more than one ABLE account may be established by a designated beneficiary. Thus, once an ABLE account has been established by a designated beneficiary, no account subsequently established by such beneficiary shall be treated as an ABLE account.

A contribution to an ABLE account is treated as a completed gift of a present interest to the designated beneficiary of the account. Such contributions qualify for the per-donee annual gift tax exclusion (\$14,000 for 2017) and, to the extent of such exclusion, are exempt from the generation skipping transfer ("GST") tax. A distribution from an ABLE account generally is not subject to gift tax or GST tax.

#### Eligible individuals

As described above, a qualified ABLE program may provide for the establishment of ABLE accounts only if those accounts are established and owned by an eligible individual, such owner referred to as a designated beneficiary. For these purposes, an eligible individual is an individual either (1) for whom a disability certification has been filed with the Secretary for the taxable year, or (2) who is entitled to Social Security Disability Insurance benefits or SSI

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<sup>79</sup> The rules of section 72 apply in determining the portion of a distribution that consists of earnings.

<sup>80</sup> For instance, if a designated beneficiary were to relocate to a different State.

<sup>81</sup> In which case the contributor ABLE account must be closed 60 days after the transfer to the new ABLE account is made.

benefits<sup>82</sup> based on blindness or disability, and such blindness or disability occurred before the individual attained age 26.

A disability certification means a certification to the satisfaction of the Secretary, made by the eligible individual or the parent or guardian of the eligible individual, that the individual has a medically determinable physical or mental impairment, which results in marked and severe functional limitations, and which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months, or is blind (within the meaning of section 1614(a)(2) of the Social Security Act). Such blindness or disability must have occurred before the date the individual attained age 26. Such certification must include a copy of the diagnosis of the individual's impairment and be signed by a licensed physician.<sup>83</sup>

#### Qualified disability expenses

As described above, the earnings on distributions from an ABLE account are excluded from income only to the extent total distributions do not exceed the qualified disability expenses of the designated beneficiary. For this purpose, qualified disability expenses are any expenses related to the eligible individual's blindness or disability which are made for the benefit of the designated beneficiary. Such expenses include the following expenses: education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses, and other expenses, which are approved by the Secretary under regulations and consistent with the purposes of section 529A.

#### Transfer to State

In the event that the designated beneficiary dies, subject to any outstanding payments due for qualified disability expenses incurred by the designated beneficiary, all amounts remaining in the deceased designated beneficiary's ABLE account not in excess of the amount equal to the total medical assistance paid such individual under any State Medicaid plan established under title XIX of the Social Security Act shall be distributed to such State upon filing of a claim for payment by such State. Such repaid amounts shall be net of any premiums paid from the account or by or on behalf of the beneficiary to the State's Medicaid Buy-In program.

#### Treatment of ABLE accounts under Federal programs

Any amounts in an ABLE account, and any distribution for qualified disability expenses, shall be disregarded for purposes of determining eligibility to receive, or the amount of, any assistance or benefit authorized by any Federal means-tested program. However, in the case of the SSI program, a distribution for housing expenses is not disregarded, nor are amounts in an

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<sup>82</sup> These are benefits, respectively, under Title II or Title XVI of the Social Security Act.

<sup>83</sup> No inference may be drawn from a disability certification for purposes of eligibility for Social Security, SSI or Medicaid benefits.

ABLE account in excess of \$100,000. In the case that an individual’s ABLE account balance exceeds \$100,000, such individual’s SSI benefits shall not be terminated, but instead shall be suspended until such time as the individual’s resources fall below \$100,000. However, such suspension shall not apply for purposes of Medicaid eligibility.

**Saver’s credit**

Present law provides a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.<sup>84</sup> The maximum annual contribution eligible for the credit is \$2,000 per individual. The credit rate depends on the adjusted gross income (“AGI”) of the taxpayer. For this purpose, AGI is determined without regard to certain excludable foreign-source earned income and certain U.S. possession income.

For taxable years beginning in 2017, married taxpayers filing joint returns with AGI of \$61,500 or less, taxpayers filing head of household returns with AGI of \$46,125 or less, and all other taxpayers filing returns with AGI of \$30,750 or less are eligible for the credit. As the taxpayer’s AGI increases, the credit rate available to the taxpayer is reduced, until, at certain AGI levels, the credit is unavailable. The credit rates based on AGI for taxable years beginning in 2016 are provided in the table below. The AGI levels used for the determination of the available credit rate are indexed for inflation.

**Table 3.–Credit Rates for Saver’s Credit**

<b>Joint Filers</b>	<b>Heads of Households</b>	<b>All Other Filers</b>	<b>Credit Rate</b>
\$0 – \$37,000	\$0 – \$27,750	\$0 – \$18,500	50 percent
\$37,001 – \$40,000	\$27,751 – \$30,000	\$18,501 – \$20,000	20 percent
\$40,001 – \$62,000	\$30,001 – \$46,500	\$20,001 – \$31,000	10 percent
Over \$62,000	Over \$46,500	Over \$31,000	0 percent

The saver’s credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets alternative minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 years old or older, other than individuals who are full-time students or claimed as a dependent on another taxpayer’s return.

Qualified retirement savings contributions consist of (1) elective deferrals to a section 401(k) plan, a section 403(b) plan, a governmental section 457 plan, a SIMPLE plan, or a SARSEP; (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a qualified retirement plan or section 403(b) plan. Under the rules governing these arrangements, an individual’s contribution to the arrangement generally cannot exceed the lesser of an annual dollar amount (for example, in 2017, \$5,500 in the case of an IRA of an

<sup>84</sup> Sec. 25B.

individual under age 50) or the individual's compensation that is includible in income. In the case of IRA contributions of a married couple, the combined includible compensation of both spouses may be taken into account.

The amount of any contribution eligible for the credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer files a joint return with the spouse) from any retirement plan to which eligible contributions can be made during the taxable year for which the credit is claimed, during the two taxable years prior to the year for which the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date (including extensions) for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.

### **Reasons for Change**

The Committee believes that it is important to reward work and encourage savings among individuals with disabilities, so as to provide those individuals with the ability to live independent and self-directed lives. Therefore, the Committee believes that the contribution limits for ABLE accounts should be increased so as to allow individuals with disabilities who earn income to contribute a portion of those funds to ABLE accounts, above and beyond the contributions that are made on their behalf by family members and others.

### **Explanation of Provision**

The provision temporarily increases the contribution limitation to ABLE accounts under certain circumstances. While the general overall limitation on contributions (the per-donee annual gift tax exclusion (\$14,000 for 2017)) remains the same, the limitation is temporarily increased with respect to contributions made by the designated beneficiary of the ABLE account. Under the temporary provision, after the overall limitation on contributions is reached, an ABLE account's designated beneficiary may contribute an additional amount, up to the lesser of (a) the Federal poverty line for a one-person household; or (b) the individual's compensation for the taxable year.

Additionally, the provision temporarily allows a designated beneficiary of an ABLE account to claim the saver's credit for contributions made to his or her ABLE account.

The provision does not apply to taxable years after December 31, 2025.

### **Effective Date**

The provision is effective for taxable years beginning after the date of enactment.

## **5. Temporarily allow tax-free rollovers between qualified tuition programs and qualified ABLÉ programs (sec. 11025 of the bill and secs. 529 and 529A of the Code)**

### **Present Law**

#### **Qualified ABLÉ programs**

The Code provides for a tax-favored savings program intended to benefit disabled individuals, known as qualified ABLÉ programs.<sup>85</sup> A qualified ABLÉ program is a program established and maintained by a State or agency or instrumentality thereof. A qualified ABLÉ program must meet the following conditions: (1) under the provisions of the program, contributions may be made to an account (an “ABLÉ account”), established for the purpose of meeting the qualified disability expenses of the designated beneficiary of the account; (2) the program must limit a designated beneficiary to one ABLÉ account; and (3) the program must meet certain other requirements discussed below. A qualified ABLÉ program is generally exempt from income tax, but is otherwise subject to the taxes imposed on the unrelated business income of tax-exempt organizations.

A designated beneficiary of an ABLÉ account is the owner of the ABLÉ account. A designated beneficiary must be an eligible individual (defined below) who established the ABLÉ account and who is designated at the commencement of participation in the qualified ABLÉ program as the beneficiary of amounts paid (or to be paid) into and from the program.

Contributions to an ABLÉ account must be made in cash and are not deductible for Federal income tax purposes. Except in the case of a rollover contribution from another ABLÉ account, an ABLÉ account must provide that it may not receive aggregate contributions during a taxable year in excess of the amount under section 2503(b) of the Code (the annual gift tax exemption). For 2017, this is \$14,000.<sup>86</sup> Additionally, a qualified ABLÉ program must provide adequate safeguards to ensure that ABLÉ account contributions do not exceed the limit imposed on accounts under the qualified tuition program of the State maintaining the qualified ABLÉ program. Amounts in the account accumulate on a tax-deferred basis (i.e., income on accounts under the program is not subject to current income tax).

A qualified ABLÉ program may permit a designated beneficiary to direct (directly or indirectly) the investment of any contributions (or earnings thereon) no more than two times in any calendar year and must provide separate accounting for each designated beneficiary. A qualified ABLÉ program may not allow any interest in the program (or any portion thereof) to be used as security for a loan.

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<sup>85</sup> Sec. 529A.

<sup>86</sup> This amount is indexed for inflation. In the case that contributions to an ABLÉ account exceed the annual limit, an excise tax in the amount of six percent of the excess contribution to such account is imposed on the designated beneficiary. Such tax does not apply in the event that the trustee of such account makes a corrective distribution of such excess amounts by the due date (including extensions) of the individual’s tax return for the year within the taxable year.

Distributions from an ABLE account are generally includible in the distributee's income to the extent consisting of earnings on the account.<sup>87</sup> Distributions from an ABLE account are excludable from income to the extent that the total distribution does not exceed the qualified disability expenses of the designated beneficiary during the taxable year. If a distribution from an ABLE account exceeds the qualified disability expenses of the designated beneficiary, a pro rata portion of the distribution is excludable from income. The portion of any distribution that is includible in income is subject to an additional 10-percent tax unless the distribution is made after the death of the beneficiary. Amounts in an ABLE account may be rolled over without income tax liability to another ABLE account for the same beneficiary<sup>88</sup> or another ABLE account for the designated beneficiary's brother, sister, stepbrother or stepsister who is also an eligible individual.

Except in the case of an ABLE account established in a different ABLE program for purposes of transferring ABLE accounts,<sup>89</sup> no more than one ABLE account may be established by a designated beneficiary. Thus, once an ABLE account has been established by a designated beneficiary, no account subsequently established by such beneficiary shall be treated as an ABLE account.

A contribution to an ABLE account is treated as a completed gift of a present interest to the designated beneficiary of the account. Such contributions qualify for the per-donee annual gift tax exclusion (\$14,000 for 2017) and, to the extent of such exclusion, are exempt from the generation skipping transfer ("GST") tax. A distribution from an ABLE account generally is not subject to gift tax or GST tax.

#### Eligible individuals

As described above, a qualified ABLE program may provide for the establishment of ABLE accounts only if those accounts are established and owned by an eligible individual, such owner referred to as a designated beneficiary. For these purposes, an eligible individual is an individual either (1) for whom a disability certification has been filed with the Secretary for the taxable year, or (2) who is entitled to Social Security Disability Insurance benefits or SSI benefits<sup>90</sup> based on blindness or disability, and such blindness or disability occurred before the individual attained age 26.

A disability certification means a certification to the satisfaction of the Secretary, made by the eligible individual or the parent or guardian of the eligible individual, that the individual has a medically determinable physical or mental impairment, which results in marked and severe

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<sup>87</sup> The rules of section 72 apply in determining the portion of a distribution that consists of earnings.

<sup>88</sup> For instance, if a designated beneficiary were to relocate to a different State.

<sup>89</sup> In which case the contributor ABLE account must be closed 60 days after the transfer to the new ABLE account is made.

<sup>90</sup> These are benefits, respectively, under Title II or Title XVI of the Social Security Act.

functional limitations, and which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months, or is blind (within the meaning of section 1614(a)(2) of the Social Security Act). Such blindness or disability must have occurred before the date the individual attained age 26. Such certification must include a copy of the diagnosis of the individual's impairment and be signed by a licensed physician.<sup>91</sup>

#### Qualified disability expenses

As described above, the earnings on distributions from an ABLE account are excluded from income only to the extent total distributions do not exceed the qualified disability expenses of the designated beneficiary. For this purpose, qualified disability expenses are any expenses related to the eligible individual's blindness or disability which are made for the benefit of the designated beneficiary. Such expenses include the following expenses: education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses, and other expenses, which are approved by the Secretary under regulations and consistent with the purposes of section 529A.

#### Transfer to State

In the event that the designated beneficiary dies, subject to any outstanding payments due for qualified disability expenses incurred by the designated beneficiary, all amounts remaining in the deceased designated beneficiary's ABLE account not in excess of the amount equal to the total medical assistance paid such individual under any State Medicaid plan established under title XIX of the Social Security Act shall be distributed to such State upon filing of a claim for payment by such State. Such repaid amounts shall be net of any premiums paid from the account or by or on behalf of the beneficiary to the State's Medicaid Buy-In program.

#### Treatment of ABLE accounts under Federal programs

Any amounts in an ABLE account, and any distribution for qualified disability expenses, shall be disregarded for purposes of determining eligibility to receive, or the amount of, any assistance or benefit authorized by any Federal means-tested program. However, in the case of the SSI program, a distribution for housing expenses is not disregarded, nor are amounts in an ABLE account in excess of \$100,000. In the case that an individual's ABLE account balance exceeds \$100,000, such individual's SSI benefits shall not be terminated, but instead shall be suspended until such time as the individual's resources fall below \$100,000. However, such suspension shall not apply for purposes of Medicaid eligibility.

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<sup>91</sup> No inference may be drawn from a disability certification for purposes of eligibility for Social Security, SSI or Medicaid benefits.



## Section 529 qualified tuition programs

### In general

A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a “prepaid tuition program”). Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.<sup>92</sup> In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a “savings account program”). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary’s higher education expenses.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary. Decisions with respect to the contract or account are typically made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an “account owner”)<sup>93</sup> whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.

### Qualified higher education expenses

For purposes of receiving a distribution from a qualified tuition program that qualifies for favorable tax treatment under the Code, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated

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<sup>92</sup> For purposes of this description, the term “account” is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

<sup>93</sup> Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term “account owner,” which is a commonly used term among qualified tuition programs.

beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time. Qualified higher education expenses include the purchase of any computer technology or equipment, or Internet access or related services, if such technology or services were to be used primarily by the beneficiary during any of the years a beneficiary is enrolled at an eligible institution.

#### Contributions to qualified tuition programs

Contributions to a qualified tuition program must be made in cash. Section 529 does not impose a specific dollar limit on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account; however, the program is required to have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions generally are treated as a completed gift eligible for the gift tax annual exclusion. Contributions are not tax deductible for Federal income tax purposes, although they may be deductible for State income tax purposes. Amounts in the account accumulate on a tax-free basis (i.e., income on accounts in the plan is not subject to current income tax).

A qualified tuition program may not permit any contributor to, or designated beneficiary under, the program to direct (directly or indirectly) the investment of any contributions (or earnings thereon) more than two times in any calendar year, and must provide separate accounting for each designated beneficiary. A qualified tuition program may not allow any interest in an account or contract (or any portion thereof) to be used as security for a loan

#### **Reasons for Change**

The Committee believes that families should be able to roll over amounts that are currently held in 529 accounts into ABLE accounts. This will enable families to ensure that amounts set aside in 529 plans have the flexibility to provide support for all members of the family.

#### **Explanation of Provision**

The provision temporarily allows for amounts from qualified tuition programs (also known as 529 accounts) to be rolled over to an ABLE account without penalty, provided that the ABLE account is owned by the designated beneficiary of that 529 account, or a member of such designated beneficiary's family.<sup>94</sup> Such rolled-over amounts count towards the overall limitation on amounts that can be contributed to an ABLE account within a taxable year.<sup>95</sup> Any amount

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<sup>94</sup> For these purposes, a member of the family means, with respect to any designated beneficiary, the taxpayer's: (1) spouse; (2) child or descendant of a child; (3) brother, sister, stepbrother or stepsister; (4) father, mother or ancestor of either; (5) stepfather or stepmother; (6) niece or nephew; (7) aunt or uncle; (8) in-law; (9) the spouse of any individual described in (2)-(8); and (10) any first cousin of the designated beneficiary.

<sup>95</sup> 529A(b)(2)(B)(i). Thus, under the provision, if \$14,000 (for 2017) was rolled over into a designated beneficiary's ABLE account from a 529 account, no additional funds could be contributed by family members into

rolled over that is in excess of this limitation shall be includible in the gross income of the distributee in a manner provided by section 72.<sup>96</sup>

The provision is not effective for distributions after December 31, 2025.

#### **Effective Date**

The provision applies to distributions after December 31, 2017.

### **6. Treatment of certain individuals performing services in the Sinai Peninsula of Egypt (sec. 11026 of the bill and secs. 2, 112, 692, 2201, 3401, 4253, 6013, and 7508 of the Code)**

#### **Present Law**

Members of the Armed Forces serving in a combat zone are afforded a number of tax benefits. These include:

1. An exclusion from gross income of certain military pay received for any month during which the member served in a combat zone or was hospitalized as a result of serving in a combat zone;<sup>97</sup>
2. An exemption from taxes on death while serving in combat zone or dying as a result of wounds, disease, or injury incurred while so serving;<sup>98</sup>
3. Special estate tax rules where death occurs in a combat zone;<sup>99</sup>
4. Special benefits to surviving spouses in the event of a service member's death or missing status;<sup>100</sup>
5. An extension of time limits governing the filing of returns and other rules regarding timely compliance with Federal income tax rules;<sup>101</sup> and

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that ABLÉ account during the taxable year. However, under the modifications made to sec. 529A in sec. 11024 of the bill, the designated beneficiary may continue to make contributions of earned income to the ABLÉ account, up to the lesser of the poverty level or compensation for the taxable year.

<sup>96</sup> 529(c)(3)(A).

<sup>97</sup> Sec. 112; see also, sec. 3401(a)(1), exempting such income from wage withholding.

<sup>98</sup> Sec. 692.

<sup>99</sup> Sec. 2201.

<sup>100</sup> Secs. 2(a)(3) and 6013(f)(1).

<sup>101</sup> Sec. 7508.

6. An exclusion from telephone excise taxes.<sup>102</sup>

### **Reasons for Change**

The Committee believes that the Sinai Peninsula of Egypt is currently sufficiently hazardous that members of the Armed Forces serving in such location should be entitled to combat zone benefits.

### **Explanation of Provision**

The provision grants combat zone tax benefits to the Sinai Peninsula of Egypt, if as of the date of enactment of the provision any member of the Armed Forces of the United States is entitled to special pay under section 310 of title 37, United States Code (relating to special pay; duty subject to hostile fire or imminent danger), for services performed in such location. This benefit lasts only during the period such entitlement is in effect but not later than taxable years beginning before January 1, 2026.

### **Effective Date**

The provision is generally effective beginning June 9, 2015. The portion of the provision related to wage withholding applies to remuneration paid after the date of enactment.

## **7. Exclusion from gross income of certain amounts received by wrongly incarcerated individuals (sec. 11027 of the bill and sec. 139F of the Code)**

### **Present Law**

Under a provision added in the PATH Act,<sup>103</sup> with respect to any wrongfully incarcerated individual, gross income does not include any civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal matter) relating to the incarceration of such individual for the covered offense for which such individual was convicted.<sup>104</sup>

A wrongfully incarcerated individual means an individual:

- (1) who was convicted of a covered offense;
  - (2) who served all or part of a sentence of imprisonment relating to that covered offense;
- and

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<sup>102</sup> Sec. 4253(d).

<sup>103</sup> Pub. L. No. 114-113 (2015), Division Q (Protecting Americans from Tax Hikes Act of 2015), sec. 304.

<sup>104</sup> Sec. 139F.

- (3) (i) was pardoned, granted clemency, or granted amnesty for such offense because the individual was innocent, or
- (ii) for whom the judgment of conviction for the offense was reversed or vacated, and whom the indictment, information, or other accusatory instrument for that covered offense was dismissed or who was found not guilty at a new trial after the judgment of conviction for that covered offense was reversed or vacated.

For these purposes, a covered offense is any criminal offense under Federal or State law, and includes any criminal offense arising from the same course of conduct as that criminal offense.

The Code contains a special rule allowing individuals to make a claim for credit or refund of any overpayment of tax resulting from the exclusion, even if such claim would be disallowed under the Code or by operation of any law or rule of law (including *res judicata*), if the claim for credit or refund is filed before the close of the one-year period beginning on the date of enactment of the PATH Act (December 18, 2015).<sup>105</sup>

#### **Reasons for Change**

The Committee believes that the period of time to file a claim for credit or refund for any overpayment of tax resulting from the exclusion should be extended.

#### **Explanation of Provision**

The provision would extend the waiver on the statute of limitations with respect to filing a claim for a credit or refund of an overpayment of tax resulting from the exclusion described above for an additional year. Thus, under the provision, such claim for credit or refund must be filed before December 18, 2017.

#### **Effective Date**

The provision is effective on the date of enactment.

### **8. Temporarily allow qualified tuition programs (529 accounts) to be established for the *in utero* (sec. 11028 of the bill and sec. 529 of the Code)**

#### **Present Law**

##### **In general**

A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on

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<sup>105</sup> Sec. 139F.

behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a “prepaid tuition program”). Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.<sup>106</sup> In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a “savings account program”). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary’s higher education expenses.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary. Decisions with respect to the contract or account are typically made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an “account owner”)<sup>107</sup> whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.

#### Qualified higher education expenses

For purposes of receiving a distribution from a qualified tuition program that qualifies for favorable tax treatment under the Code, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time. Qualified higher education expenses include the purchase of any computer technology or equipment, or Internet access or related services, if such technology or services were to be used primarily by the beneficiary during any of the years a beneficiary is enrolled at an eligible institution.

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<sup>106</sup> For purposes of this description, the term “account” is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

<sup>107</sup> Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term “account owner,” which is a commonly used term among qualified tuition programs.

### Contributions to qualified tuition programs

Contributions to a qualified tuition program must be made in cash. Section 529 does not impose a specific dollar limit on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account; however, the program is required to have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions generally are treated as a completed gift eligible for the gift tax annual exclusion. Contributions are not tax deductible for Federal income tax purposes, although they may be deductible for State income tax purposes. Amounts in the account accumulate on a tax-free basis (i.e., income on accounts in the plan is not subject to current income tax).

A qualified tuition program may not permit any contributor to, or designated beneficiary under, the program to direct (directly or indirectly) the investment of any contributions (or earnings thereon) more than two times in any calendar year, and must provide separate accounting for each designated beneficiary. A qualified tuition program may not allow any interest in an account or contract (or any portion thereof) to be used as security for a loan.

### **Reasons for Change**

The Committee believes that families should be allowed to begin saving for college in Code section 529 accounts as soon as possible. The sooner funds are deposited in a tax-advantaged 529 account, the longer the positive effects of compound interest can operate to maximize the amount of assets available to pay for college expenses. Therefore, the Committee believes an unborn child should qualify as a designated beneficiary in Code section 529. The Committee believes that, for these purposes, an unborn child means a child in utero, and the term child *in utero* means a member of the species *homo sapiens*, at any stage of development, carried in the womb.

### **Explanation of Provision**

For contributions made after December 31, 2017, the provision specifies that nothing in Code section 529 shall prevent an unborn child from qualifying as a designated beneficiary. For these purposes, an unborn child means a child in utero, and the term child *in utero* means a member of the species *homo sapiens*, at any stage of development, who is carried in the womb.

The provision does not apply to contributions made after December 31, 2025.

### **Effective Date**

The provision is effective for contributions made after December 31, 2017.

## **9. Relief for retirement plan distributions and modification of casualty loss deduction for the Mississippi River Delta flood disaster area (sec. 11029 of the bill and secs. 72(t), 165, 401-403, 408, 457, and 3405 of the Code)**

### **Present Law**

#### **Distributions from tax-favored retirement plans**

A distribution from a qualified retirement plan, a tax-sheltered annuity plan (a “section 403(b) plan”), an eligible deferred compensation plan of a State or local government employer (a “governmental section 457(b) plan”), or an individual retirement arrangement (an “IRA”) generally is included in income for the year distributed.<sup>108</sup> These plans are referred to collectively as “eligible retirement plans.” In addition, unless an exception applies, a distribution from a qualified retirement plan, a section 403(b) plan, or an IRA received before age 59½ is subject to a 10-percent additional tax (referred to as the “early withdrawal tax”) on the amount includible in income.<sup>109</sup>

In general, a distribution from an eligible retirement plan may be rolled over to another eligible retirement plan within 60 days, in which case the amount rolled over generally is not includible in income. The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster or other events beyond the reasonable control of the individual.

The terms of a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan generally determine when distributions are permitted. However, in some cases, restrictions may apply to distribution before an employee’s termination of employment, referred to as “in-service” distributions. Despite such restrictions, an in-service distribution may be permitted in the case of financial hardship or an unforeseeable emergency.

Tax-favored retirement plans are generally required to be operated in accordance with the terms of the plan document, and amendments to reflect changes to the plan generally must be adopted within a limited period.

#### **Itemized deduction for casualty losses**

A taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.<sup>110</sup> For individual taxpayers, deductible

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<sup>108</sup> Secs. 401(a), 403(a), 403(b), 457(b) and 408. Under section 3405, distributions from these plans are generally subject to income tax withholding unless the recipient elects otherwise. In addition, certain distributions from a qualified retirement plan, a section 403(b) plan, or a governmental section 457(b) plan are subject to mandatory income tax withholding at a 20-percent rate unless the distribution is rolled over.

<sup>109</sup> Sec. 72(t). Under present law, the 10-percent early withdrawal tax does not apply to distributions from a governmental section 457(b) plan.

<sup>110</sup> Sec. 165.



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. Personal casualty or theft losses are deductible only if they exceed \$100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.

### **Reasons for Change**

The withdrawal, before retirement age, of funds from tax-favored retirement savings arrangements undercuts retirement income security, the purpose of the tax subsidy. The 10-percent early withdrawal tax is therefore intended to discourage such withdrawals. However, the Committee recognizes that the financial need caused by a presidentially declared disaster often forces individuals to make such withdrawals, and the Committee is concerned that the additional tax burden may aggravate an individual's financial need. The Committee therefore wishes to provide relief by removing the 10-percent early withdrawal tax and allowing income attributable to a withdrawal to be included over a multi-year period. Further, the Committee wishes to enable individuals to restore the amount withdrawn, and thus replenish their retirement savings, by providing an extended period to do so.

Additionally, the Committee believes that it is important to provide additional relief to individuals who suffered uninsured losses as a result of damage suffered in the Mississippi River Delta flood disaster area. The Committee believes it is appropriate to relax certain limitations on claiming the deduction for casualty losses in this circumstance.

### **Explanation of Provision**

#### **In general**

The provision provides tax relief, as described below, relating to the "Mississippi River Delta flood disaster area," defined as an area—

- with respect to which a major disaster was declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act before March 31, 2016, by reason of severe storms and flooding occurring in Louisiana, Texas, and Mississippi during March of 2016 (referred to herein as the "March 2016 flood area"), or
- with respect to which a major disaster was declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act before September 3, 2016, by reason of severe storms and flooding occurring in Louisiana during August of 2016 (referred to herein as the "August 2016 flood area").

#### **Distributions from eligible retirement plans**

Under the provision, an exception to the 10-percent early withdrawal tax applies in the case of a qualified Mississippi River Delta flooding distribution from a qualified retirement plan, a section 403(b) plan or an IRA. In addition, as discussed further, income attributable to a qualified Mississippi River Delta flooding distribution may be included in income ratably over

three years, and the amount of a qualified Mississippi River Delta flooding distribution may be recontributed to an eligible retirement plan within three years.

A qualified Mississippi River Delta flooding distribution is a distribution from an eligible retirement plan—

- made on or after March 1, 2016, and before January 1, 2018, to an individual whose principal place of abode on March 1, 2016, was located in the March 2016 flood area and who has sustained an economic loss by reason of the severe storms and flooding giving rise to the related Presidential disaster declaration, or
- made on or after August 11, 2016, and before January 1, 2018, to an individual whose principal place of abode on August 11, 2016, was located in the August 2016 flood area and who has sustained an economic loss by reason of the severe storms and flooding giving rise to the related Presidential disaster declaration.

The total amount of distributions to an individual from all eligible retirement plans that may be treated as qualified Mississippi River Delta flooding distributions is \$100,000. Thus, any distributions in excess of \$100,000 during the applicable period are not qualified Mississippi River Delta flooding distributions.

Any amount required to be included in income as a result of a qualified Mississippi River Delta flooding distribution is included in income ratably over the three-year period beginning with the year of distribution unless the individual elects not to have ratable inclusion apply.

Any portion of a qualified Mississippi River Delta flooding distribution may, at any time during the three-year period beginning the day after the date on which the distribution was received, be recontributed to an eligible retirement plan to which a rollover can be made. Any amount recontributed within the three-year period is treated as a rollover and thus is not includible in income. For example, if an individual receives a qualified hurricane distribution in 2016, that amount is included in income, generally ratably over the year of the distribution and the following two years, but is not subject to the 10-percent early withdrawal tax. If, in 2018, the amount of the qualified Mississippi River Delta flooding distribution is recontributed to an eligible retirement plan, the individual may file an amended return to claim a refund of the tax attributable to the amount previously included in income. In addition, if, under the ratable inclusion provision, a portion of the distribution has not yet been included in income at the time of the contribution, the remaining amount is not includible in income.

A qualified Mississippi River Delta flooding distribution is a permissible distribution from a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan, regardless of whether a distribution otherwise would be permissible.<sup>111</sup> A plan is not treated as violating any Code requirement merely because it treats a distribution as a qualified Mississippi River Delta flooding distribution, provided that the aggregate amount of such distributions from

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<sup>111</sup> A qualified Mississippi River Delta flooding distributions is subject to income tax withholding unless the recipient elects otherwise. Mandatory 20-percent withholding does not apply.

plans maintained by the employer and members of the employer's controlled group or affiliated service group does not exceed \$100,000. Thus, a plan is not treated as violating any Code requirement merely because an individual might receive total distributions in excess of \$100,000, taking into account distributions from plans of other employers or IRAs.

A plan amendment made pursuant to the provision (or a regulation issued thereunder) may be retroactively effective if, in addition to the requirements described below, the amendment is made on or before the last day of the first plan year beginning after December 31, 2018 (or in the case of a governmental plan, December 31, 2020), or a later date prescribed by the Secretary. In addition, the plan will be treated as operated in accordance with plan terms during the period beginning with the date the provision or regulation takes effect (or the date specified by the plan if the amendment is not required by the provision or regulation) and ending on the last permissible date for the amendment (or, if earlier, the date the amendment is adopted). In order for an amendment to be retroactively effective, it must apply retroactively for that period, and the plan must be operated in accordance with the amendment during that period.

#### **Modification of rules related to casualty losses**

Under the provision, in the case of a personal casualty loss which arose in the March 2016 flood area (and was attributable to the severe storms and flooding giving rise to the Presidential disaster declaration) or the August 2016 flood area (and was attributable to the severe storms and flooding giving rise to the Presidential disaster declaration), such losses are deductible without regard to whether aggregate net losses exceed ten percent of a taxpayer's adjusted gross income. Under the provision, in order to be deductible the losses must exceed \$500 per casualty. Additionally, such losses may be claimed in addition to the standard deduction.

#### **Effective Date**

The provision is effective on the date of enactment.

## **PART IV – EDUCATION**

### **1. Temporary treatment of student loans discharged on account of death or disability (sec. 11031 of the bill and sec. 108 of the Code)**

#### **Present Law**

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.<sup>112</sup>

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses. The loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation.

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

Finally, an individual's gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program, certain State loan repayment programs, or any amount received by an individual under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by the State).

#### **Reasons for Change**

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<sup>112</sup> Sec. 108(f).

The Committee believes that taxpayers should not have to bear a tax burden for student loan forgiveness in the event that a student dies or becomes permanently disabled. The Committee further believes that the exclusion of student loan forgiveness in these cases is fair and compassionate.

### **Explanation of Provision**

The provision temporarily modifies the exclusion of student loan discharges from gross income, by including within the exclusion certain discharges on account of death or total and permanent disability of the student.<sup>113</sup> Loans eligible for the exclusion under the provision are loans made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation, or (5) private education loans (for this purpose, private education loan is defined in section 140(7) of the Consumer Protection Act).<sup>114</sup>

The provision does not apply to discharges of indebtedness occurring after December 31, 2025.

### **Effective Date**

The provision is effective for discharges of loans after December 31, 2017.

## **2. Temporary increase in deduction for certain educator expenses (sec. 11032 of the bill and sec. 62 of the Code)**

### **Present Law**

In general, unreimbursed business expenses incurred by an employee are deductible, but only as an itemized deduction and only to the extent the expenses exceed two percent of adjusted gross income.<sup>115</sup> However, in the case of certain employees and certain expenses, a deduction may be taken in determining adjusted gross income (referred to as an “above-the-line” deduction), including certain expenses of eligible educators.<sup>116</sup> Eligible educators are elementary

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<sup>113</sup> Although the provision makes specific reference to those provisions of the Higher Education Act of 1965 that discharge William D. Ford Federal Direct Loan Program loans, Federal Family Education Loan Program loans, and Federal Perkins Loan Program loans in the case of death and total and permanent disability, the provision provides generally for an exclusion in the case of a student loan discharged on account of the death or total and permanent disability of the student, in addition to those specific statutory references.

<sup>114</sup> 15 U.S.C. 1650(7).

<sup>115</sup> Secs. 62(a)(1), 67, and 162.

<sup>116</sup> Sec. 62(a)(2)(D).

or secondary school teachers, instructors, counselors, principals, or aides in a school for at least 900 hours during a school year.<sup>117</sup>

An eligible educator may take an “above-the-line” deduction for ordinary and necessary expenses incurred 1) by reason of participation in professional development courses related to the curriculum or students the educator teaches, or 2) in connection with books, supplies, computer and other equipment, and supplementary materials to be used in the classroom. The deduction may not exceed \$250 (for 2017) in expenses, indexed for inflation.

### **Reasons for Change**

The Committee believes that teachers perform an indispensable function in the economy, and that many teachers spend out-of-pocket money on classroom supplies in excess of the present-law \$250 amount. Accordingly, the Committee believes that the above-the-line deduction for educator expenses, which has remained at \$250 since introduction in 2002 (even after indexing), should be increased to \$500.

### **Explanation of Provision**

The provision temporarily increases the limit for the deduction of certain expenses of eligible educators, in determining adjusted gross income, to \$500. Any deduction for expenses in excess of this amount (under present law generally a miscellaneous itemized deduction subject to the two-percent floor) is suspended.<sup>118</sup>

The provision does not apply to taxable years beginning after December 31, 2025.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

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<sup>117</sup> Sec. 62(d)(1).

<sup>118</sup> Sec. 11045 of the bill.

## PART V - DEDUCTIONS AND EXCLUSIONS

### 1. Suspension of deduction for personal exemptions (sec. 11041 of the bill and secs. 151 through 153 of the Code)

#### Present Law

Under present law, in determining taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2017, the amount deductible for each personal exemption is \$4,050. This amount is indexed annually for inflation. The personal exemption amount is phased out in the case of an individual with AGI in excess of \$313,800 for married taxpayers filing jointly, \$287,650 for heads of household, \$156,900 for married taxpayers filing separately, and \$261,500 for all other filers. In addition, no personal exemption is allowed in the case of a dependent if a deduction is allowed to another taxpayer.

#### Withholding rules

Under present law, the amount of tax required to be withheld by employers from a taxpayer's wages is based in part on the number of withholding exemptions a taxpayer claims on his Form W-4. An employee is entitled to the following exemptions: (1) an exemption for himself, unless he allowed to be claimed as a dependent of another person; (2) an exemption to which the employee's spouse would be entitled, if that spouse does not file a Form W-4 for that taxable year claiming an exemption described in (1); (3) an exemption for each individual who is a dependent (but only if the employee's spouse has not also claimed such a withholding exemption on a Form W-4); (4) additional withholding allowances (taking into account estimated itemized deductions, estimated tax credits, and additional deductions as provided by the Secretary of the Treasury); and (5) a standard deduction allowance.

#### Filing requirements

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

#### Trusts and estates

In lieu of the deduction for personal exemptions, an estate is allowed a deduction of \$600. A trust is allowed a deduction of \$100; \$300 if required to distribute all its income currently; and an amount equal to the personal exemption of an individual in the case of a qualified disability trust.

### **Reasons for Change**

The Committee believes that consolidating the basic standard deduction and personal exemptions for a taxpayer and his or her spouse into a larger standard deduction simplifies the Code while still allowing a minimum level of income to be exempt from Federal income taxation. Although the deduction for personal exemptions is suspended, the Committee believes it is appropriate to continue to provide benefits for dependents by increasing the child tax credit for qualifying children and expanding a modified credit to other dependents.

### **Explanation of Provision**

The provision suspends the deduction for personal exemptions.<sup>119</sup>

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

The provision does not apply to taxable years beginning after December 31, 2025.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **2. Suspension of deduction for State and local taxes (sec. 11042 of the bill and sec. 164 of the Code)**

### **Present Law**

Individuals are permitted a deduction for certain taxes paid or accrued, whether or not incurred in a taxpayer's trade or business. These taxes are: (i) State, local and foreign real property taxes;<sup>120</sup> (ii) State and local personal property taxes;<sup>121</sup> (iii) State, local and foreign

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<sup>119</sup> The provision also clarifies that, for purposes of taxable years in which the personal exemption is reduced to zero, this should not alter the operation of those provisions of the Code which refer to a taxpayer allowed a deduction (or an individual with respect to whom a taxpayer is allowed a deduction) under section 151. Thus, for instance, sec. 24(a) allows a credit against tax with respect to each qualifying child of the taxpayer for which the taxpayer is allowed a deduction under section 151. A qualifying child, as defined under section 152(c), remains eligible for the credit, notwithstanding that the deduction under section 151 has been reduced to zero.

<sup>120</sup> Sec. 164(a)(1).



income, war profits, and excess profits taxes.<sup>122</sup> At the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes.<sup>123</sup>

Property taxes may be allowed as a deduction in computing adjusted gross income if incurred in connection with property used in a trade or business; otherwise they are an itemized deduction. In the case of State and local income taxes, the deduction is an itemized deduction notwithstanding that the tax may be imposed on profits from a trade or business.<sup>124</sup>

Individuals also are permitted a deduction for Federal and State generation skipping transfer tax (“GST tax”) imposed on certain income distributions that are included in the gross income of the distributee.<sup>125</sup>

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

### **Reasons for Change**

The Committee believes that the repeal of many existing tax incentives, including the deduction for State and local taxes, makes the system simpler and fairer for all families and individuals, and allows for lower tax rates. The Committee further believes that repeal of this provision is consistent with streamlining the Code, broadening the tax base, lowering rates, and growing the economy.

The deduction for State and local taxes provides a Federal subsidy for public services provided by State and local governments, such as public education and sanitary services. Allowing a deduction for State and local taxes permits taxpayer to finance personal consumption with pre-tax dollars. If the taxpayer acquired similar services by private purchase, no deduction would be permitted for such expenditures. In addition, the deduction provided for State and local taxes disproportionately benefits those taxpayers in high-tax states. Those taxpayers in low-tax states, in essence, subsidize the public service benefits received by taxpayers in high-tax states.<sup>126</sup>

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<sup>121</sup> Sec. 164(a)(2).

<sup>122</sup> Sec. 164(a)(3). A foreign tax credit, in lieu of a deduction, is allowable for foreign taxes if the taxpayer so elects.

<sup>123</sup> Sec. 164(b)(5).

<sup>124</sup> See H. Rep. No. 1365 to accompany Individual Income Tax Bill of 1944 (78<sup>th</sup> Cong., 2d. Sess.), reprinted at 19 C.B. 839 (1944).

<sup>125</sup> Sec. 164(a)(4).

<sup>126</sup> See Staff Report on Comprehensive Tax Reform for 2015 and Beyond, Prepared by the Republican Staff of the Committee on Finance United States Senate, S. Prt. No. 113-31 (Dec. 2014), at 97.

### **Explanation of Provision**

The provision provides for a suspension of the itemized deduction for State and local taxes, as described below.

For the taxable years to which the suspension applies, in the case of an individual, State, local and foreign property taxes and State and local sales taxes are allowed as a deduction only when paid or accrued in carrying on a trade or business or an activity described in section 212 (relating to expenses for the production of income).<sup>127</sup> Thus, the provision allows only those deductions for State, local and foreign property taxes, and sales taxes, that are presently deductible in computing income on an individual's Schedule C, Schedule E, or Schedule F on such individual's tax return. For instance, in the case of property taxes, an individual may deduct such items only if these taxes were imposed on business assets (such as residential rental property).

For the taxable years to which the suspension applies, in the case of an individual, State and local income, war profits, and excess profits taxes are not allowable as a deduction.

The suspension ends for taxable years beginning after December 31, 2025.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

### **3. Suspension of deduction for home equity interest (sec. 11043 of the bill and sec. 163(h) of the Code)**

#### **Present Law**

As a general matter, personal interest is not deductible.<sup>128</sup> Qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations.<sup>129</sup> Qualified residence interest means interest paid or accrued during the taxable year on either acquisition indebtedness or home equity indebtedness. A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

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<sup>127</sup> The provision does not modify the deductibility of GST tax imposed on certain income distributions. Additionally, taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law.

<sup>128</sup> Sec. 163(h)(1).

<sup>129</sup> Sec. 163(h)(2)(D) and (h)(3).

### Acquisition indebtedness

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

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

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

### Home equity indebtedness

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

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

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

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

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

### **Reasons for Change**

The Committee believes that scaling back many of the existing tax incentives, including the deduction for interest paid on home equity indebtedness, makes the system simpler and fairer for all families and individuals, and allows for lower tax rates. The Committee further believes that modification of this provision is consistent with streamlining the Code, broadening the tax base, lowering rates, and growing the economy.

The deduction for interest paid on home equity indebtedness permits taxpayers to borrow against their residence and purchase consumer goods thereby circumventing the prohibition on deduction of consumer interest. In the event of an economic downturn, a taxpayer may lose his or her home as a result of having the home secure the indebtedness. In addition, the deduction for interest paid on home equity indebtedness favors homeowners versus renters as the deduction is only available for homeowners.

### **Explanation of Provision**

The provision suspends the deduction for interest on home equity indebtedness. Thus, for taxable years beginning after December 31, 2017, a taxpayer may not claim a deduction for interest on home equity indebtedness. The suspension ends for taxable years beginning after December 31, 2025.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **4. Temporary modification of deduction for personal casualty and theft losses (sec. 11044 of the bill and sec. 165 of the Code)**

### **Present Law**

A taxpayer may generally claim a deduction for any loss sustained during the taxable year, not compensated by insurance or otherwise. For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft.<sup>130</sup> Personal casualty or theft losses are deductible only if they exceed \$100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed ten percent of an individual taxpayer's adjusted gross income.

### **Reasons for Change**

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<sup>130</sup> Sec. 165(c).

The Committee believes that the repeal of many existing tax incentives, including the deduction for personal casualty and theft losses, except in the case of Presidentially declared disasters, makes the system simpler and fairer for all families and individuals, and allows for lower tax rates. The Committee further believes that repeal of this provision is consistent with streamlining the Code, broadening the tax base, lowering rates, and growing the economy.

The Committee believes that the deduction for personal casualty or theft losses should be limited to those losses that may be considered extraordinary, nonrecurring losses, and go beyond the average (or usual) losses incurred by most taxpayers in everyday living. The Committee believes it appropriate to identify such extraordinary situations by the standard of a Presidentially declared disaster.

### **Explanation of Provision**

The provision temporarily modifies the deduction for personal casualty and theft losses. Under the provision, a taxpayer may claim a personal casualty loss (subject to the limitations described above) only if such loss was attributable to a disaster declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

The above-described limitation does not apply with respect to losses incurred after December 31, 2025.

### **Effective Date**

The provision is effective for losses incurred in taxable years beginning after December 31, 2017.

## **5. Suspension of miscellaneous itemized deductions subject to the two-percent floor (sec. 11045 of the bill and secs. 62, 67, and 212 of the Code)**

### **Present Law**

Individuals may claim itemized deductions for certain miscellaneous expenses. Certain of these expenses are not deductible unless, in aggregate, they exceed two percent of the taxpayer's adjusted gross income ("AGI").<sup>131</sup> The deductions described below are subject to the aggregate two-percent floor.<sup>132</sup>

### **Expenses for the production or collection of income**

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<sup>131</sup> Sec. 67(a).

<sup>132</sup> The miscellaneous itemized deduction for tax preparation expenses is described in a separate section of this document.

Individuals may deduct all ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income.<sup>133</sup>

Present law and IRS guidance provide examples of items that may be deducted under this provision. This non-exhaustive list includes:<sup>134</sup>

- Appraisal fees for a casualty loss or charitable contribution;
- Casualty and theft losses from property used in performing services as an employee;
- Clerical help and office rent in caring for investments;
- Depreciation on home computers used for investments;
- Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust;
- Fees to collect interest and dividends;
- Hobby expenses, but generally not more than hobby income;
- Indirect miscellaneous deductions from pass-through entities;
- Investment fees and expenses;
- Loss on deposits in an insolvent or bankrupt financial institution;
- Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed;
- Repayments of income;
- Safe deposit box rental fees, except for storing jewelry and other personal effects;
- Service charges on dividend reinvestment plans; and
- Trustee's fees for an IRA, if separately billed and paid.

### **Tax preparation expenses**

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

### **Unreimbursed expenses attributable to the trade or business of being an employee**

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<sup>133</sup> Sec. 212(1).

<sup>134</sup> See IRS Publication 529, "*Miscellaneous Deductions*" (2016), p. 9.

<sup>135</sup> Sec. 212.

In general, unreimbursed business expenses incurred by an employee are deductible, but only as an itemized deduction and only to the extent the expenses exceed two percent of adjusted gross income.<sup>136</sup>

Present law and IRS guidance provide examples of items that may be deducted under this provision. This non-exhaustive list includes:<sup>137</sup>

- Business bad debt of an employee;
- Business liability insurance premiums;
- Damages paid to a former employer for breach of an employment contract;
- Depreciation on a computer a taxpayer's employer requires him to use in his work;
- Dues to a chamber of commerce if membership helps the taxpayer perform his job;
- Dues to professional societies;
- Educator expenses;<sup>138</sup>
- Home office or part of a taxpayer's home used regularly and exclusively in the taxpayer's work;
- Job search expenses in the taxpayer's present occupation;
- Laboratory breakage fees;
- Legal fees related to the taxpayer's job;
- Licenses and regulatory fees;
- Malpractice insurance premiums;
- Medical examinations required by an employer;
- Occupational taxes;
- Passport fees for a business trip;
- Repayment of an income aid payment received under an employer's plan;
- Research expenses of a college professor;
- Rural mail carriers' vehicle expenses;
- Subscriptions to professional journals and trade magazines related to the taxpayer's work;
- Tools and supplies used in the taxpayer's work;

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<sup>136</sup> Secs. 62(a)(1) and 67.

<sup>137</sup> See IRS Publication 529, "*Miscellaneous Deductions*" (2016), p. 3.

<sup>138</sup> Under a special provision, these expenses are deductible "above the line" up to \$250.

- Purchase of travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer's work;
- Union dues and expenses;
- Work clothes and uniforms if required and not suitable for everyday use; and
- Work-related education.

**Other miscellaneous itemized deductions subject to the two-percent floor**

Other miscellaneous itemized deductions subject to the two-percent floor include:

- Tax preparation fees;
- Repayments of income received under a claim of right (only subject to the two-percent floor if less than \$3,000);
- Repayments of Social Security benefits; and
- The share of deductible investment expenses from pass-through entities.

**Reasons for Change**

The Committee believes that the repeal of many existing tax incentives, including miscellaneous itemized deductions subject to the two-percent floor, makes the system simpler and fairer for all families and individuals, and allows for lower tax rates. The Committee further believes that repeal of this provision is consistent with streamlining the Code, broadening the tax base, lowering rates, and growing the economy.

The Committee believes that keeping records of miscellaneous itemized deductions, which in many cases are small expenditures, adds to the administrative and enforcement complexity of the tax system for both taxpayers and the Internal Revenue Service. With the significant increase of the standard deduction for all individuals, the Committee believes that significant simplification without any loss of fairness can be achieved through suspending the deduction for miscellaneous itemized deductions. In addition, the Committee believes that some miscellaneous itemized deductions are sufficiently personal in nature, such as safe deposit box rental fees, that they would be paid or incurred in the absence of any business or investment activities of the taxpayer.

**Explanation of Provision**

The provision suspends all miscellaneous itemized deductions that are subject to the two-percent floor under present law. Thus, under the provision, taxpayers may not claim the above-listed items as itemized deductions for the taxable years to which the suspension applies. The provision does not apply for taxable years beginning after December 31, 2025.



### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **6. Suspension of overall limitation on itemized deductions (sec. 11046 of the bill and sec. 68 of the Code)**

### **Present Law**

The total amount of most otherwise allowable itemized deductions (other than the deductions for medical expenses, investment interest and casualty, theft or gambling losses) is limited for certain upper-income taxpayers.<sup>139</sup> All other limitations applicable to such deductions (such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced by three percent of the amount by which the taxpayer's adjusted gross income exceeds a threshold amount.

For 2017, the threshold amounts are \$261,500 for single taxpayers, \$287,650 for heads of household, \$313,800 for married taxpayers filing jointly, and \$156,900 for married taxpayers filing separately. These threshold amounts are indexed for inflation. The otherwise allowable itemized deductions may not be reduced by more than 80 percent by reason of the overall limit on itemized deductions.

### **Reasons for Change**

The Committee believes that the overall limitation on itemized deductions has functioned as a hidden marginal tax rate. In its mission to make the Code simpler, fairer, and more transparent, the Committee believes that the provision should be suspended.

### **Explanation of Provision**

The provision suspends the overall limitation on itemized deductions.

The suspension of the overall limitation on itemized deductions does not apply to taxable years beginning after December 31, 2025.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

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<sup>139</sup> Sec. 68.

## **7. Temporary modification of exclusion of gain from sale of a principal residence (sec. 11047 of the bill and sec. 121 of the Code)**

### **Present Law**

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

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

### **Reasons for Change**

The Committee believes that the current exclusion on proceeds from the sale of a principal residence is too liberal in its residency requirements. The exclusion is intended to prevent longtime homeowners from recognizing a gain upon an infrequent and important transaction, and to allow those individuals to use the full proceeds of the home sale to purchase another home. The Committee believes that the rule allowing individuals to live in their home for only two out of the prior five years to qualify for the exclusion has allowed individuals to cycle between building homes and living in those homes while they build the next home, selling the lived-in home and qualifying for the exclusion on the proceeds. This Committee believes taxpayers are utilizing the exclusion in a manner that was not intended.

### **Explanation of Provision**

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

Under the provision, a taxpayer may benefit from the exclusion only once every five years.

The provision does not apply to taxable years beginning after December 31, 2025.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **8. Suspension of exclusion for qualified bicycle commuting reimbursement (sec. 11048 of the bill and sec. 132(f) of the Code)**

### **Present Law**

Qualified bicycle commuting reimbursements of up to \$20 per qualifying bicycle commuting month are excludible from an employee's gross income<sup>140</sup>. A qualifying bicycle commuting month is any month during which the employee regularly uses the bicycle for a substantial portion of travel to a place of employment and during which the employee does not receive transportation in a commuter highway vehicle, a transit pass, or qualified parking from an employer.

Qualified reimbursements are any amount received from an employer during a 15-month period beginning with the first day of the calendar year as payment for reasonable expenses during a calendar year. Reasonable expenses are those incurred in a calendar year for the purchase of a bicycle and bicycle improvements, repair, and storage, if the bicycle is regularly used for travel between the employee's residence and place of employment.

Amounts that are excludible from gross income for income tax purposes are also excluded from wages for employment tax purposes.

### **Reasons for Change**

The Committee believes that the repeal of many existing tax incentives, including the exclusion for qualified bicycle commuting reimbursements, makes the system simpler and fairer for all families and individuals, and allows for lower tax rates. The Committee further believes that repeal of this provision is consistent with streamlining the Code, broadening the tax base, lowering rates, and growing the economy.

### **Explanation of Provision**

The provision suspends the exclusion from gross income and wages for qualified bicycle commuting reimbursements for taxable years beginning after December 31, 2017 and before January 1, 2026.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

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<sup>140</sup> Section 132(a)(5) and 132(f)(1)(D).

## **9. Suspension of exclusion for qualified moving expense reimbursement (sec. 11049 of the bill and sec. 132(g) of the Code)**

### **Present Law**

Qualified moving expense reimbursements are excludible from an employee's gross income<sup>141</sup>, and are defined as any amount received (directly or indirectly) from an employer as payment for (or reimbursement of) expenses which would be deductible as moving expenses under section 217<sup>142</sup> if directly paid or incurred by the employee. However, qualified moving expense reimbursements do not include amounts actually deducted by the individual.

Amounts excludible from gross income for income tax purposes as qualified moving expense reimbursements are also excluded from wages for employment tax purposes.

### **Reasons for Change**

The Committee believes that the repeal of many existing tax incentives, including the exclusion for qualified moving expense reimbursements, makes the system simpler and fairer for all families and individuals, and allows for lower tax rates. The Committee further believes that repeal of this provision is consistent with streamlining the Code, broadening the tax base, lowering rates, and growing the economy.

### **Explanation of Provision**

The provision suspends the exclusion from gross income and wages for qualified moving expense reimbursements for taxable years beginning after December 31, 2017 and before January 1, 2026.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **10. Suspension of deduction for moving expenses (sec. 11050 of the bill and sec. 217 of the Code)**

### **Present Law**

Individuals are permitted an above-the-line deduction for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer

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<sup>141</sup> Section 132(a)(6) and 132(g).

<sup>142</sup> Sec. 217(a). Individuals are allowed an above-the-line deduction for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work. Such expenses are deductible only if the move meets certain conditions related to distance from the taxpayer's previous residence and the taxpayer's status as a full-time employee in the new location.

as an employee or as a self-employed individual at a new principal place of work.<sup>143</sup> Such expenses are deductible only if the move meets certain conditions related to distance from the taxpayer's previous residence and the taxpayer's status as a full-time employee in the new location.

Special rules apply in the case of a member of the Armed Forces of the United States. In the case of any such individual who is on active duty, who moves pursuant to a military order and incident to a permanent change of station, the limitations related to distance from the taxpayer's previous residence and status as a full-time employee in the new location do not apply.<sup>144</sup> Additionally, any moving and storage expenses which are furnished in kind to such an individual, spouse, or dependents, or if such expenses are reimbursed or an allowance for such expenses is provided, such amounts are excluded from gross income.<sup>145</sup> Rules also apply to exclude amounts furnished to the spouse and dependents of such an individual in the event that such individuals move to a location other than to where the member of the Armed Forces is moving.

Present law provides income exclusions for various benefits provided to members of the Armed Forces.<sup>146</sup>

### **Reasons for Change**

The Committee believes that the repeal of many existing tax incentives, including the deduction for moving expenses, makes the system simpler and fairer for all families and individuals, and allows for lower tax rates. The Committee further believes that repeal of this provision is consistent with streamlining the Code, broadening the tax base, lowering rates, and growing the economy.

However, the Committee recognizes that special circumstances apply to members of the Armed Forces, and thus the provision retains present law benefits relating to the moving expenses of these taxpayers.

### **Explanation of Provision**

The provision generally suspends the deduction for moving expenses from taxable years from 2018 through 2025. However, during that suspension period, the provision retains the deduction for moving expenses and the rules providing for exclusions of amounts attributable to in-kind moving and storage expenses (and reimbursements or allowances for these expenses) for

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<sup>143</sup> Sec. 217(a).

<sup>144</sup> Sec. 217(g).

<sup>145</sup> Sec. 217(g)(2).

<sup>146</sup> Sec. 134.

members of the Armed Forces (or their spouse or dependents) on active duty that move pursuant to a military order and incident to a permanent change of station.<sup>147</sup>

The suspension of the deduction for moving expenses does not apply to taxable years beginning after December 31, 2025.

#### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

### **11. Temporary modification to the limitation on wagering losses (sec. 11051 of the bill and sec. 165 of the Code)**

#### **Present Law**

Losses sustained during the taxable year on wagering transactions are allowed as a deduction only to the extent of the gains during the taxable year from such transactions.<sup>148</sup>

#### **Reasons for Change**

The Committee believes that the scope of the limitation on wagering losses should be broadened to cover expenses incurred in the conduct of the individual's gambling activity.

#### **Explanation of Provision**

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

The provision is intended to clarify that the limitation on losses from wagering transactions applies not only to the actual costs of wagers incurred by an individual, but to other expenses incurred by the individual in connection with the conduct of that individual's gambling activity.<sup>149</sup> The provision clarifies, for instance, an individual's otherwise deductible expenses in traveling to or from a casino are subject to the limitation under section 165(d).

The provision does not apply to taxable years beginning after December 31, 2025.

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<sup>147</sup> Under the provision, these exclusions are added to section 134.

<sup>148</sup> Sec. 165(d).

<sup>149</sup> The provision thus reverses the result reached by the Tax Court in *Ronald A. Mayo v. Commissioner*, 136 T.C. 81 (2011). In that case, the Court held that a taxpayer's expenses incurred in the conduct of the trade or business of gambling, other than the cost of wagers, were not limited by section 165(d), and were thus deductible under section 162(a).

**Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## PART VI – INCREASE IN ESTATE AND GIFT TAX EXEMPTION

### 1. Temporary increase in estate and gift tax exemption (sec. 11061 of the bill and sec. 2010 of the Code)

#### Present Law

##### In general

A gift tax is imposed on certain lifetime transfers, and an estate tax is imposed on certain transfers at death. A generation-skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a “skip person” (*i.e.*, a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

Income tax rules determine the recipient’s tax basis in property acquired from a decedent or by gift. Gifts and bequests generally are excluded from the recipient’s gross income.<sup>150</sup>

##### Common features of the estate, gift and generation-skipping transfer taxes

###### Unified credit (exemption) and tax rates

Unified credit.—A unified credit is available with respect to taxable transfers by gift and at death.<sup>151</sup> The unified credit offsets tax, computed using the applicable estate and gift tax rates, on a specified amount of transfers, referred to as the applicable exclusion amount, or exemption amount. The exemption amount was set at \$5 million for 2011 and is indexed for inflation for later years.<sup>152</sup> For 2017, the inflation-indexed exemption amount is \$5.49 million.<sup>153</sup> Exemption used during life to offset taxable gifts reduces the amount of exemption that remains at death to offset the value of a decedent’s estate. An election is available under which exemption that is not used by a decedent may be used by the decedent’s surviving spouse (exemption portability).

Common tax rate table.—A common tax-rate table with a top marginal tax rate of 40 percent is used to compute gift tax and estate tax. The 40-percent rate applies to transfers in excess of \$1 million (to the extent not exempt). Because the exemption amount currently shields the first \$5.49 million in gifts and bequests from tax, transfers in excess of the exemption amount generally are subject to tax at the highest marginal rate (40 percent).

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<sup>150</sup> Sec. 102.

<sup>151</sup> Sec. 2010.

<sup>152</sup> For 2011 and later years, the gift and estate taxes were reunified, meaning that the gift tax exemption amount was increased to equal the estate tax exemption amount.

<sup>153</sup> For 2017, the \$5.49 million exemption amount results in a unified credit of \$2,141,800, after applying the applicable rates set forth in section 2001(c).



Generation-skipping transfer tax exemption and rate.—The generation-skipping transfer tax is a separate tax that can apply in addition to either the gift tax or the estate tax. The tax rate and exemption amount for generation-skipping transfer tax purposes, however, are set by reference to the estate tax rules. Generation-skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate (40 percent). Tax is imposed on cumulative generation-skipping transfers in excess of the generation-skipping transfer tax exemption amount in effect for the year of the transfer. The generation-skipping transfer tax exemption for a given year is equal to the estate tax exemption amount in effect for that year (currently \$5.49 million).

Transfers between spouses.—A 100-percent marital deduction generally is permitted for the value of property transferred between spouses.<sup>154</sup> In addition, transfers of “qualified terminable interest property” also are eligible for the marital deduction. Qualified terminable interest property is property: (1) that passes from the decedent, (2) in which the surviving spouse has a “qualifying income interest for life,” and (3) to which an election under these rules applies. A qualifying income interest for life exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse’s life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States. A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

Tax is imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Transfers to charity.—Contributions to section 501(c)(3) charitable organizations and certain other organizations may be deducted from the value of a gift or from the value of the assets in an estate for Federal gift or estate tax purposes.<sup>155</sup> The effect of the deduction generally is to remove the full fair market value of assets transferred to charity from the gift or estate tax base; unlike the income tax charitable deduction, there are no percentage limits on the deductible amount. For estate tax purposes, the charitable deduction is limited to the value of the transferred property that is required to be included in the gross estate.<sup>156</sup> A charitable

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<sup>154</sup> Secs. 2056 and 2523.

<sup>155</sup> Secs. 2055 and 2522.

<sup>156</sup> Sec. 2055(d).

contribution of a partial interest in property, such as a remainder or future interest, generally is not deductible for gift or estate tax purposes.<sup>157</sup>

## **The estate tax**

### Overview

The Code imposes a tax on the transfer of the taxable estate of a decedent who is a citizen or resident of the United States.<sup>158</sup> The taxable estate is determined by deducting from the value of the decedent's gross estate any deductions provided for in the Code. After applying tax rates to determine a tentative amount of estate tax, certain credits are subtracted to determine estate tax liability.<sup>159</sup>

Because the estate tax shares a common unified credit (exemption) and tax rate table with the gift tax, the exemption amounts and tax rates are described together above, along with certain other common features of these taxes.

### Gross estate

A decedent's gross estate includes, to the extent provided for in other sections of the Code, the date-of-death value of all of a decedent's property, real or personal, tangible or intangible, wherever situated.<sup>160</sup> In general, the value of property for this purpose is the fair market value of the property as of the date of the decedent's death, although an executor may elect to value certain property as of the date that is six months after the decedent's death (the alternate valuation date).<sup>161</sup>

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<sup>157</sup> Secs. 2055(e)(2) and 2522(c)(2).

<sup>158</sup> Sec. 2001(a).

<sup>159</sup> More mechanically, the taxable estate is combined with the value of adjusted taxable gifts made during the decedent's life (generally, post-1976 gifts), before applying tax rates to determine a tentative total amount of tax. The portion of the tentative tax attributable to lifetime gifts is then subtracted from the total tentative tax to determine the gross estate tax, *i.e.*, the amount of estate tax before considering available credits. Credits are then subtracted to determine the estate tax liability.

This method of computation was designed to ensure that a taxpayer only gets one run up through the rate brackets for all lifetime gifts and transfers at death, at a time when the thresholds for applying the higher marginal rates exceeded the exemption amount. However, the higher (\$5.49 million) present-law exemption amount effectively renders the lower rate brackets irrelevant, because the top marginal rate bracket applies to all transfers in excess of \$1 million. In other words, all transfers that are not exempt by reason of the \$5.49 million exemption amount are taxed at the highest marginal rate of 40 percent.

<sup>160</sup> Sec. 2031(a).

<sup>161</sup> Sec. 2032.

The gross estate includes not only property directly owned by the decedent, but also other property in which the decedent had a beneficial interest at the time of his or her death.<sup>162</sup> The gross estate also includes certain transfers made by the decedent prior to his or her death, including: (1) certain gifts made within three years prior to the decedent's death;<sup>163</sup> (2) certain transfers of property in which the decedent retained a life estate;<sup>164</sup> (3) certain transfers taking effect at death;<sup>165</sup> and (4) revocable transfers.<sup>166</sup> In addition, the gross estate also includes property with respect to which the decedent had, at the time of death, a general power of appointment (generally, the right to determine who will have beneficial ownership).<sup>167</sup> The value of a life insurance policy on the decedent's life is included in the gross estate if the proceeds are payable to the decedent's estate or the decedent had incidents of ownership with respect to the policy at the time of his or her death.<sup>168</sup>

#### Deductions from the gross estate

A decedent's taxable estate is determined by subtracting from the value of the gross estate any deductions provided for in the Code.

Marital and charitable transfers.—As described above, transfers to a surviving spouse or to charity generally are deductible for estate tax purposes. The effect of the marital and charitable deductions generally is to remove assets transferred to a surviving spouse or to charity from the estate tax base.

State death taxes.—An estate tax deduction is permitted for death taxes (*e.g.*, any estate, inheritance, legacy, or succession taxes) actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent.<sup>169</sup> Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

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<sup>162</sup> Sec. 2033.

<sup>163</sup> Sec. 2035.

<sup>164</sup> Sec. 2036.

<sup>165</sup> Sec. 2037.

<sup>166</sup> Sec. 2038.

<sup>167</sup> Sec. 2041.

<sup>168</sup> Sec. 2042.

<sup>169</sup> Sec. 2058.

Other deductions.—A deduction is available for funeral expenses, estate administration expenses, and claims against the estate, including certain taxes.<sup>170</sup> A deduction also is available for uninsured casualty and theft losses incurred during the settlement of the estate.<sup>171</sup>

#### Credits against tax

After accounting for allowable deductions, a gross amount of estate tax is computed. Estate tax liability is then determined by subtracting allowable credits from the gross estate tax.

Unified credit.—The most significant credit allowed for estate tax purposes is the unified credit, which is discussed in greater detail above.<sup>172</sup> For 2017, the value of the unified credit is \$2,141,800, which has the effect of exempting \$5.49 million in transfers from tax. The unified credit available at death is reduced by the amount of unified credit used to offset gift tax on gifts made during the decedent's life.

Other credits.—Estate tax credits also are allowed for: (1) gift tax paid on certain pre-1977 gifts (before the estate and gift tax computations were integrated);<sup>173</sup> (2) estate tax paid on certain prior transfers (to limit the estate tax burden when estate tax is imposed on transfers of the same property in two estates by reason of deaths in rapid succession);<sup>174</sup> and (3) certain foreign death taxes paid (generally, where the property is situated in a foreign country but included in the decedent's U.S. gross estate).<sup>175</sup>

#### Provisions affecting small and family-owned businesses and farms

Special-use valuation.—An executor can elect to value for estate tax purposes certain “qualified real property” used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value.<sup>176</sup> The maximum reduction in value for such real property is \$750,000 (adjusted for inflation occurring after 1997; the inflation-adjusted amount for 2017 is \$1,120,000). In general, real property qualifies for special-use valuation only if (1) at least 50 percent of the adjusted value of the decedent's gross estate (including both real and personal property) consists of a farm or closely-held business property in the decedent's estate and (2) at least 25 percent of the adjusted value of the gross estate consists of farm or

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<sup>170</sup> Sec. 2053.

<sup>171</sup> Sec. 2054.

<sup>172</sup> Sec. 2010.

<sup>173</sup> Sec. 2012.

<sup>174</sup> Sec. 2013.

<sup>175</sup> Sec. 2014. In certain cases, an election may be made to deduct foreign death taxes. See section 2053(d).

<sup>176</sup> Sec. 2032A.

closely held business real property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed to recapture the entire estate-tax benefit of the special-use valuation.

Installment payment of estate tax for closely held businesses.—Under present law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10).<sup>177</sup> An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (*i.e.*, the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2017 is \$1,490,000) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of \$1 million (adjusted for inflation) is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (*i.e.*, 45 percent of the Federal short-term rate plus three percentage points).<sup>178</sup> Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

## **The gift tax**

### Overview

The Code imposes a tax for each calendar year on the transfer of property by gift during such year by any individual, whether a resident or nonresident of the United States.<sup>179</sup> The amount of taxable gifts for a calendar year is determined by subtracting from the total amount of gifts made during the year: (1) the gift tax annual exclusion (described below); and (2) allowable deductions.

Gift tax for the current taxable year is determined by: (1) computing a tentative tax on the combined amount of all taxable gifts for the current and all prior calendar years using the common gift tax and estate tax rate table; (2) computing a tentative tax only on all prior-year gifts; (3) subtracting the tentative tax on prior-year gifts from the tentative tax computed for all

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<sup>177</sup> Sec. 6166.

<sup>178</sup> The interest rate on this portion adjusts with the Federal short-term rate.

<sup>179</sup> Sec. 2501(a).

years to arrive at the portion of the total tentative tax attributable to current-year gifts; and, finally, (4) subtracting the amount of unified credit not consumed by prior-year gifts.

Because the gift tax shares a common unified credit (exemption) and tax rate table with the estate tax, the exemption amounts and tax rates are described together above, along with certain other common features of these taxes.

### Transfers by gift

The gift tax applies to a transfer by gift regardless of whether: (1) the transfer is made outright or in trust; (2) the gift is direct or indirect; or (3) the property is real or personal, tangible or intangible.<sup>180</sup> For gift tax purposes, the value of a gift of property is the fair market value of the property at the time of the gift.<sup>181</sup> Where property is transferred for less than full consideration, the amount by which the value of the property exceeds the value of the consideration is considered a gift and is included in computing the total amount of a taxpayer's gifts for a calendar year.<sup>182</sup>

For a gift to occur, a donor generally must relinquish dominion and control over donated property. For example, if a taxpayer transfers assets to a trust established for the benefit of his or her children, but retains the right to revoke the trust, the taxpayer may not have made a completed gift, because the taxpayer has retained dominion and control over the transferred assets. A completed gift made in trust, on the other hand, often is treated as a gift to the trust beneficiaries.

By reason of statute, certain transfers are not treated as transfers by gift for gift tax purposes. These include, for example, certain transfers for educational and medical purposes,<sup>183</sup> transfers to section 527 political organizations,<sup>184</sup> and transfers to tax-exempt organizations described in sections 501(c)(4), (5), or (6).<sup>185</sup>

### Taxable gifts

As stated above, the amount of a taxpayer's taxable gifts for the year is determined by subtracting from the total amount of the taxpayer's gifts for the year the gift tax annual exclusion and any available deductions.

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<sup>180</sup> Sec. 2511(a).

<sup>181</sup> Sec. 2512(a).

<sup>182</sup> Sec. 2512(b).

<sup>183</sup> Sec. 2503(e).

<sup>184</sup> Sec. 2501(a)(4).

<sup>185</sup> Sec. 2501(a)(6).

Gift tax annual exclusion.—Under present law, donors of lifetime gifts are provided an annual exclusion of \$14,000 per donee in 2017 (indexed for inflation from the 1997 annual exclusion amount of \$10,000) for gifts of present interests in property during the taxable year.<sup>186</sup> If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is \$28,000 per donee in 2017. In general, unlimited transfers between spouses are permitted without imposition of a gift tax. Special rules apply to the contributions to a qualified tuition program (“529 Plan”) including an election to treat a contribution that exceeds the annual exclusion as a contribution made ratably over a five-year period beginning with the year of the contribution.<sup>187</sup>

Marital and charitable deductions.—As described above, transfers to a surviving spouse or to charity generally are deductible for gift tax purposes. The effect of the marital and charitable deductions generally is to remove assets transferred to a surviving spouse or to charity from the gift tax base.

### **The generation-skipping transfer tax**

A generation-skipping transfer tax generally is imposed (in addition to the gift tax or the estate tax) on transfers, either directly or in trust or similar arrangement, to a “skip person” (*i.e.*, a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

#### Exemption and tax rate

An exemption generally equal to the estate tax exemption amount (\$5.49 million for 2017) is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property, and in some cases is automatically allocated. The allocation of generation-skipping transfer tax exemption effectively reduces the tax rate on a generation-skipping transfer.

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate (40 percent) multiplied by the “inclusion ratio.” The inclusion ratio with respect to any property transferred indicates the amount of “generation-skipping transfer tax exemption” allocated to a trust (or to property transferred in a direct skip) relative to the total value of property transferred.<sup>188</sup> If, for example, a taxpayer transfers \$5 million in property to a trust and allocates \$5 million of exemption to the transfer, the inclusion ratio is zero, and the applicable tax rate on any subsequent generation-skipping transfers from the trust is zero percent (40 percent multiplied by the inclusion ratio of zero). If, however, the taxpayer allocated only

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<sup>186</sup> Sec. 2503(b).

<sup>187</sup> Sec. 529(c)(2).

<sup>188</sup> The inclusion ratio is one minus the applicable fraction. The applicable fraction is the amount of exemption allocated to a trust (or to a direct skip) divided by the value of assets transferred.

\$2.5 million of exemption to the transfer, the inclusion ratio is 0.5, and the applicable tax rate on any subsequent generation-skipping transfers from the trust is 20 percent (40 percent multiplied by the inclusion ratio of 0.5). If the taxpayer allocates no exemption to the transfer, the inclusion ratio is one, and the applicable tax rate on any subsequent generation-skipping transfers from the trust is 40 percent (40 percent multiplied by the inclusion ratio of one).

### Generation-skipping transfers

Generation-skipping transfer tax generally is imposed at the time of a generation-skipping transfer – a direct skip, a taxable termination, or a taxable distribution.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. A skip person may be a natural person or certain trusts. All persons assigned to the second or more remote generation below the transferor are skip persons (*e.g.*, grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person.

A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation-skipping transfer tax exemption to a trust prior to the taxable distribution, generation-skipping transfer tax may be avoided.

## **Income tax basis in property received**

### In general

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (*i.e.*, gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

A gift or bequest of appreciated (or loss) property is not an income tax realization event for the transferor. The Code provides special rules for determining a recipient's basis in assets received by lifetime gift or from a decedent.

### Basis in property received by lifetime gift

Under present law, property received from a donor of a lifetime gift generally takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a



lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If a donor's basis in property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss on a subsequent sale of the property, the donee's basis is the property's fair market value on the date of the gift.

#### Basis in property acquired from a decedent

Property acquired from a decedent's estate generally takes a stepped-up basis. "Stepped-up basis" means that the basis of property acquired from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). Providing a fair market value basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death and eliminates the tax benefit from any unrealized loss.

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any State, U.S. possession, or foreign country) generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Thus, both the decedent's one-half share and the surviving spouse's one-half share are stepped up to fair market value. This rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

Stepped-up basis treatment generally is denied to certain interests in foreign entities. Stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that stock of a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped-up basis. Stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped-up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (*i.e.*, generally the date of the decedent's death unless an alternate valuation date is elected).

#### **Reasons for Change**

The Committee believes the Federal estate tax harms taxpayers and the economy and therefore should be modified by doubling the estate and gift tax exemption. A tax on capital, such as the estate tax, motivates wealth holders to reduce savings and increase spending during life, rather than passing it to the next generation, ultimately increasing the consumption gap between the wealthy and poor. A tax on capital also causes investors to provide less capital to workers, thereby reducing wages in the long run.

The Committee is particularly concerned about the effect of the estate tax on the owners of farms and family businesses, which create jobs and support our economy. The estate tax hits such entrepreneurs especially hard, forcing families of deceased owners to make the difficult decision to sell all or part of the farm or business or take out costly loans to satisfy the estate tax liability.

### **Explanation of Provision**

The provision generally doubles the estate and gift tax exemption amount for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026. This is accomplished by increasing the basic exclusion amount provided in section 2010(c)(3) of the Code from \$5 million to \$10 million. The \$10 million amount is indexed for inflation occurring after 2011.

As a conforming amendment to section 2010(g) (regarding computation of estate tax), the provision provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of the section with respect to differences between the basic exclusion amount in effect: (1) at the time of the decedent's death; and (2) at the time of any gifts made by the decedent.

### **Effective Date**

The provision is effective for estates of decedents dying and gifts made after December 31, 2017.

## **PART VII – TAXPAYER RIGHTS AND TAX ADMINISTRATION**

### **1. Extension of time limit for contesting IRS levy (sec. 11071 of the bill and secs. 6343 and 6532 of the Code)**

#### **Present Law**

The IRS is authorized to return property that has been wrongfully levied upon.<sup>189</sup> In general, monetary proceeds from the sale of levied property may be returned within nine months of the date of the levy.

Generally, any person (other than the person against whom is assessed the tax out of which such levy arose) who claims an interest in levied property and that such property was wrongfully levied upon may bring a civil action for wrongful levy in a district court of the United States.<sup>190</sup> Generally, an action for wrongful levy must be brought within nine months from the date of levy.<sup>191</sup>

#### **Reasons for Change**

The Committee understands that in many cases the time period for bringing an action may be insufficient for taxpayers or third parties to discover a wrongful or mistaken levy and seek to remedy it. Accordingly, the Committee believes it is appropriate to provide for a longer period of time within which a person may contest a wrongful IRS levy.

#### **Explanation of Provision**

The provision extends from nine months to two years the period for returning the monetary proceeds from the sale of property that has been wrongfully levied upon.

The provision also extends from nine months to two years the period for bringing a civil action for wrongful levy.

#### **Effective Date**

The provision is effective with respect to: (1) levies made after the date of enactment; and (2) levies made on or before the date of enactment provided that the nine-month period has not expired as of the date of enactment.

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<sup>189</sup> Sec. 6343.

<sup>190</sup> Sec. 7426.

<sup>191</sup> Sec. 6532.

## **2. Individuals held harmless on improper levy on retirement plans (sec. 11072 of the bill and sec. 6343 of the Code)**

### **Present Law**

#### **Tax-favored retirement savings**

Under the Code, tax-favored treatment applies to traditional and Roth individual retirement arrangements (“IRAs”) and certain employer-sponsored retirement plans (“employer-sponsored plans”).<sup>192</sup> The rules for tax-favored treatment include annual limits on the amount that may be contributed to an IRA or employer-sponsored plan.

In general, a distribution from a traditional IRA or employer-sponsored plan (other than from a designated Roth account under an employer-sponsored plan) is includible in income, except to the extent attributable to any contributions that were made to the IRA or plan on an after-tax basis.<sup>193</sup> Contributions made to a Roth IRA or a designated Roth account are made on an after-tax basis.<sup>194</sup> Certain distributions from a Roth IRA or a designated Roth account are excluded from income; otherwise, a distribution is includible in income, except to the extent attributable to contributions.<sup>195</sup> Amounts that are withdrawn from an IRA or employer-sponsored plan before age 59½ and are includible in income are subject to a 10-percent early withdrawal tax unless an exception applies.<sup>196</sup>

A distribution from a traditional IRA or employer-sponsored plan (other than from a designated Roth account) generally may be rolled over to another traditional IRA or employer-sponsored plan (other than to a designated Roth account).<sup>197</sup> The rollover generally can be achieved by a direct payment from the distributing IRA or plan to the recipient IRA or plan (“direct rollover”) or by contributing the distribution to the recipient IRA or plan within 60 days of receiving the distribution (“60-day rollover”). Amounts that are rolled over generally are not includible in gross income. A distribution from a Roth IRA generally may be rolled over to another Roth IRA by direct rollover or a 60-day rollover, and a distribution from a designated

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<sup>192</sup> Secs. 219, 408, and 408A provide rules for IRAs. Tax-favored employer-sponsored retirement plans consist of qualified retirement plans under sections 401(a) and 403(a), tax-deferred annuity plans under section 403(b), and State and local government eligible deferred compensation plans under section 457(b). Under section 7701(j), the Thrift Savings Fund is treated as a qualified retirement plan.

<sup>193</sup> Secs. 408(d) and 402.

<sup>194</sup> Secs. 408A(c) and 402A(a)(2).

<sup>195</sup> Secs. 408A(d) and 402A(d).

<sup>196</sup> Sec. 72(t).

<sup>197</sup> A rollover is not permitted with respect to an IRA that an individual has inherited from another individual (“inherited IRA”). In addition, the beneficiary of a deceased employee under an employer-sponsored plan, other than a surviving spouse, may roll a distribution from the plan only to an IRA that is designated as an inherited IRA.

Roth account generally may be rolled over to a Roth IRA or another designated Roth account by direct rollover or a 60-day rollover. In general, an individual is permitted to make only one 60-day rollover from an IRA to another IRA within a one-year period.

In addition to these rollovers, an individual generally may convert an amount in a traditional IRA or a non-Roth account under an employer-sponsored defined contribution plan into a Roth IRA or a designated Roth account, referred to as a “Roth conversion.” The amount converted is generally includible in the individual’s income to the same extent as if a distribution had been made. The conversion may be accomplished by a direct transfer of the amount from the traditional IRA or non-Roth account to the Roth IRA or designated Roth account or by a distribution from the traditional IRA or non-Roth account and contribution to the Roth IRA or designated Roth account within 60 days.

An amount withdrawn from an IRA or employer-sponsored plan made on account of an IRS levy is includible in income in the same manner as other distributions. However, the 10-percent early withdrawal tax does not apply.<sup>198</sup>

### **Incorrect levies on IRAs and employer-sponsored plans**

Present law provides rules under which the IRS returns amounts subject to an incorrect levy.<sup>199</sup> For example, amounts withdrawn from an IRA pursuant to a levy are returned to the individual owning the IRA in the case of a wrongful levy or if the levy was not in accordance with IRS administrative procedures.<sup>200</sup> In the case of a wrongful levy, the IRS is required to pay interest on the amount returned to the individual at the overpayment rate.<sup>201</sup> The IRS is not required to pay interest if the levy was not in accordance with IRS administrative procedures.<sup>202</sup>

Present law does not provide special rules to allow an individual to recontribute to an IRA or employer-sponsored plan an amount withdrawn pursuant to a levy and later returned to the individual by the IRS, or interest thereon. Thus, if an individual wishes to contribute such returned amounts to an IRA or employer-sponsored plan, the contribution is subject to the normally applicable rules, including limits on contributions and the time for making a rollover.

### **Reasons for Change**

IRAs and employer sponsored retirement plans provide an important source of retirement income for many Americans. Under present law, if the IRS improperly levies on an individual’s IRA or benefits under an employer sponsored plan, the individual may not be made whole, even

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<sup>198</sup> Sec. 72(t)(2)(vii).

<sup>199</sup> Sec. 6343(b)-(d).

<sup>200</sup> Secs. 6343(b)(2), 6343(d)(2)(A).

<sup>201</sup> Sec. 6343(c)(1).

<sup>202</sup> Sec. 6343(d)(2).

if the IRS returns the amount levied, with interest, because the individual may lose the opportunity to have those funds accumulate on a tax-favored basis until retirement. The Committee believes that improper levies should not reduce retirement income security. Thus, the Committee bill provides that retirement funds that are withdrawn from an IRA or employer sponsored retirement plan pursuant to an improper IRS levy and returned by the IRS may be recontributed to the IRA or plan or to a different IRA.

### **Explanation of Provision**

Under the provision, if an amount withdrawn from an IRA (“original IRA”) or employer-sponsored plan pursuant to a levy is returned to an individual by the IRS, the individual may contribute the amount returned, and any interest thereon, either to the original IRA or to the employer-sponsored plan, if permissible,<sup>203</sup> or to a different IRA to which a rollover from the original IRA or employer-sponsored plan would be permitted.<sup>204</sup> The contribution is allowed without regard to the normally applicable limits on IRA contributions and rollovers. The provision applies to a levied amount that is returned to the individual because the levy on the original IRA or employer-sponsored plan (1) was wrongful, or (2) is determined to be premature or otherwise not in accordance with administrative procedures.

A contribution under the provision must be made by the due date (not including extensions) for the individual’s income tax return for the year in which the IRS returns the amount previously levied on. A contribution under the provision is treated as a rollover (“rollover contribution”) made for the taxable year in which the distribution on account of the levy occurred, but is not taken into account for purposes of the limit on one IRA rollover within a one-year period. In addition, except in the case of a rollover contribution that is treated as a Roth conversion, any tax attributable to the amount distributed from the original IRA or employer-sponsored plan by reason of a levy (1) is not to be assessed, (2) if assessed, is to be abated, and (3) if collected, is to be credited or refunded as an overpayment made on the due date for the return for the taxable year in which the amount was levied on.

Under the provision, the IRS is required to pay interest on an amount returned to the individual at the overpayment rate in the case of a levy that is determined to be premature or otherwise not in accordance with administrative procedures (as well as in the case of a wrongful levy under present law). Interest paid by the IRS on the amount returned to the individual and contributed to an IRA or employer-sponsored plan is treated as earnings within the IRA or employer-sponsored plan after the rollover contribution was made and is not includible in gross income when received from the IRS.

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<sup>203</sup> The terms of an employer-sponsored plan might not permit the amount returned by the IRS to be contributed to the plan. In addition, in the case of an amount withdrawn from a designated Roth account pursuant to the levy, the returned amount could be contributed only to the original designated Roth account (or to a Roth IRA).

<sup>204</sup> The provision allows a rollover with respect to an inherited IRA to an inherited IRA of the same type (traditional or Roth) as the original IRA.

When the IRS returns to an individual an amount that was levied on, the IRS must notify the individual that a contribution to the original IRA, the employer-sponsored plan, or a new IRA may be made of the amount returned, and the interest paid, by the due date (not including extensions) for the individual's income tax return for the year in which the amount is returned.

### **Effective Date**

The provision is effective for levied amounts, and interest thereon, returned to individuals in taxable years beginning after December 31, 2017.

### **3. Modifications of user fees requirements for installment agreements (sec. 11073 of the bill and new sec. 6159(f) of the Code)**

#### **Present Law**

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer agrees to pay taxes owed, as well as interest and penalties, in installments over an agreed schedule, if the IRS determines that doing so will facilitate collection of the amounts owed. This agreement provides for a period during which payments may be made and while other IRS enforcement actions are held in abeyance.<sup>205</sup> An installment agreement generally does not reduce the amount of taxes, interest, or penalties owed. However, the IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement. The IRS is required to review such partial payment installment agreements at least every two years to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

Taxpayers can request an installment agreement by filing Form 9465, Installment Agreement Request.<sup>206</sup> If the request for an installment agreement is approved by the IRS, the IRS charges a user fee.<sup>207</sup> The IRS currently charges \$225 for entering into an installment agreement.<sup>208</sup> If the application is for a direct debit installment agreement, whereby the taxpayer authorizes the IRS to request the monthly electronic transfer of funds from the taxpayer's bank account to the IRS, the fee is reduced to \$107.<sup>209</sup> In addition, regardless of the method of

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<sup>205</sup> Sec. 6331(k).

<sup>206</sup> The IRS accepts applications for installment agreements online, from individuals and businesses, if the total tax, penalties and interest is below \$50,000 for the former, and \$25,000 for the latter.

<sup>207</sup> 31 U.S.C. sec. 9701; Treas. reg. sec. 300.1; The Independent Offices Appropriations Act of 1952 (IOAA) 65 Stat. B70 (June 27, 1951). A discussion of the IRS practice regarding user fees and a list of actions for which fees are charged is included in the Internal Revenue Manual. See "User Fees," paragraph 1.32.19 IRM, available at [https://www.irs.gov/irm/part1/irm\\_01-035-019](https://www.irs.gov/irm/part1/irm_01-035-019).

<sup>208</sup> Treas. reg. sec. 300.1.

<sup>209</sup> *Ibid.*

payment, the fee is \$43 for low-income taxpayers.<sup>210</sup> For this purpose, low-income is defined as a person who falls below 250 percent of the Federal poverty guidelines published annually. Finally, there is no user fee if the agreement qualifies for a short term agreement (120 days or less).

### **Reasons for Change**

The Committee believes user fees are a barrier to compliance in collection and discourage low-income taxpayers from voluntary tax compliance, as many of them do not have the means to pay the user fee, even at the reduced rate. Further, when negotiating installment agreements, many low-income taxpayers are charged the full user fee, despite qualifying for the reduced amount.<sup>211</sup>

### **Explanation of Provision**

The provision generally prohibits increases in the amount of user fees charged by the IRS for installment agreements. For low-income taxpayers (those whose income falls below 250 percent of the Federal poverty guidelines), it alleviates the user fee requirement in two ways. First, it waives the user fee if the low-income taxpayer enters into an installment agreement under which the taxpayer agrees to make automated installment payments through a debit account. Second, it provides that low-income taxpayers who are unable to agree to make payments electronically remain subject to the required user fee, but the fee is reimbursed upon completion of the installment agreement.

### **Effective Date**

The provision is effective for agreements entered into on or after the date that is 60 days after the date of enactment.

## **4. Form 1040SR for seniors (sec. 11074 of the bill)**

### **Present Law**

Persons required to make returns of income are generally required to file returns in the form prescribed by the Secretary in regulations.<sup>212</sup> Income tax returns are required from each individual whose taxable year gross income equals or exceeds the exemption amount, with

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<sup>210</sup> *Ibid.*

<sup>211</sup> See American Bar Association letter to Mr. Daniel Werfel, Acting Commissioner, IRS, "Comments Concerning User Fees for Processing Installment Agreements and Offers in Compromise," October 1, 2013, page 2, available at <http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/100113comments.authcheckdam.pdf>.

<sup>212</sup> Sec. 6011.



certain exceptions.<sup>213</sup> The income tax returns are due on April 15 of the year following the taxable year, for taxpayers using a calendar year.

The standard form available for individuals subject to income tax are in the series of form known as Form 1040, and include two simplified versions, the Form 1040A and the Form 1040EZ. In recent filing seasons, the majority of returns filed by individuals were filed electronically.<sup>214</sup>

### **Reason for Change**

The Committee believes that, for seniors, filing a tax return and its numerous schedules, is unnecessarily difficult. The Committee believes that this legislation will help simplify the tax filing process for older taxpayers with straightforward returns who can be especially hard-hit by the financial and technical considerations involved in the filing process.

### **Explanation of Provision**

The provision requires that the IRS publish a simplified income tax return form designated a Form 1040SR, for use by persons who are age 65 or older by the close of the taxable year. The form is to be as similar as possible to the Form 1040EZ. The use of Form 1040SR is not to be restricted based on the amount of taxable income to be shown on the return, or the fact that the income to be reported for the taxable year includes social security benefits, distributions from qualified retirement plans, annuities or other such deferred payment arrangements, interest and dividends, or capital gains and losses taken into account in determining adjusted net capital gain.

### **Effective Date**

The provision is effective for taxable years beginning after the date of enactment and ending before January 1, 2026.

## **5. Sense of the Senate on improving customer service and protections for taxpayers by reinstating appropriate funding levels (sec. 11075 of the bill)**

The provision expresses the sense of the Senate that politically motivated budget cuts are counterproductive to deficit reduction, diminish the IRS's ability to adequately serve taxpayers and protect taxpayer information, and reduce the IRS's ability to enforce the law.

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<sup>213</sup> See section 6012(a)(1)(A), which enumerates several conditions under which individuals with gross income in excess of the exemption amount in section 151(d) are nevertheless excused from the filing requirements.

<sup>214</sup> The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998") states a Congressional policy to promote the paperless filing of Federal tax returns, and set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007. See sec. 2001(a) of RRA 1998. The Electronic Tax Administration Advisory Committee, the body charged with oversight of IRS progress in reaching that goal reported that e-filing by individuals exceeded 80 percent in the 2013 filing season, but projected an overall rate of 72.8 percent based on all Federal returns. See Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, June 2013, IRS Pub. 3415, p. 6.

## **6. Return preparation programs for low-income taxpayers (sec. 11076 of the bill and new sec. 7526A of the Code)**

### **Present Law**

The Code provides that the Secretary may allocate up to \$6 million per year for matching grants to certain qualified low-income taxpayer clinics.<sup>215</sup> Eligible clinics are those that charge no more than a nominal fee to either represent low-income taxpayers in controversies with the IRS or provide tax information to individuals for whom English is a second language. No clinic can receive more than \$100,000 per year.

A qualified low-income taxpayer clinic includes (1) a clinical program at an accredited law, business, or accounting school, in which students represent low-income taxpayers, or (2) an organization exempt from tax under Code section 501(c) which either represents low-income taxpayers or provides referral to qualified representatives. A clinic is treated as representing low-income taxpayers if (i) at least 90 percent of the taxpayers represented by the clinic have income which does not exceed 250 percent of the poverty level, as determined in accordance with criteria established by the Director of the Office of Management and Budget, and (ii) the amount in controversy for any taxable year is generally \$50,000 or less.<sup>216</sup>

There is no provision in the Code allowing for the allocation of funds for matching grants for return preparation for low-income taxpayers.

In the Consolidated Appropriations Act, 2017,<sup>217</sup> Congress appropriated approximately \$2.157 billion to the IRS for taxpayer services, of which not less than \$15 million is to be made available for a Community Volunteer Income Tax Assistance (“VITA”) matching grants program for tax return preparation assistance. VITA is a program created by the IRS in 1969 which utilizes volunteers to provide tax return preparation and filing service assistance to certain low-income taxpayers and members of underserved populations.

### **Reason for Change**

The Committee believes that low-income taxpayer clinics contribute to compliance with the Code by providing representation to taxpayers who might otherwise be uncertain about their rights and obligations under the Code. Accordingly, the Committee believes that the amount authorized to be appropriated for matching grants to them should be increased and codified. The Committee also believes that qualified entities providing outreach relating to the eligibility and availability of income supports through the Code should particularly be supported.

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<sup>215</sup> Sec. 7526.

<sup>216</sup> Sec. 7463.

<sup>217</sup> Pub. L. No. 115-31, Div. E, Title I (May 5, 2017).

### **Explanation of Provision**

The provision codifies the VITA program and provides that the Secretary, unless otherwise provided by specific appropriation, may allocate from otherwise appropriated funds up to \$30 million per year in matching grants to qualified entities for the development, expansion, or continuation of qualified tax return preparation programs assisting low-income taxpayers and members of underserved populations. The Secretary is authorized to award a multi-year grant not to exceed three years.

The grant funds may be used for ordinary and necessary operation costs (including for wages or salaries of persons coordinating the activities of the program, to develop training materials, conduct training, and perform quality reviews of the returns for which assistance has been provided under the program, and for equipment purchases and vehicle-related expenses associates with remote or rural tax preparation services), outreach and educational activities relating to the eligibility and availability of income supports available through the Code, and services related to financial education and capability, asset development, and the establishment of savings accounts in connection with tax return preparation, but not for overhead expenses that are not directly related to any qualified return preparation program. In awarding grants, priority is given to applications that (i) demonstrate assistance to certain low-income taxpayers with an emphasis on outreach; (ii) demonstrate taxpayer outreach and education around available income supports available through the Code; and (iii) demonstrate specific outreach and focus on one or more underserved populations. The provision allows the IRS to use mass communications, referrals, and other means to promote the benefits and encourage the use of the program. The Secretary can refer taxpayers to qualified return preparation programs receiving grants and those programs are encouraged to refer eligible individuals to local or regional low income taxpayer clinics.

Qualified return preparation program means any program which provides assistance to individuals, at least 90 percent of whom are low-income taxpayers, in preparing and filing Federal income tax returns, which is administered by a qualified entity, in which all volunteers who assist in the preparation of Federal income tax returns meet the training requirements prescribed by the Secretary, and which uses a quality review process which reviews 100 percent of all returns. Qualified entity means any entity which is an eligible organization (as defined), is in compliance with Federal tax filing and payment requirements, is not debarred or suspended from Federal contracts, grants, or cooperative agreements, and agrees to provide documentation to substantiate any matching funds provided under the VITA grant program. Eligible organization means an institution of higher education described in section 102 (other than subsection (a)(1)(C) thereof) of the Higher Education Act of 1965, as in effect on the date of enactment, and which has not been disqualified from participating in a program under Title IV of such Act, an exempt organization described in Code section 501(c), a local government agency, including a county or municipal government agency, and an Indian tribe, as defined in section 4(12) of the Native American Housing Assistance and Self-Determination Act of 1996 (“Act”), including any tribally designated housing entity (as defined in such Act), tribal subsidiary, subdivision, or other wholly owned tribal entity, or a local, State, regional, or national coalition (with one lead organization which meets the eligibility requirements described above acting as the applicant organization. If no eligible organization is available to assist the targeted population or community, the eligible organization includes a State government agency, and a Cooperative

Extension Service office. Low-income taxpayer means a taxpayer who has income for the taxable year which does not exceed an amount equal to the completed phaseout amount under section 32(b) for a married couple filing a joint return with three or more qualifying children, as determined in a revenue procedure or other published guidance. Underserved population includes populations of persons with disabilities, persons with limited English proficiency, Native Americans, individuals living in rural areas, members of the Armed Forces and their spouses, and the elderly.

#### **Effective Date**

The provision is effective on the date of enactment.

### **7. Free File Program (sec. 11077 of the bill)**

#### **Present Law**

The IRS has entered into cooperative relationships with commercial return preparation service providers (known as the Free File Alliance) to provide free tax preparation and electronic filing services to eligible low-income or elderly taxpayers. This arrangement is commonly known as the Free File Program. Taxpayers generally must select a designated service provider through the IRS' website to access commercial online software provided by Free File Alliance companies to prepare and file their tax returns. To qualify, taxpayers must have adjusted gross income (AGI) of \$64,000 or less (for 2016 returns). Each participating company sets its own eligibility requirements and not all taxpayers will qualify to use the software of all companies. There is no fee for taxpayers using Free File Program, and Free File Alliance companies also do not pay any fee to the IRS to participate in the program.

#### **Reasons for Change**

The Committee believes that electronic filing promotes effective tax administration and wants to encourage increased use of electronic filing. The Committee understands that fewer IRS resources are required to process electronic returns, errors are reduced, and taxpayers receive their refunds more quickly. The Committee also understands that many taxpayers are unwilling to pay a fee to electronically file their tax returns even if they are electronically prepared. The Committee further understands that many taxpayers are unwilling to use an intermediary to electronically transmit their tax returns to the IRS because of privacy and security concerns. The Committee believes that the availability of free and direct electronic filing to the IRS will address those concerns and result in the increased use of electronic filing.

#### **Explanation of Provision**

The provision requires the Secretary of the Treasury, or the Secretary's delegate, in cooperation with the private sector, to maintain the current IRS Free File Program that provides free individual income tax preparation and electronic filing services to the lowest 70 percent of taxpayers by income. The number of taxpayers eligible to receive these services is to be calculated by the IRS annually based on prior year aggregate taxpayer adjusted gross income. The provision requires the IRS Free File Program to continue to make available to taxpayers at all income levels a basic, online electronic fillable forms utility. The provision further requires

the IRS Free File Program work with State government agencies to enhance and expand the use of the program to provide needed benefits to the taxpayer while reducing the cost of processing returns.

The provision does not impact the services provided under Taxpayer Assistance Centers, Tax Counseling for the Elderly, and Volunteer Income Tax Assistance programs.

### **Effective Date**

The provision is effective on the date of enactment.

## **8. Attorneys' fees relating to awards to whistleblowers (sec. 11078 of the bill and sec. 62(a)(21) of the Code)**

### **Present Law**

The Code provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination, certain claims against the Federal Government, or a private cause of action under the Medicare Secondary Payer statute.<sup>218</sup> The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim. Additionally, the Code provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the individual in connection with any award for providing information regarding violations of the tax laws.<sup>219</sup> The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of such award.<sup>220</sup>

### **Reasons for Change**

The Committee believes that the treatment of legal fees and court costs in connection with various whistleblower awards should be uniform. The Committee further believes that an above-the-line deduction for such fees and costs may encourage more whistleblowers to come forward.

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<sup>218</sup> Secs. 62(a)(20) and (e). Section 62(e) defines "unlawful discrimination" to include a number of specific statutes, any federal whistle-blower statute, and any federal, state, or local law "providing for the enforcement of civil rights" or "regulating any aspect of the employment relationship...or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law."

<sup>219</sup> Secs. 7623 and 62(a)(21).

<sup>220</sup> Secs. 7623 and 62(a)(21).

## **Explanation of Provision**

The provision provides an above-the-line deduction for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim under State False Claim Acts, the SEC whistleblower program,<sup>221</sup> and the commodity Future Trading Commission whistleblower program.<sup>222</sup>

## **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **9. Clarification of whistleblower awards (sec. 11079 of the bill and new sec. 7623(c) of the Code)**

### **Present Law**

#### **Awards to whistleblowers**

The Code authorizes the IRS to pay such sums as deemed necessary for: “(1) detecting underpayments of tax; or (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same.”<sup>223</sup> Generally, amounts are paid based on a percentage of proceeds collected based on the information provided.

The Tax Relief and Health Care Act of 2006 (the “Act”)<sup>224</sup> established an enhanced reward program for actions in which the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed \$2,000,000 and, if the taxpayer is an individual, the individual’s gross income exceeds \$200,000 for any taxable year in issue. In such cases, the award is calculated to be at least 15 percent but not more than 30 percent of collected proceeds (including penalties, interest, additions to tax, and additional amounts).

The Act permits an individual to appeal the amount or a denial of an award determination to the United States Tax Court (the “Tax Court”) within 30 days of such determination. Tax Court review of an award determination may be assigned to a special trial judge.

#### **Rules relating to taxpayers with foreign assets**

U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign entities may be subject to self-reporting requirements under both the Foreign Account Tax Compliance Act provisions in the Code and the provisions in the Bank Secrecy Act and its

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<sup>221</sup> 15 U.S.C. secs. 78u-6 and 78u-7.

<sup>222</sup> 7 U.S.C. sec. 26.

<sup>223</sup> Sec. 7623.

<sup>224</sup> Pub. L. No. 109-432.

underlying regulations (which provide for FinCEN Form 114, Report of Foreign Bank and Financial Accounts, the “FBAR”), as discussed below. Amounts recovered for violations of FATCA provisions in the Code may be considered for purposes of computing a whistleblower award under the Code. However, the IRS has found that amounts recovered for violations of non-tax laws, including the provisions of the Bank Secrecy Act (and FBAR) for which the IRS has delegated authority, may not be considered for purposes of computing an award under the Code.<sup>225</sup>

### Foreign Account Tax Compliance Act (“FATCA”)

The Code imposes a withholding and reporting regime for U.S. persons engaged in foreign activities, directly or indirectly, through a foreign business entity.<sup>226</sup> This regime for outbound payments,<sup>227</sup> commonly referred to as the Foreign Account Tax Compliance Act (“FATCA”),<sup>228</sup> imposes a withholding tax of 30 percent of the gross amount of certain payments to foreign financial institutions (“FFIs”) unless the FFI establishes that it is compliant with the information reporting requirements of FATCA which include identifying certain U.S. accounts held in the FFI. An FFI must report with respect to a U.S. account (1) the name, address, and taxpayer identification number of each U.S. person holding an account or a foreign entity with one or more substantial U.S. owners holding an account; (2) the account number; (3) the account balance or value; and (4) except as provided by the Secretary, the gross receipts, including from dividends and interest, and gross withdrawals or payments from the account.<sup>229</sup>

Individuals are required to disclose with their annual Federal income tax return any interest in foreign accounts and certain foreign securities if the aggregate value of such assets is in excess of the greater of \$50,000 or an amount determined by the Secretary in regulations. Failure to do so is punishable by a penalty of \$10,000, which may increase for each 30-day period during which the failure continues after notification by the IRS, up to a maximum penalty of \$50,000.<sup>230</sup>

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<sup>225</sup> Chief Counsel Memorandum, “Scope of Awards Payable Under I.R.C. section 7623,” April 23, 2012, available at <http://www.tax-whistleblower.com/resources/PMTA-2012-10.pdf>. Under Title 31, “[t]he Secretary may pay a reward to an individual who provides original information which leads to a recovery of a criminal fine, civil penalty, or forfeiture, which exceeds \$50,000, for a violation of [chapter 53 of Title 31]. The Secretary shall determine the amount of a reward...[and]... may not award more than 25 per centum of the net amount of the fine, penalty, or forfeiture collected or \$150,000, whichever is less.” 31 U.S.C. § 5323.

<sup>226</sup> See, e.g., secs. 6038, 6038B, and 6046.

<sup>227</sup> Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147.

<sup>228</sup> Foreign Account Tax Compliance Act of 2009 is the name of the House and Senate bills in which the provisions first appeared. See H.R. 3933 and S. 1934 (October 27, 2009).

<sup>229</sup> Sec. 1471(c).

<sup>230</sup> Sec. 6038D. Guidance on the scope of reporting required, the threshold values triggering reporting requirements for various fact patterns and how the value of assets is to be determined is found in Treas. Reg. secs. 1.6038D-1 to 1.6038D-8.

## Report of Foreign Bank and Financial Accounts (the “FBAR”)

In addition to the reporting requirements under the Code, U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign entities may be subject to self-reporting requirements under the Bank Secrecy Act.<sup>231</sup>

The Bank Secrecy Act imposes reporting obligations on both financial institutions and account holders. With respect to account holders, a U.S. citizen, resident, or person doing business in the United States is required to keep records and file reports, as specified by the Secretary, when that person enters into a transaction or maintains an account with a foreign financial agency.<sup>232</sup> Regulations promulgated pursuant to broad regulatory authority granted to the Secretary in the Bank Secrecy Act<sup>233</sup> provide additional guidance regarding the disclosure obligation with respect to foreign accounts.

The FBAR must be filed by June 30<sup>234</sup> of the year following the year in which the \$10,000 filing threshold is met.<sup>235</sup> Failure to file the FBAR is subject to both criminal<sup>236</sup> and civil penalties.<sup>237</sup> Willful failure to file an FBAR may be subject to penalties in amounts not to exceed the greater of \$100,000 or 50 percent of the amount in the account at the time of the violation.<sup>238</sup> A non-willful, but negligent, failure to file is subject to a penalty of \$10,000 for each negligent violation.<sup>239</sup> The penalty may be waived if (1) there is reasonable cause for the failure to report and (2) the amount of the transaction or balance in the account was properly reported. In addition, serious violations are subject to criminal prosecution, potentially resulting

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<sup>231</sup> Bank Secrecy Act, 31 U.S.C. secs. 5311-5332.

<sup>232</sup> 31 U.S.C. sec. 5314. The term “agency” in the Bank Secrecy Act includes financial institutions.

<sup>233</sup> 31 U.S.C. sec. 5314(a) provides: “Considering the need to avoid impeding or controlling the export or import of monetary instruments and the need to avoid burdening unreasonably a person making a transaction with a foreign financial agency, the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency.”

<sup>234</sup> The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, changed the filing date for FinCEN Form 114 from June 30 to April 15 (with a maximum extension for a 6-month period ending on October 15 and with provision for an extension under rules similar to the rules in Treas. Reg. section 1.6081-5) for tax returns for taxable years beginning after December 31, 2015.

<sup>235</sup> 31 C.F.R. sec. 103.27(c). The \$10,000 threshold is the aggregate value of all foreign financial accounts in which a U.S. person has a financial interest or over which the U.S. person has signature or other authority.

<sup>236</sup> 31 U.S.C. sec. 5322 (failure to file is punishable by a fine up to \$250,000 and imprisonment for five years, which may double if the violation occurs in conjunction with certain other violations).

<sup>237</sup> 31 U.S.C. sec. 5321(a)(5).

<sup>238</sup> 31 U.S.C. sec. 5321(a)(5)(C).

<sup>239</sup> 31 U.S.C. sec. 5321(a)(5)(B)(i), (ii).



in both monetary penalties and imprisonment. Civil and criminal sanctions are not mutually exclusive.

### FBAR enforcement responsibility

Until 2003, the Financial Crimes Enforcement Network (“FinCEN”), an agency of the Department of the Treasury, had exclusive responsibility for civil penalty enforcement of FBAR, although administration of the FBAR reporting regime was delegated to the IRS.<sup>240</sup> As a result, persons who were more than 180 days delinquent in paying any FBAR penalties were referred for collection action to the Financial Management Service of the Treasury Department, which is responsible for such non-tax collections.<sup>241</sup> Continued nonpayment resulted in a referral to the Department of Justice for institution of court proceedings against the delinquent person. In 2003, the Secretary delegated FBAR civil enforcement authority to the IRS.<sup>242</sup> The authority delegated to the IRS in 2003 included the authority to determine and enforce civil penalties,<sup>243</sup> as well as to revise the form and instructions. However, the Bank Secrecy Act does not include collection powers similar to those available for enforcement of the tax laws under the Code. As a consequence, FBAR civil penalties remain collectible only in accord with the procedures for non-tax collection described above.

### **FBAR and awards to whistleblowers**

Recent cases have considered FBAR penalties in connection with IRS whistleblower awards.<sup>244</sup> One case analyzed the provision dealing with “additional amounts in dispute” and linked that concept to amounts assessed and collected under the Code which FBAR is not.<sup>245</sup> The issue was whether FBAR penalties constituted “additional amounts” for purposes of determining whether “additional amounts in dispute exceed \$2,000,000.” The case was disposed on summary judgment on the grounds that FBAR penalties are not assessed, collected or paid in

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<sup>240</sup> Treas. Directive 15-14 (December 1, 1992), in which the Secretary delegated to the IRS authority to investigate violations of the Bank Secrecy Act. If the IRS Criminal Investigation Division declines to pursue a possible criminal case, it is to refer the matter to FinCEN for civil enforcement.

<sup>241</sup> 31 U.S.C. sec. 3711(g).

<sup>242</sup> 31 C.F.R. sec. 103.56(g). Memorandum of Agreement and Delegation of Authority for Enforcement of FBAR Requirements (April 2, 2003); News Release, Internal Revenue Service, IR-2003-48 (April 10, 2003). Secretary of the Treasury, “A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)” (April 24, 2003).

<sup>243</sup> A penalty may be assessed before the end of the six-year period beginning on the date of the transaction with respect to which the penalty is assessed. 31 U.S.C. sec. 5321(b)(1). A civil action for collection may be commenced within two years of the later of the date of assessment and the date a judgment becomes final in any a related criminal action. 31 U.S.C. sec. 5321(b)(2).

<sup>244</sup> *Whistleblower 22716-13W v. Commissioner*, 146 T.C. No. 6 (March 14, 2016); and *Whistleblower 21276-13W v. Commissioner*, 147 T.C. No. 4 (August 3, 2016).

<sup>245</sup> *Whistleblower 22716-13W v. Commissioner*, 146 T.C. No. 6 (March 14, 2016).

the same manner as taxes. As such, they are not additional amounts in dispute and therefore the threshold was not exceeded. Notably, the court suggested that the petitioner present its policy arguments to Congress based on the fact that the connection between FBAR and tax enforcement justified the Secretary to redelegate FBAR administrative authority to the IRS.<sup>246</sup>

Another case dealt with the provision “collected proceeds” and held that the term is not limited to amounts assessed and collected under Title 26.<sup>247</sup> The issue in the case was whether payments of a criminal fine and civil forfeitures constitute collected proceeds.

The criminal fine was imposed under Title 18 as a result of guilty plea to conspiring to defraud the IRS, file false Federal income tax returns, and evade Federal income taxes. The money was forfeited pursuant to Title 18. The IRS argued that criminal fines and forfeitures are not collected proceeds because only amounts assessed and collected under Title 26 can be used to pay a whistleblower award. The IRS also argued that a criminal fine collected by the Government cannot be considered collected proceeds because (1) pursuant to 42 U.S.C. sec. 10601 all criminal fines collected from persons convicted of offenses against the United States are to be deposited in the Crime Victims Fund; (2) criminal fines are paid by the taxpayer directly to the imposing court, which in turn deposits them into the Crime Victims Fund; and (3) at no time are criminal fines available to the Secretary. The court said that the Code did not refer to, or require, the availability of funds to be used in making an award.<sup>248</sup>

Petitioners said the payment resulted from action taken by Secretary and relates to acts committed by taxpayer in violation of Title 26 provisions. The court agreed and held that collected proceeds are not limited to amounts assessed and collected under Title 26. In reaching its holding it referenced *Whistleblower 22716-13W v. Commissioner*, discussed above and noted there is no inconsistency because the issue there was about whether the threshold of \$2,000,000 was exceeded. It is not clear whether FBAR penalties would be included under their holding because in the case, the taxpayer did violate Title 26 (even if the penalties were imposed under Title 18).

### **Reasons for Change**

The Committee believes it is important to provide clarification regarding the scope of the term “collected proceeds.” The Committee believes this clarification is necessary because there have been conflicting interpretations of law as to whether FBAR penalties are within the meaning of collected proceeds and this clarification will encourage more whistleblowers to come forward.

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<sup>246</sup> *Whistleblower 22716-13W v. Commissioner*, 146 T.C. No. 6 at 26-27.

<sup>247</sup> *Whistleblower 21276-13W v. Commissioner*, 147 T.C. No. 4 (August 3, 2016).

<sup>248</sup> *Whistleblower 21276-13W v. Commissioner*, 147 T.C. No. 4 at 28-29.

### **Explanation of Provision**

Collected proceeds eligible for awards under the Code are defined to include: (1) penalties, interest, additions to tax, and additional amounts and (2) any proceeds under enforcement programs that the Treasury has delegated to the IRS the authority to administer, enforce, or investigate, including criminal fines and civil forfeitures, and violations of reporting requirements. This definition is also used to determine eligibility for the enhanced reward program under which proceeds and additional amounts in dispute exceed \$2,000,000.

The collected proceeds amounts are determined without regard to whether such proceeds are available to the Secretary.

### **Effective Date**

The provision is effective for information provided before, on, or after date of enactment with respect to which a final determination has not been made before such date.

## PART VIII - INDIVIDUAL MANDATE

### 1. Elimination of shared responsibility payment for individuals failing to maintain minimal essential coverage (sec. 11081 of the bill and sec. 5000A of the Code)

#### Present Law

Under the Patient Protection and Affordable Care Act<sup>249</sup> (also called the Affordable Care Act, or “ACA”), individuals must be covered by a health plan that provides at least minimum essential coverage or be subject to a tax (also referred to as a penalty) for failure to maintain the coverage (commonly referred to as the “individual mandate”).<sup>250</sup> Minimum essential coverage includes government-sponsored programs (including Medicare, Medicaid, and CHIP, among others), eligible employer-sponsored plans, plans in the individual market, grandfathered group health plans and grandfathered health insurance coverage, and other coverage as recognized by the Secretary of Health and Human Services (“HHS”) in coordination with the Secretary of the Treasury.<sup>251</sup> The tax is imposed for any month that an individual does not have minimum essential coverage unless the individual qualifies for an exemption for the month as described below.

The tax for any calendar month is one-twelfth of the tax calculated as an annual amount. The annual amount is equal to the greater of a flat dollar amount or an excess income amount. The flat dollar amount is the lesser of (1) the sum of the individual annual dollar amounts for the members of the taxpayer’s family and (2) 300 percent of the adult individual dollar amount. The individual adult annual dollar amount is \$695 for 2017 and 2018.<sup>252</sup> For an individual who has not attained age 18, the individual annual dollar amount is one half of the adult amount. The excess income amount is 2.5 percent of the excess of the taxpayer’s household income for the taxable year over the threshold amount of income for requiring the taxpayer to file an income tax return.<sup>253</sup> The total annual household payment may not exceed the national average annual premium for bronze level health plans for the applicable family size offered through Exchanges that year.

Exemptions from the requirement to maintain minimum essential coverage are provided for the following: (1) an individual for whom coverage is unaffordable because the required

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<sup>249</sup> Pub. L. No. 111-148.

<sup>250</sup> Section 5000A. If an individual is a dependent, as defined in section 152, of another taxpayer, the other taxpayer is liable for any tax for failure to maintain the required coverage with respect to the individual.

<sup>251</sup> Sec. 5000A(f). Minimum essential coverage does not include coverage that consists of only certain excepted benefits, such as limited scope dental and vision benefits or long-term care insurance offered under a separate policy, certificate or contract.

<sup>252</sup> For years after 2016, the \$695 amount is indexed to CPI-U, rounded to the next lowest multiple of \$50.

<sup>253</sup> Sec. 6012(a).

contribution exceeds 8.16<sup>254</sup> percent of household income, (2) an individual with household income below the income tax return filing threshold, (3) a member of an Indian tribe, (4) a member of certain recognized religious sects or a health sharing ministry, (5) an individual with a coverage gap for a continuous period of less than three months, and (6) an individual who is determined by the Secretary of HHS to have suffered a hardship with respect to the capability to obtain coverage.<sup>255</sup>

### **Reasons for Change**

The Committee believes that relief from the shared responsibility payment imposed on non-exempt individuals who fail to obtain health coverage under the Affordable Care Act, and application of the associated savings towards broader tax reform, will provide for a more fair tax system for individuals, families, and businesses.

### **Explanation of Provision**

The provision reduces the amount of the individual responsibility payment, enacted as part of the Affordable Care Act, to zero.

### **Effective Date**

The provision is effective with respect to health coverage status for months beginning after December 31, 2018.

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<sup>254</sup> For 2017. Rev. Proc. 2016-24. The rate applicable for 2018 is 8.05 percent of household income. Rev. Proc. 2017-36.

<sup>255</sup> In addition, certain individuals present or residing outside of the United States and bona fide residents of United States territories are deemed to maintain minimum essential coverage.

## **B. Alternative Minimum Tax**

### **1. Repeal of tax for corporations, suspension of tax for individuals, and credit for prior year minimum tax liability (secs. 12001 through 12003 of the bill and sec. 55 of the Code)**

#### Present Law

##### Individual alternative minimum tax

###### In general

An alternative minimum tax (“AMT”) is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. For taxable years beginning in 2017, the tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$187,800 (\$93,900 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The breakpoints are indexed for inflation. The taxable excess is so much of the alternative minimum taxable income (“AMTI”) as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the taxable income adjusted to take account of specified tax preferences and adjustments.

The exemption amounts for taxable years beginning in 2017 are: (1) \$84,500 in the case of married individuals filing a joint return and surviving spouses; (2) \$54,300 in the case of other unmarried individuals; (3) \$42,250 in the case of married individuals filing separate returns; and (4) \$24,100 in the case of an estate or trust. For taxable years beginning in 2017, the exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual’s AMTI exceeds (1) \$160,900 in the case of married individuals filing a joint return and surviving spouses, (2) \$120,700 in the case of other unmarried individuals, and (3) \$80,450 in the case of married individuals filing separate returns or an estate or a trust. The amounts are indexed for inflation.

AMTI is the taxpayer’s taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

###### Preference items in computing AMTI

- The minimum tax preference items are:
- The excess of the deduction for percentage depletion over the adjusted basis of each mineral property (other than oil and gas properties) at the end of the taxable year.
- The amount by which excess intangible drilling costs (*i.e.*, expenses in excess the amount that would have been allowable if amortized over a 10-year period) exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference applies to independent producers only to the extent it reduces the producer’s AMTI (determined without regard to this preference and the net operating loss deduction) by more than 40 percent.

- Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds, certain housing bonds, and bonds issued in 2009 and 2010) issued after August 7, 1986.
- Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.
- Seven percent of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock).

In addition, losses from any tax shelter farm activity or passive activities are not taken into account in computing AMTI.

#### Adjustments in computing AMTI

The adjustments that individuals must make to compute AMTI are:

- Depreciation on property placed in service after 1986 and before January 1, 1999, is computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence. Depreciation on property acquired after September 10, 2001, which is allowed an additional allowance under section 168(k) for the regular tax is computed without regard to any AMT adjustments.
- Mining exploration and development costs are capitalized and amortized over a 10-year period.
- Taxable income from a long-term contract (other than a home construction contract) is computed using the percentage of completion method of accounting.
- Depreciation on property placed in service after 1986 and before January 1, 1999, is computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence. Depreciation on property acquired after September 10, 2001, which is allowed an additional allowance under section 168(k) for the regular tax is computed without regard to any AMT adjustments.
- Mining exploration and development costs are capitalized and amortized over a 10-year period.
- Taxable income from a long-term contract (other than a home construction contract) is computed using the percentage of completion method of accounting.

- The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), is calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.
- Miscellaneous itemized deductions are not allowed.
- Itemized deductions for State, local, and foreign real property taxes; State and local personal property taxes; State, local, and foreign income, war profits, and excess profits taxes; and State and local sales taxes are not allowed.
- Medical expenses are allowed only to the extent they exceed ten percent of the taxpayer's adjusted gross income.
- Deductions for interest on home equity loans are not allowed.
- The standard deduction and the deduction for personal exemptions are not allowed.
- The amount allowable as a deduction for circulation expenditures is capitalized and amortized over a three-year period.
- The amount allowable as a deduction for research and experimentation expenditures from passive activities is capitalized and amortized over a 10-year period.
- The regular tax rules relating to incentive stock options do not apply.

#### Other rules

The taxpayer's net operating loss deduction generally cannot reduce the taxpayer's AMTI by more than 90 percent of the AMTI (determined without the net operating loss deduction).

The alternative minimum tax foreign tax credit reduces the tentative minimum tax.

The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT. Certain exceptions apply.

If an individual is subject to AMT in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit (the "AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax liability in such subsequent year. The AMT credit is allowed only to the extent that the taxpayer's AMT liability is the result of adjustments that are timing in nature. The individual AMT adjustments relating to itemized deductions and personal exemptions are not timing in nature, and no minimum tax credit is allowed with respect to these items.

An individual may elect to write off certain expenditures paid or incurred with respect of circulation expenses, research and experimental expenses, intangible drilling and development expenditures, development expenditures, and mining exploration expenditures over a specified period (three years in the case of circulation expenses, 60 months in the case of intangible



drilling and development expenditures, and 10 years in case of other expenditures). The election applies for purposes of both the regular tax and the alternative minimum tax.

### **Corporate alternative minimum tax**

#### **In general**

An AMT is also imposed on a corporation to the extent the corporation's tentative minimum tax exceeds its regular tax. This tentative minimum tax is computed at the rate of 20 percent on the AMTI in excess of a \$40,000 exemption amount that phases out. The exemption amount is phased out by an amount equal to 25 percent of the amount that the corporation's AMTI exceeds \$150,000.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

A corporation with average gross receipts of less than \$7.5 million for the prior three taxable years is exempt from the corporate minimum tax. The \$7.5 million threshold is reduced to \$5 million for the corporation's first three-taxable year period.

#### **Preference items in computing AMTI**

The corporate minimum tax preference items are:

- The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.
- The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to an independent producer to the extent the preference would not reduce the producer's AMTI by more than 40 percent.
- Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds, certain housing bonds, and bonds issued in 2009 and 2010) issued after August 7, 1986.
- Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

#### **Adjustments in computing AMTI**

The adjustments that corporations must make in computing AMTI are:

- Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax

or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence. Depreciation on property which is allowed “bonus depreciation” for the regular tax is computed without regard to any AMT adjustments.

- Mining exploration and development costs must be capitalized and amortized over a 10-year period.
- Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.
- The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.
- The special rules applicable to Merchant Marine construction funds are not applicable.
- The special deduction allowable under section 833(b) for Blue Cross and Blue Shield organizations is not allowed.

The adjusted current earnings adjustment applies, as described below.

#### Adjusted current earning (“ACE”) adjustment

The adjusted current earnings adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings of a corporation exceed its AMTI (determined without the ACE adjustment and the alternative tax net operating loss deduction). In determining ACE the following rules apply:

- For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.
- Amounts excluded from gross income under the regular tax but included for purposes of determining earnings and profits are generally included in determining ACE.
- The inside build-up of a life insurance contract is included in ACE (and the related premiums are deductible).
- Intangible drilling costs of integrated oil companies must be capitalized and amortized over a 60-month period.
- The regular tax rules of section 173 (allowing circulation expenses to be amortized) and section 248 (allowing organizational expenses to be amortized) do not apply.
- Inventory must be calculated using the FIFO, rather than LIFO, method.

- The installment sales method generally may not be used.
- No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.
- Depletion (other than for oil and gas properties) must be calculated using the cost, rather than the percentage, method.
- In certain cases, the assets of a corporation that has undergone an ownership change must be stepped down to their fair market values.

#### Other rules

The taxpayer's net operating loss carryover generally cannot reduce the taxpayer's AMT liability by more than 90 percent of AMTI determined without this deduction.

The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT. Certain exceptions apply.

If a corporation is subject to AMT in any year, the amount of AMT is allowed as an AMT credit in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in the subsequent year. Corporations are allowed to claim a limited amount of AMT credits in lieu of bonus depreciation.

A corporation may elect to write off certain expenditures paid or incurred with respect of circulation expenses, research and experimental expenses, intangible drilling and development expenditures, development expenditures, and mining exploration expenditures over a specified period (three years in the case of circulation expenses, 60 months in the case of intangible drilling and development expenditures, and 10 years in case of other expenditures). The election applies for purposes of both the regular tax and the alternative minimum tax.

#### **Reasons for Change**

The requirement that taxpayers compute their income for purposes of both the regular income tax and the AMT is one of the most far-reaching complexities of the Code. The AMT is particularly burdensome for individuals with small businesses, because they often do not know whether they will be affected until they file their taxes and therefore must maintain a reserve that cannot be used to invest in their businesses.

#### **Explanation of Provision**

The provision repeals the corporate alternative minimum tax.

The provision repeals the individual alternative minimum tax for taxable years beginning before January 1, 2026.

The provision allows the AMT credit to offset the taxpayer's regular tax liability for any taxable year. In addition, the AMT credit is refundable for any taxable year beginning after 2017

and before 2022 in an amount equal to 50 percent (100 percent in the case of taxable years beginning in 2021) of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability. Thus, the full amount of the minimum tax credit will be allowed in taxable years beginning before 2022.

**Effective Date**

The provision applies to taxable years beginning after December 31, 2017.

## C. Business-Related Provisions

### PART I – CORPORATE PROVISIONS

#### 1. 20-percent corporate tax rate (sec. 13001 of the bill and sec. 11 of the Code)

##### Present Law

Corporate taxable income is subject to tax under a four-step graduated rate structure.<sup>256</sup> 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 \$100,000. 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.<sup>257</sup>

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.<sup>258</sup>

##### Reasons for Change

The United States has one of the highest statutory corporate tax rates among developed countries. The Committee believes that lowering the corporate tax rate is necessary to ensure domestic corporations remain globally competitive with their counterparts domiciled in the United States' largest international competitors. The average corporate income tax rate among nations in the Organisation for Economic Co-operation and Development is 22.5 percent. A low

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<sup>256</sup> Sec. 11(a) and (b)(1).

<sup>257</sup> Sec. 11(b)(2).

<sup>258</sup> Sec. 1201(a).

competitive corporate tax rate also contributes to making the United States an attractive location for foreign corporations to invest. In addition, a lower corporate tax rate means corporations will have more resources to invest in growing their businesses and creating jobs.

### **Explanation of Provision**

The provision eliminates the graduated corporate rate structure and instead taxes corporate taxable income at 20 percent.

The provision eliminates the special tax rate for personal service corporations.

The provision repeals the maximum corporate tax rate on net capital gain as obsolete.

For taxpayers subject to the normalization method of accounting (*e.g.*, regulated public utilities), the provision 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).

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2018.

## **2. Reduction in dividends-received deductions to reflect lower corporate income tax rates (sec. 13002 of the bill and sec. 243 of the Code)**

### **Present Law**

Corporations are generally taxable on their income.<sup>259</sup> With respect to dividends received from other taxable domestic corporations, however, a corporation is allowed a deduction.<sup>260</sup> The amount of the deduction is generally equal to 70 percent of the dividend received.

In the case of any dividend received from a 20-percent owned corporation, the amount of the deduction is equal to 80 percent of the dividend received.<sup>261</sup> The term “20-percent owned corporation” means any corporation if 20 percent or more of the stock of such corporation (by vote and value) is owned by the taxpayer. For this purpose, certain preferred stock is not taken into account.

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<sup>259</sup> Sec. 11(a).

<sup>260</sup> Sec. 243(a). Such dividends are taxed at a maximum rate of 10.5 percent (30 percent of the top corporate tax rate of 35 percent).

<sup>261</sup> Sec. 243(c). Such dividends are taxed at a maximum rate of 7 percent (20 percent of the top corporate tax rate of 35 percent).

In the case of a dividend received from a corporation that is a member of the same affiliated group, a corporation is generally allowed a deduction equal to 100 percent of the dividend received.<sup>262</sup>

### **Reasons for Change**

The Committee believes that the marginal tax rate on dividends received by corporations should remain the same. Thus, in light of the reduction in the corporate tax rate, the Committee believes that commensurate reductions in the dividends-received deduction percentages are appropriate.

### **Explanation of Provision**

The provision reduces the 70 percent dividends-received deduction to 50 percent and the 80 percent dividends-received deduction to 65 percent.<sup>263</sup>

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2018.

## **3. Dividends-paid deduction (secs. 13011 through 13013 of the bill and new sec. 242 of the Code)**

### **Present Law**

#### **Domestic corporations and their shareholders**

A domestic corporation is taxed on its taxable income as an entity separate from its shareholders.<sup>264</sup> Dividends paid by a corporation generally are not deductible in computing its taxable income.<sup>265</sup> Thus, when a shareholder is taxed on a dividend paid out of income that was taxed at the corporate level, the same income generally bears two levels of tax. For individuals, the shareholder tax is partially alleviated by preferential rates for qualified dividends.<sup>266</sup> For corporations, the shareholder tax is alleviated by a dividends-received deduction that ranges from 70 to 100 percent of the dividends received, depending on the corporate shareholder's percentage

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<sup>262</sup> Sec. 243(a)(3) and (b)(1). For this purpose, the term "affiliated group" generally has the meaning given such term by section 1504(a). Sec. 243(b)(2).

<sup>263</sup> Such dividends would be taxed at a maximum rate of 10 percent (50 percent of the top corporate tax rate of 20 percent) and 7 percent (35 percent of the top corporate tax rate of 20 percent), respectively.

<sup>264</sup> Sec. 11.

<sup>265</sup> *But see, e.g.*, secs. 561 through 565.

<sup>266</sup> Sec. 1(h)(11).

of stock ownership in the payor corporation.<sup>267</sup> If the shareholder is a U.S. person not subject to U.S. tax (such as a tax-exempt organization), no U.S. tax is paid on amounts that are characterized as dividends. Dividends paid to foreign shareholders generally are subject to a 30-percent tax on the gross amount of dividends, collected by means of withholding by the payor.<sup>268</sup> U.S. bilateral income tax treaties reduce or eliminate this 30-percent tax on dividends paid by domestic corporations to persons who are eligible for reduced rates under those treaties.

### **U.S. branches of foreign corporations**

The branch profits tax imposes a 30-percent tax on deemed remittances (the “dividend equivalent amount”) from a U.S. branch of a foreign corporation to its foreign home office.<sup>269</sup> This tax is intended to replicate for a foreign corporation’s U.S. branch operations the 30-percent withholding tax that would apply to a domestic subsidiary’s payment of dividends to its foreign parent corporation. Similar branch interest taxes apply to interest paid or deducted by a U.S. trade or business of a foreign corporation.<sup>270</sup> U.S. bilateral income tax treaties reduce or eliminate this 30-percent tax for foreign corporations eligible for reduced rates under those treaties.

### **Allocation of expenses for purposes of the foreign tax credit**

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources by allocating and apportioning deductions between U.S.-source gross income and foreign-source gross income. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.<sup>271</sup> Expenses other than interest, however, that are not directly allocable or apportioned to any specific income producing activity are allocated and apportioned as if all members of an affiliated group were a single corporation.<sup>272</sup>

### **Reasons for Change**

The Committee believes that all business income—whether earned by an individual, a pass-through entity, or a corporation—should bear only one level of tax. The Committee further believes that the best method for achieving one level of tax for corporations is through a

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<sup>267</sup> Sec. 243. *See also* section 13002 of the bill (Reduction in dividends received deductions to reflect lower corporate income tax rates).

<sup>268</sup> Secs. 871(a)(1)(A), 881(a)(1)(A), 1441(a), and 1442(a).

<sup>269</sup> Sec. 884(a).

<sup>270</sup> Sec. 884(f).

<sup>271</sup> Treas. Reg. sec. 1.861-8(b), Temp. Treas. Reg. sec. 1.861-8T(c).

<sup>272</sup> Sec. 864(e)(1) and (6). The term “affiliated group” is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns. Secs. 864(e)(5) and 1504.



dividends-paid deduction. By enacting the mechanism for a dividends-paid deduction, complete with the necessary reporting requirements, the Committee is taking an important step toward the ultimate goal of full corporate integration.<sup>273</sup>

### **Explanation of Provision**

The provision allows domestic corporations a zero percent deduction for applicable dividends paid to shareholders. Applicable dividends are dividends paid from applicable earnings and profits, which generally are earnings and profits accumulated in taxable years beginning after December 31, 2018. Applicable earnings and profits do not include earnings and profits properly allocable to amounts that are exempt from or otherwise have not been subject to the corporate tax.

For purposes of the dividends-paid deduction, corporations may elect to treat certain dividends paid in the first 3½ months after the close of the taxable year as paid immediately before the close of the taxable year.

Corporations must report with their tax return (A) the aggregate amount of dividends paid in the reporting period, (B) the aggregate amount of such dividends with respect to which the corporation is claiming a dividends-paid deduction under the provision, (C) the aggregate amount of such dividends paid in the first 3½ months of the taxable year that the taxpayer elected to treat as paid in the prior taxable year, (D) the aggregate amount of such dividends paid in the 3½ months after the close of the taxable year that the taxpayer elected to treat as paid in the current taxable year, and (E) such other information as the Secretary requires for the administration of the provision. For this purpose, the reporting period includes the taxable year and the first 3½ months after the close of the taxable year.

The provision imposes a penalty on the failure to report the information described above. Unless the corporation shows the failure is because of reasonable cause, the penalty is \$1,000 a day for each day the failure continues. The maximum penalty under this provision for any taxable year is \$250,000.

For foreign corporations, the provision allows a deduction equal to zero percent of the dividend equivalent amount.

The provision allocates and apportions dividend expense of any domestic corporation that is a member of an affiliated group to foreign-source income in the same proportion that (i) the aggregate foreign-source income of all domestic corporations that are members of such group (determined without regard to such dividend expense) bears to (ii) the aggregate income from all sources of such domestic corporations (as so determined).

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<sup>273</sup> See, e.g., Michael J. Graetz and Alvin C. Warren, Jr., *Integration of Corporate and Shareholder Taxes*, 69 Nat'l Tax J. 677 (2016); Staff Report on Comprehensive Tax Reform for 2015 and Beyond, Prepared by the Republican Staff of the Committee on Finance United States Senate, S. Prt. No. 113-31 (Dec. 2014), at 123-238

## Effective Date

The dividends-paid deduction applies to dividends paid in taxable years beginning after December 31, 2018.

The rules regarding the branch profits tax and the allocation of dividend expense among members of an affiliated group apply to taxable years beginning after December 31, 2018.

## **PART II – SMALL BUSINESS REFORMS**

### **1. Modifications of rules for expensing depreciable business assets (sec. 13101 of the bill and sec. 179 of the Code)**

#### Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.<sup>274</sup> Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period,<sup>275</sup> and convention.<sup>276</sup>

#### **Election to expense certain depreciable business assets**

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. The maximum amount a taxpayer may expense is \$500,000 of the cost of qualifying property placed in service for the taxable year.<sup>277</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

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<sup>274</sup> See secs. 263(a) and 167. However, where property is not used exclusively in a taxpayer’s business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, e.g., section 280A.

<sup>275</sup> The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. Exercising authority granted by Congress, the Secretary issued Rev. Proc. 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 Rev. Proc. 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary’s authority to modify the class lives of depreciable property. Rev. Proc. 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>276</sup> Sec. 168.

<sup>277</sup> Sec. 179(b)(1).

exceeds \$2,000,000.<sup>278</sup> The \$500,000 and \$2,000,000 amounts are indexed for inflation for taxable years beginning after 2015.<sup>279</sup>

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. 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>280</sup> Qualifying property excludes any property described in section 50(b) (*i.e.*, certain property not eligible for the investment tax credit).<sup>281</sup>

Passenger automobiles subject to the section 280F limitation are eligible for section 179 expensing only to the extent of the dollar limitations in section 280F. For sport utility vehicles above the 6,000 pound weight rating and not more than the 14,000 pound weight rating, which are not subject to the limitation under section 280F, the maximum cost that may be expensed for any taxable year under section 179 is \$25,000 (the “sport utility vehicle limitation”).<sup>282</sup>

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 without regard to this provision).<sup>283</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).

No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.<sup>284</sup> If a corporation makes an election under section 179 to deduct expenditures, the full amount of the deduction does not reduce earnings

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<sup>278</sup> Sec. 179(b)(2).

<sup>279</sup> Sec. 179(b)(6).

<sup>280</sup> Sec. 179(d)(1)(A)(ii) and (f).

<sup>281</sup> Sec. 179(d)(1) flush language. Property described in section 50(b) is generally property used outside the United States, certain property used for lodging, property used by certain tax exempt organizations, and property used by governmental units and foreign persons or entities.

<sup>282</sup> Sec. 179(b)(5). For this purpose, a sport utility vehicle is defined to exclude any vehicle that: (1) is designed for more than nine individuals in seating rearward of the driver’s seat; (2) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length; or (3) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver’s seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

<sup>283</sup> Sec. 179(b)(3).

<sup>284</sup> Sec. 179(d)(9).

and profits. Rather, the expenditures that are deducted reduce corporate earnings and profits ratably over a five-year period.<sup>285</sup>

An expensing election is made under rules prescribed by the Secretary.<sup>286</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.

### **Reasons for Change**

The Committee believes that section 179 expensing provides two important benefits for small businesses. First, it lowers the cost of capital for tangible property used in a trade or business. With a lower cost of capital, the Committee believes small businesses will invest in more equipment and employ more workers. Second, it eliminates depreciation recordkeeping requirements with respect to expensed property. In order to increase the value of these benefits and the number of eligible taxpayers that may receive these benefits, the provision increases both the amount allowed to be expensed under section 179 and the amount of the phase-out threshold. In addition, in order to counteract the negative effect of inflation on the limit and phase-out threshold of this provision for small businesses, the provision indexes such amounts, as well the sport utility vehicle limitation, for inflation.

The Committee also believes that investments in certain tangible personal property used in rental real estate (*e.g.*, appliances and furnishings) should be included within the definition of qualifying property to remove a disincentive for small active businesses to invest in these types of assets. Similarly, the Committee believes that additional types of nonresidential real property improvements should be included in the section 179 expensing provision to facilitate investment by small businesses in such improvement property.

### **Explanation of Provision**

The provision increases the maximum amount a taxpayer may expense under section 179 to \$1,000,000, and increases the phase-out threshold amount to \$2,500,000. Thus, the provision provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2017, is \$1,000,000 of the cost of qualifying property placed in service for the taxable year. The \$1,000,000 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 \$2,500,000. The \$1,000,000 and \$2,500,000 amounts, as well as the \$25,000 sport utility vehicle limitation, are indexed for inflation for taxable years beginning after 2018.

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<sup>285</sup> Sec. 312(k)(3)(B).

<sup>286</sup> Sec. 179(c)(1).

The provision expands the definition of section 179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.<sup>287</sup>

The provision also expands the definition of qualified real property eligible for section 179 expensing to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

### **Effective Date**

The provision applies to property placed in service in taxable years beginning after December 31, 2017.

## **2. Modifications of gross receipts test for use of cash method of accounting by corporations and partnerships (sec. 13102 of the bill and secs. 447 and 448 of the Code)**

### **Present Law**

#### **General rule for methods of accounting**

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>288</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.<sup>289</sup> Examples of any one item for which an accounting method may be adopted include cost recovery,<sup>290</sup> revenue recognition,<sup>291</sup> and timing of deductions.<sup>292</sup> For each separate

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<sup>287</sup> As defined in section 50(b)(2). Property used predominantly to furnish lodging or in connection with furnishing lodging generally includes, *e.g.*, beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let. See Treas. Reg. sec. 1.48-1(h).

<sup>288</sup> Treas. Reg. sec. 1.446-1(a)(1).

<sup>289</sup> Sec. 446(c).

<sup>290</sup> See, *e.g.*, secs. 167 and 168.

<sup>291</sup> See, *e.g.*, secs. 451 and 460.

<sup>292</sup> See, *e.g.*, secs. 461 and 467.

trade or business, a taxpayer is entitled to adopt any permissible method, subject to certain restrictions.<sup>293</sup>

A taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for such year.<sup>294</sup> Except as otherwise provided, section 446(e) 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>295</sup>

### **Cash and accrual methods**

Taxpayers using the cash method generally recognize items of income when actually or constructively received and items of expense when paid. The cash method is administratively easy and provides the taxpayer flexibility in the timing of income recognition. It is the method generally used by most individual taxpayers, including farm and nonfarm sole proprietorships.

Taxpayers using an accrual method 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>296</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 obligation to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.<sup>297</sup> Accrual methods of accounting generally result in a more accurate measure of economic income than does the cash method. The accrual method is often used by businesses for financial accounting purposes.

A C corporation, a partnership that has a C corporation as a partner, or a tax-exempt trust or corporation with unrelated business income generally may not use the cash method. 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 may not be used by any tax shelter.<sup>298</sup> In addition, the cash

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<sup>293</sup> Sec. 446(d); Treas. Reg. sec. 1.446-1(d).

<sup>294</sup> Treas. Reg. sec. 1.446-1(e)(1).

<sup>295</sup> Treas. Reg. sec. 1.446-1(e).

<sup>296</sup> See, e.g., sec. 451.

<sup>297</sup> See, e.g., sec. 461.

<sup>298</sup> Secs. 448(a)(3) and (d)(3) and 461(i)(3) and (4). For this purpose, a tax shelter includes: (1) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale; (2) any syndicate (within the meaning of section 1256(e)(3)(B)); or (3) any tax shelter as defined in section 6662(d)(2)(C)(ii). In the case of a farming trade or business, a tax shelter includes any tax shelter as defined in section 6662(d)(2)(C)(ii) or any partnership or any other enterprise other than a corporation which is not

method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor.<sup>299</sup> Such taxpayers generally are required to keep inventories and use an accrual method with respect to inventory items.<sup>300</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>301</sup> Such farming businesses are not precluded from using the cash method regardless of whether they meet the gross receipts test. However, section 447 generally requires a farming C corporation (and any farming partnership if a corporation is a partner in such partnership) to use an accrual method of accounting. Section 447 does not apply to nursery or sod farms, to the raising or harvesting of trees (other than fruit and nut trees), nor to farming C corporations meeting a gross receipts test with a \$1 million threshold. For family farm C corporations, the threshold under the gross receipts test is \$25 million.

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.

### **Reasons for Change**

The Committee believes that the present law accounting method rules impose overly complex recordkeeping requirements that increase compliance costs for small businesses, as such rules have non-uniform small business exception requirements, rely on varying forms of gross receipts tests with widely different exception thresholds, and vary depending on the classification of a taxpayer's business activities. The Committee believes that using an accrual method is more complicated than using the cash method and any difference in income for a small business may be relatively small, such that either method may clearly reflect the income of a small business. In addition, the Committee believes that the cash method may address liquidity concerns of small businesses in that it measures income when the taxpayer is most likely to have the cash to pay any tax.

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an S corporation engaged in the trade or business of farming, (1) if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale or (2) if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.

<sup>299</sup> Treas. Reg. secs. 1.446-1(c)(2) and 1.471-1.

<sup>300</sup> Sec. 471 and Treas. Reg. secs. 1.446-1(c)(2) and 1.471-1.

<sup>301</sup> Sec. 448(d)(1).

The Committee believes that a uniform definition of small business for determining applicable accounting method rules and consistent application of a gross receipts test will simplify tax administration and taxpayer compliance. An increase in the gross receipts test to \$15 million will materially increase the number of business entities that are able to obtain relief from complex tax accounting rules. Many rules under present law prohibit a taxpayer from taking advantage of a small business accounting method exception if they ever fail to meet the relevant gross receipts test. The Committee believes that such taxpayers should be allowed to avail themselves of simplified accounting methods if they subsequently are able to meet the gross receipts test. Finally, the Committee believes that indexing the threshold for inflation will ensure that the small business definition remains an accurate reflection of the appropriate level of gross receipts for exempting entities from certain tax accounting rules.

### **Explanation of Provision**

The provision expands the universe of taxpayers that may use the cash method of accounting. Under the provision, the cash method of accounting may be used by 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 \$15 million for the three prior taxable-year period (the “\$15 million gross receipts test”) to use the cash method.<sup>302</sup> The \$15 million amount is indexed for inflation for taxable years beginning after 2018.

The provision retains the exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations. Thus, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other pass-through entities are allowed to use the cash method without regard to whether they meet the \$15 million gross receipts test, so long as the use of such method clearly reflects income.<sup>303</sup>

The provision expands the universe of farming C corporations (and farming partnerships with a C corporation partner) that may use the cash method to include any farming C corporation (or farming partnership with a C corporation partner) that meets the \$15 million gross receipts test. The provision retains the \$25 million dollar limit for family farming corporations, but uses the \$15 million gross receipts test in section 448 (substituting a \$25 million threshold for the \$15

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<sup>302</sup> Consistent with present law, the cash method generally may not be used by taxpayers if the purchase, production, or sale of merchandise is an income-producing factor. However, for taxable years beginning after December 31, 2017, under other provisions described in the bill, an exception to the requirement to use inventories is provided for taxpayers that meet the \$15 million gross receipts test, thus allowing such taxpayers to also use the cash method. See section 13103 of the bill (Clarification of inventory accounting rules for small businesses). In addition, the cash method may not be used by a tax shelter.

<sup>303</sup> Consistent with present law, the cash method generally may not be used by taxpayers if the purchase, production, or sale of merchandise is an income-producing factor. However, for taxable years beginning after December 31, 2017, under other provisions of described in the bill, an exception to the requirement to use inventories is provided for taxpayers that meet the \$15 million gross receipts test, thus allowing such taxpayers to also use the cash method. See section 13103 of the bill (Clarification of inventory accounting rules for small businesses). In addition, the cash method may not be used by a tax shelter.



million threshold). The \$25 million amount is indexed for inflation for taxable years beginning after 2018.

If a taxpayer changes its method of accounting because it is either prohibited or no longer prohibited from using the cash method by reason of this provision, such change is treated as initiated by the taxpayer and made with the consent of the Secretary.

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

## **3. Clarification of inventory accounting rules for small businesses (sec. 13103 of the bill 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 an income-producing factor to the taxpayer.<sup>304</sup> Treasury regulations also provide that in any case in which the use of inventories is necessary to clearly reflect income, the accrual method must be used with regard to purchases and sales.<sup>305</sup> However, an exception is provided for taxpayers whose average annual gross receipts do not exceed \$1 million.<sup>306</sup> A second exception is provided for taxpayers in certain industries whose average annual gross receipts do not exceed \$10 million and that are not otherwise prohibited from using the cash method under section 448.<sup>307</sup> Such taxpayers may account for inventory as materials and supplies that are not incidental (*i.e.*, “non-incidental materials and supplies”).<sup>308</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.

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<sup>304</sup> Sec. 471(a) and Treas. Reg. sec. 1.471-1.

<sup>305</sup> Treas. Reg. sec. 1.446-1(c)(2).

<sup>306</sup> Rev. Proc. 2001-10, 2001-1 C.B. 272.

<sup>307</sup> Rev. Proc. 2002-28, 2002-1 C.B. 815.

<sup>308</sup> Treas. Reg. sec. 1.162-3(a)(1). A deduction is generally permitted for the cost of non-incidental materials and supplies in the taxable year in which they are first used or are consumed in the taxpayer's operations.

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.

### **Reasons for Change**

The Committee believes that the present law accounting method rules impose overly complex recordkeeping requirements that increase compliance costs for small businesses, as such rules have non-uniform small business exception requirements, rely on varying forms of gross receipts tests with widely different exception thresholds, and vary depending on the classification of a taxpayer’s business activities. The Committee believes that using an accrual method, along with keeping inventory records, is more complicated than the cash method and any difference in income for a small business may be relatively small, such that either method may clearly reflect the income of a small business. The Committee also believes that the ability of small businesses to use simplified methods of accounting for inventory generally will be practical and administratively convenient for such taxpayers.

The Committee believes that a uniform definition of small business for determining applicable accounting method rules and consistent application of a gross receipts test will simplify tax administration and taxpayer compliance. The Committee believes that providing a small business exception to the inventory rules for taxpayers meeting the \$15 million gross receipts test will materially increase the number of business entities that are able to obtain relief from complex tax accounting rules. In addition, the Committee believes that indexing the threshold for inflation will ensure that the small business definition remains an accurate reflection of the appropriate level of gross receipts for exempting entities from certain tax accounting rules.

### **Explanation of Provision**

The provision exempts certain taxpayers from the requirement to keep inventories. Specifically, taxpayers that meet the \$15 million gross receipts test<sup>309</sup> are not required to account for inventories under section 471<sup>310</sup>, but rather may use a method of accounting for inventories

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<sup>309</sup> The \$15 million gross receipts test is described in section 13102 of the bill (Modifications of gross receipts test for use of cash method of accounting by corporations and partnerships).

<sup>310</sup> In the case of a sole proprietorship, the \$15 million gross receipts test is applied as if the sole proprietorship were a corporation. The cash method generally may not be used by taxpayers if the purchase, production, or sale of merchandise is an income-producing factor. However, for taxpayers that meet the \$15 million gross receipts test to be exempt from accounting for inventories under section 471, such taxpayers are thus also eligible to use the cash method under the provision. See section 13102 of the bill (Modifications of gross receipts test for use of cash method of accounting by corporations and partnerships).

that either (1) treats inventories as non-incidentals materials and supplies<sup>311</sup>, or (2) conforms to the taxpayer's financial accounting treatment of inventories.<sup>312</sup>

If a taxpayer changes its method of accounting because it is either no longer required or is required to use inventories by reason of this provision, such change is treated as initiated by the taxpayer and made with the consent of the Secretary.

#### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

#### **4. Modification of rules for uniform capitalization of certain expenses (sec. 13104 of the bill and sec. 263A of the Code)**

##### **Present Law**

The uniform capitalization rules 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>313</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.

Section 263A provides a number of exceptions to the general uniform 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,<sup>314</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>315</sup> Under this exception, section 263A does not apply to trees raised, harvested, or grown by the taxpayer

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<sup>311</sup> Consistent with present law, a deduction is generally permitted for the cost of non-incidentals materials and supplies in the taxable year in which they are first used or are consumed in the taxpayer's operations. See Treas. Reg. sec. 1.162-3(a)(1).

<sup>312</sup> The taxpayer's financial accounting treatment of inventories is determined by reference to the method of accounting used in the taxpayer's applicable financial statement (as defined in section 13221 of the bill (Certain special rules for taxable year of inclusion)) or, if the taxpayer does not have an applicable financial statement, the method of accounting used in the taxpayer's book and records prepared in accordance with the taxpayer's accounting procedures.

<sup>313</sup> Sec. 263A.

<sup>314</sup> Sec. 263A(b)(2)(B). No exception is available for small taxpayers who produce property subject to section 263A. However, a *de minimis* rule under Treasury regulations treats producers with total indirect costs of \$200,000 or less as having no additional indirect costs beyond those normally capitalized for financial accounting purposes. Treas. Reg. sec. 1.263A-2(b)(3)(iv).

<sup>315</sup> Sec. 263A(c)(5).

(other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the uniform capitalization rules do not apply to any plant having a preproductive period of two years or less or to any animal, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under section 447 or 448(a)(3)).<sup>316</sup>

Freelance authors, photographers, and artists also are exempt from section 263A for any qualified creative expenses.<sup>317</sup>

### **Reasons for Change**

The Committee believes that the present law accounting method rules impose overly complex recordkeeping requirements that increase compliance costs for small businesses, as such rules have non-uniform small business exception requirements, rely on varying forms of gross receipts tests with widely different exception thresholds, and vary depending on the classification of a taxpayer's business activities. The Committee believes that using an accrual method, along with applying the uniform capitalization rules, is more complicated than using the cash method and any difference in income for a small business may be relatively small, such that either method may clearly reflect the income of a small business. In addition, the Committee believes that the uniform capitalization rules are relatively complex and any potential distortion to income caused by not applying such rules is not material enough to warrant the application of unduly burdensome rules to small businesses.

The Committee believes that a uniform definition of small business for determining applicable accounting method rules and consistent application of a gross receipts test will simplify tax administration and taxpayer compliance. An increase in the gross receipts test to \$15 million, and the expansion of the test to include any producer or reseller, will materially increase the number of business entities that are able to obtain relief from the complex uniform capitalization rules. In addition, the Committee believes that indexing the threshold for inflation will ensure that the small business definition remains an accurate reflection of the appropriate level of gross receipts for exempting entities from certain tax accounting rules.

### **Explanation of Provision**

The provision expands the exception for small taxpayers from the uniform capitalization rules. Under the provision, any producer or reseller that meets the \$15 million gross receipts test<sup>318</sup> is exempted from the application of section 263A.<sup>319</sup> The provision retains the

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<sup>316</sup> Sec. 263A(d).

<sup>317</sup> Sec. 263A(h). 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.

<sup>318</sup> The \$15 million gross receipts test is described in section 13102 of the bill (Modifications of gross receipts test for use of cash method of accounting by corporations and partnerships).

exemptions from the uniform capitalization rules that are not based on a taxpayer's gross receipts.

If a taxpayer changes its method of accounting because it is either no longer required or is required to apply section 263A by reason of this provision, such change is treated as initiated by the taxpayer and made with the consent of the Secretary.

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

## **5. Increase in gross receipts test for construction contract exception to percentage of completion method (sec. 13105 of the bill and sec. 460 of the Code)**

### **Present Law**

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>320</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>321</sup> The percentage of the contract 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>322</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>323</sup> The allocation of costs to a contract is made in accordance with regulations.<sup>324</sup> Costs incurred with respect to the long-term contract are deductible in the year incurred, subject to general accrual method of accounting principles and limitations.<sup>325</sup>

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<sup>319</sup> In the case of a sole proprietorship, the \$15 million gross receipts test is applied as if the sole proprietorship were a corporation.

<sup>320</sup> Sec. 460(a).

<sup>321</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>322</sup> Sec. 460(b)(1).

<sup>323</sup> Sec. 460(c).

<sup>324</sup> Treas. Reg. sec. 1.460-5.

<sup>325</sup> Treas. Reg. secs. 1.460-4(b)(2)(iv) and 1.460-1(b)(8).

An 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>326</sup> Thus, long-term contract income from small construction contracts must be reported consistently using the taxpayer’s exempt contract method.<sup>327</sup> 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>328</sup>

### **Reasons for Change**

The Committee believes that the present law accounting method rules impose overly complex recordkeeping requirements that increase compliance costs for small businesses, as such rules have non-uniform small business exception requirements, rely on varying forms of gross receipts tests with widely different exception thresholds, and vary depending on the classification of a taxpayer’s business activities. The Committee believes that using an accrual method, along with using the percentage-of-completion method, is more complicated than using the cash method and any difference in income for a small business may be relatively small, such that either method may clearly reflect the income of a small business. The Committee also believes that the ability of small businesses to use simplified methods of accounting for certain construction contracts generally will be practical and administratively convenient for such taxpayers.

The Committee believes that a uniform definition of small business for determining applicable accounting method rules and consistent application of a gross receipts test will simplify tax administration and taxpayer compliance. An increase in the gross receipts test to \$15 million for small construction contracts will materially increase the number of business entities that are able to obtain relief from the complex percentage-of-completion method. In addition, the Committee believes that indexing the threshold for inflation will ensure that the small business definition remains an accurate reflection of the appropriate level of gross receipts for exempting entities from certain tax accounting rules.

### **Explanation of Provision**

The provision expands the exception for small construction contracts from the requirement to use the percentage-of-completion method. Under the provision, contracts within this exception are those contracts for the construction or improvement of real property if the

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<sup>326</sup> Secs. 460(e)(1)(B) and (4).

<sup>327</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.

<sup>328</sup> Treas. Reg. sec. 1.460-4(c)(1).

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 that (for the taxable year in which the contract was entered into) meets the \$15 million gross receipts test.<sup>329</sup>

### **Effective Date**

The provision applies to contracts entered into after December 31, 2017, in taxable years ending after such date.

Application of this rule is a change in the taxpayer's method of accounting for purposes of section 481, but is applied on a cutoff basis for all similarly classified contracts (hence there is no adjustment under section 481(a) for contracts entered into before January 1, 2018).

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<sup>329</sup> The \$15 million gross receipts test is described in section 13102 of the bill (Modifications of gross receipts test for use of cash method of accounting by corporations and partnerships). In the case of a sole proprietorship, the \$15 million gross receipts test is applied as if the sole proprietorship were a corporation.

## PART III – COST RECOVERY AND ACCOUNTING METHODS

### 1. Temporary 100-percent expensing for certain business assets (sec. 13201 of the bill and sec. 168(k) of the Code)

#### Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.<sup>330</sup>

#### Tangible property

Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period,<sup>331</sup> and convention.<sup>332</sup>

#### Bonus depreciation

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property acquired and placed in service before January 1, 2020 (January 1, 2021, for longer production period property<sup>333</sup> and certain aircraft<sup>334</sup>).<sup>335</sup> The 50-percent allowance is phased down for property placed in service after December 31, 2017 (after December 31, 2018 for longer production period property and certain aircraft). The bonus depreciation percentage rates are as follows.

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<sup>330</sup> See secs. 263(a) and 167. However, where property is not used exclusively in a taxpayer’s business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, e.g., section 280A.

<sup>331</sup> The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. Exercising authority granted by Congress, the Secretary issued Rev. Proc. 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 Rev. Proc. 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary’s authority to modify the class lives of depreciable property. Rev. Proc. 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>332</sup> Sec. 168.

<sup>333</sup> As defined in section 168(k)(2)(B).

<sup>334</sup> As defined in section 168(k)(2)(C).

<sup>335</sup> Sec. 168(k). The additional first-year depreciation deduction is generally subject to the rules regarding whether a cost must be capitalized under section 263A.



Placed in Service Year	Bonus Depreciation Percentage	
	Qualified Property in General	Longer Production Period Property and Certain Aircraft
2017	50 percent	50 percent
2018	40 percent	50 percent <sup>336</sup>
2019	30 percent	40 percent
2020	n/a	30 percent <sup>337</sup>

The additional first-year depreciation deduction is allowed for both the regular tax and the alternative minimum tax (“AMT”),<sup>338</sup> but is not allowed in computing earnings and profits.<sup>339</sup> The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction.<sup>340</sup> The amount of the additional first-year depreciation deduction is not affected by a short taxable year.<sup>341</sup> The taxpayer may elect out of the additional first-year depreciation for any class of property for any taxable year.<sup>342</sup>

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2017 a taxpayer purchases new depreciable property and places it in service.<sup>343</sup> The property’s cost is \$10,000, and it is five-year property subject to the 200 percent declining balance method and half-year convention. The amount of additional first-year depreciation allowed is \$5,000. The remaining \$5,000 of the cost of the property is depreciable under the rules applicable to five-year property.

<sup>336</sup> It is intended that for longer production period property placed in service in 2018, 50 percent applies to the entire adjusted basis. Similarly, for longer production period property placed in service in 2019, 40 percent applies to the entire adjusted basis. A technical correction may be necessary with respect to longer production period property placed in service in 2018 and 2019 so that the statute reflects this intent.

<sup>337</sup> In the case of longer production period property described in section 168(k)(2)(B) and placed in service in 2020, 30 percent applies to the adjusted basis attributable to manufacture, construction, or production before January 1, 2020, and the remaining adjusted basis does not qualify for bonus depreciation. Thirty percent applies to the entire adjusted basis of certain aircraft described in section 168(k)(2)(C) and placed in service in 2020.

<sup>338</sup> Sec. 168(k)(2)(G). See also Treas. Reg. sec. 1.168(k)-1(d).

<sup>339</sup> Sec. 312(k)(3) and Treas. Reg. sec. 1.168(k)-1(f)(7).

<sup>340</sup> Sec. 168(k)(1)(B).

<sup>341</sup> *Ibid.*

<sup>342</sup> Sec. 168(k)(7). For the definition of a class of property, see Treas. Reg. sec. 1.168(k)-1(e)(2).

<sup>343</sup> Assume that the cost of the property is not eligible for expensing under section 179 or Treas. Reg. sec. 1.263(a)-1(f).

Thus, \$1,000 also is allowed as a depreciation deduction in 2017.<sup>344</sup> The total depreciation deduction with respect to the property for 2017 is \$6,000. The remaining \$4,000 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

### Qualified property

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements.<sup>345</sup> First, the property must be: (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property,<sup>346</sup> (3) computer software other than computer software covered by section 197; or (4) qualified improvement property.<sup>347</sup> Second, the original use<sup>348</sup> of the property must commence with the taxpayer.<sup>349</sup> Third, the taxpayer must acquire the property within the applicable time period (as described below). Finally, the property must be placed in service before January 1, 2020. As noted above, an extension of the placed-in-service date of one year (*i.e.*, before January 1, 2021) is provided for certain property with a recovery period of 10 years or longer, certain transportation property, and certain aircraft.<sup>350</sup>

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<sup>344</sup> \$1,000 results from the application of the half-year convention and the 200 percent declining balance method to the remaining \$5,000.

<sup>345</sup> Requirements relating to actions taken before 2008 are not described herein since they have little (if any) remaining effect.

<sup>346</sup> As defined in section 168(e)(5).

<sup>347</sup> The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. Sec. 168(k)(2)(D)(i).

<sup>348</sup> The term “original use” means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (*i.e.*, each fractional owner is considered the original user of its proportionate share of the property). Treas. Reg. sec. 1.168(k)-1(b)(3).

<sup>349</sup> A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. If property is originally placed in service by a lessor, such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale. Sec. 168(k)(2)(E)(ii) and (iii).

<sup>350</sup> Property qualifying for the extended placed-in-service date must have an estimated production period exceeding one year and a cost exceeding \$1 million. Transportation property generally is defined as tangible personal property used in the trade or business of transporting persons or property. Certain aircraft which is not transportation property, other than for agricultural or firefighting uses, also qualifies for the extended placed-in-service date, if at the time of the contract for purchase, the purchaser made a nonrefundable deposit of the lesser of 10 percent of the cost or \$100,000, and which has an estimated production period exceeding four months and a cost exceeding \$200,000.

To qualify, property must be acquired (1) before January 1, 2020, or (2) pursuant to a binding written contract which was entered into before January 1, 2020. With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property before January 1, 2020.<sup>351</sup> Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.<sup>352</sup> For property eligible for the extended placed-in-service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2020 (“progress expenditures”) is eligible for the additional first-year depreciation deduction.<sup>353</sup>

#### Qualified improvement property

Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.<sup>354</sup> Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

#### Election to accelerate AMT credits in lieu of bonus depreciation

A corporation otherwise eligible for additional first-year depreciation may elect to claim additional AMT credits in lieu of claiming additional depreciation with respect to qualified property.<sup>355</sup> In the case of a corporation making this election, the straight line method is used for the regular tax and the AMT with respect to qualified property.<sup>356</sup>

A corporation making an election increases the tax liability limitation under section 53(c) on the use of minimum tax credits by the bonus depreciation amount. The aggregate increase in credits allowable by reason of the increased limitation is treated as refundable.

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<sup>351</sup> Sec. 168(k)(2)(E)(i).

<sup>352</sup> Treas. Reg. sec. 1.168(k)-1(b)(4)(iii).

<sup>353</sup> Sec. 168(k)(2)(B)(ii). For purposes of determining the amount of eligible progress expenditures, rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

<sup>354</sup> Sec. 168(k)(3).

<sup>355</sup> Sec. 168(k)(4).

<sup>356</sup> Sec. 168(k)(4)(A)(ii).

The bonus depreciation amount generally is equal to 20 percent of bonus depreciation for qualified property that could be claimed as a deduction absent an election under this provision.<sup>357</sup> As originally enacted, the bonus depreciation amount for all taxable years was limited to the lesser of (1) \$30 million or (2) six percent of the minimum tax credits allocable to the adjusted net minimum tax imposed for taxable years beginning before January 1, 2006. However, extensions of this provision have provided that this limitation applies separately to property subject to each extension.

For taxable years ending after December 31, 2015, the bonus depreciation amount for a taxable year (as defined under present law with respect to all qualified property) is limited to the lesser of (1) 50 percent of the minimum tax credit for the first taxable year ending after December 31, 2015 (determined before the application of any tax liability limitation) or (2) the minimum tax credit for the taxable year allocable to the adjusted net minimum tax imposed for taxable years ending before January 1, 2016 (determined before the application of any tax liability limitation and determined on a first-in, first-out basis).

All corporations treated as a single employer under section 52(a) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.<sup>358</sup>

In the case of a corporation making an election which is a partner in a partnership, for purposes of determining the electing partner's distributive share of partnership items, bonus depreciation does not apply to any qualified property and the straight line method is used with respect to that property.<sup>359</sup>

In the case of a partnership having a single corporate partner owning (directly or indirectly) more than 50 percent of the capital and profits interests in the partnership, each partner takes into account its distributive share of partnership depreciation in determining its bonus depreciation amount.<sup>360</sup>

### Special rules

#### Passenger automobiles

The limitation under section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by \$8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year

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<sup>357</sup> For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation determined if section 168(k)(1) applied to all qualified property placed in service during the taxable year and (ii) the amount of depreciation that would be so determined if section 168(k)(1) did not so apply. This determination is made using the most accelerated depreciation method and the shortest life otherwise allowable for each property.

<sup>358</sup> Sec. 168(k)(4)(B)(iii).

<sup>359</sup> Sec. 168(k)(4)(D)(ii).

<sup>360</sup> Sec. 168(k)(4)(D)(iii).

deduction).<sup>361</sup> The \$8,000 amount is phased down from \$8,000 by \$1,600 per calendar year beginning in 2018. Thus, the section 280F increase amount for property placed in service during 2018 is \$6,400, and during 2019 is \$4,800. While the underlying section 280F limitation is indexed for inflation,<sup>362</sup> the section 280F increase amount is not indexed for inflation. The increase does not apply to a taxpayer who elects to accelerate AMT credits in lieu of bonus depreciation for a taxable year.

#### Certain plants bearing fruits and nuts

A special election is provided for certain plants bearing fruits and nuts.<sup>363</sup> Under the election, the applicable percentage of the adjusted basis of a specified plant which is planted or grafted after December 31, 2015, and before January 1, 2020, is deductible for regular tax and AMT purposes in the year planted or grafted by the taxpayer, and the adjusted basis is reduced by the amount of the deduction.<sup>364</sup> The percentage is 50 percent for 2017, 40 percent for 2018, and 30 percent for 2019. A specified plant is any tree or vine that bears fruits or nuts, and any other plant that will have more than one yield of fruits or nuts and generally has a preproductive period of more than two years from planting or grafting to the time it begins bearing fruits or nuts.<sup>365</sup> The election is revocable only with the consent of the Secretary, and if the election is made with respect to any specified plant, such plant is not treated as qualified property eligible for bonus depreciation in the subsequent taxable year in which it is placed in service.

#### Long-term contracts

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>366</sup> Solely for purposes of determining the percentage of completion under section 460(b)(1)(A), the cost of qualified property with a MACRS recovery period of seven years or less is taken into account as a cost allocated to the contract as if bonus depreciation had not been enacted for property placed in service before January 1, 2020 (January 1, 2021, in the case of longer production period property).<sup>367</sup>

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<sup>361</sup> Sec. 168(k)(2)(F).

<sup>362</sup> Sec. 280F(d)(7).

<sup>363</sup> See sec. 168(k)(5).

<sup>364</sup> Any amount deducted under this election is not subject to capitalization under section 263A.

<sup>365</sup> A specified plant does not include any property that is planted or grafted outside the United States.

<sup>366</sup> Sec. 460.

<sup>367</sup> Sec. 460(c)(6). Other dates involving prior years are not described herein.

## Intangible property

MACRS does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years.<sup>368</sup> Section 197 (amortization of goodwill and certain other intangibles) does not apply to certain intangible property, including certain property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.<sup>369</sup> Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a “stand-alone” basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property if it is used in a trade or business or held for the production of income. In addition, the costs of motion picture films, video tapes, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.<sup>370</sup>

### Expensing of certain qualified film, television and live theatrical productions

Under section 181, a taxpayer may elect<sup>371</sup> to deduct the cost of any qualifying film, television and live theatrical production, commencing prior to January 1, 2017, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.<sup>372</sup> A taxpayer may elect to deduct up to \$15 million of the aggregate cost of the film or television production under this section.<sup>373</sup> The threshold is increased to \$20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as

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<sup>368</sup> Sec. 168(f)(1), (3) and (4).

<sup>369</sup> Sec. 197(c)(2) and (e)(4)(A). If section 197 applies to the acquisition of 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. Sec. 197(a) and (c).

<sup>370</sup> Sec. 167(g)(6). 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. 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. Sec. 167(g)(1).

<sup>371</sup> See Treas. Reg. sec. 1.181-2 for rules on making an election under this section.

<sup>372</sup> For this purpose, a qualified film or television production is treated as commencing on the first date of principal photography. The date on which a qualified live theatrical production commences is the date of the first public performance of such production for a paying audience.

<sup>373</sup> Sec. 181(a)(2)(A). See Treas. Reg. sec. 1.181-1 for rules on determining eligible production costs.

a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.<sup>374</sup>

A qualified film, television or live theatrical production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format), television program or live staged play 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>375</sup> The term “compensation” does not include participations and residuals (as defined in section 167(g)(7)(B)).<sup>376</sup>

Each episode of a television series is treated as a separate production, and only the first 44 episodes of a particular series qualify under the provision.<sup>377</sup> Qualified productions do not include sexually explicit productions as referenced by section 2257 of title 18 of the U.S. Code.<sup>378</sup>

A qualified live theatrical production is defined as a live staged production of a play (with or without music) which is derived from a written book or script and is produced or presented by a commercial entity in any venue which has an audience capacity of not more than 3,000, or a series of venues the majority of which have an audience capacity of not more than 3,000.<sup>379</sup> In addition, qualified live theatrical productions include any live staged production which is produced or presented by a taxable entity no more than 10 weeks annually in any venue which has an audience capacity of not more than 6,500.<sup>380</sup> In general, in the case of multiple live-staged productions, each such live-staged production is treated as a separate production. Similar to the exclusion for sexually explicit productions from the definition of qualified film or television productions, qualified live theatrical productions do not include stage performances that would be excluded by section 2257(h)(1) of title 18 of the U.S. Code, if such provision were extended to live stage performances.<sup>381</sup>

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>382</sup>

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<sup>374</sup> Sec. 181(a)(2)(B).

<sup>375</sup> Sec. 181(d)(3)(A).

<sup>376</sup> Sec. 181(d)(3)(B).

<sup>377</sup> Sec. 181(d)(2)(B).

<sup>378</sup> Sec. 181(d)(2)(C).

<sup>379</sup> Sec. 181(e)(2)(A).

<sup>380</sup> Sec. 181(e)(2)(D).

<sup>381</sup> Sec. 181(e)(2)(E).

<sup>382</sup> Sec. 1245(a)(2)(C).

## **Reasons for Change**

The Committee believes that providing full expensing for certain business assets will accelerate purchases of equipment and other assets, and promote capital investment, modernization, and growth. The Committee also believes that full expensing under section 168(k) for certain business assets is important for small businesses that qualify for section 179 expensing because a business may only expense costs under section 179 to the extent of its taxable income for the year. Thus, increased expensing under section 168(k) will provide additional flexibility and accelerated cost recovery for most businesses.

In addition, the Committee believes that providing full expensing for certain production costs of qualified film, television and live theatrical productions (as defined in section 181) once placed in service will encourage investment in and financing of these types of domestic productions, and will help to prevent the production of American projects abroad. The Committee also believes that these productions create broader economic effects in cities and towns across the United States, with revenues and jobs generated in a variety of other local businesses. Hotels, restaurants, catering companies, equipment rental facilities, transportation vendors, and many others benefit from these productions.

## **Explanation of Provision**

### **In general**

The provision extends and modifies the additional first-year depreciation deduction through 2022 (through 2023 for longer production period property and certain aircraft). The 50-percent allowance is increased to 100 percent for property placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for longer production period property and certain aircraft), as well as for specified plants planted or grafted after September 27, 2017, and before January 1, 2023. Thus, the provision repeals the phase-down of the additional first-year depreciation deduction for property placed in service after December 31, 2017, and for specified plants planted or grafted after such date.

As a conforming amendment to the repeal of corporate AMT, the election to accelerate AMT credits in lieu of bonus depreciation is repealed.<sup>383</sup>

### **Special rules**

The provision maintains the section 280F increase amount of \$8,000 for passenger automobiles placed in service after December 31, 2017.

The provision extends the special rule under the percentage-of-completion method for the allocation of bonus depreciation to a long-term contract for property placed in service before January 1, 2023 (January 1, 2024, in the case of longer production period property).

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<sup>383</sup> See sec. 12001 of the bill (Repeal of tax for corporations).



## **Application to qualified film, television and live theatrical productions**

The provision expands the definition of qualified property eligible for the additional first-year depreciation allowance to include qualified film, television and live theatrical productions<sup>384</sup> placed in service after September 27, 2017, and before January 1, 2023, for which a deduction otherwise would have been allowable under section 181 without regard to the dollar limitation or termination of such section. For purposes of this provision, a production is considered placed in service at the time of initial release, broadcast, or live staged performance (*i.e.*, at the time of the first commercial exhibition, broadcast, or live staged performance of a production to an audience).

## **Exception for certain utility property**

The provision excludes from the definition of qualified property any property which is primarily used in the trade or business of the furnishing<sup>385</sup> or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.<sup>386</sup>

## **Effective Date**

The provision generally applies to property placed in service after September 27, 2017, in taxable years ending after such date, and to specified plants planted or grafted after such date.

A transition rule provides that, for a taxpayer's first taxable year ending after September 27, 2017, the taxpayer may elect to apply a 50-percent allowance.<sup>387</sup>

## **2. Modifications to depreciation limitations on luxury automobiles and personal use property (sec. 13202 of the bill and sec. 280F of the Code)**

### **Present Law**

Section 280F(a) limits the annual cost recovery deduction with respect to certain passenger automobiles. This limitation is commonly referred to as the "luxury automobile depreciation limitation." For passenger automobiles placed in service in 2017, and for which the additional first-year depreciation deduction under section 168(k) is not claimed, the maximum

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<sup>384</sup> As defined in section 181(d) and (e).

<sup>385</sup> The term "furnishing" includes generation, transmission, and distribution activities.

<sup>386</sup> See sec. 13301 of the bill (Limitation on deduction for interest).

<sup>387</sup> Such election shall be made at such time and in such form and manner as prescribed by the Secretary.

amount of allowable depreciation is \$3,160 for the year in which the vehicle is placed in service, \$5,100 for the second year, \$3,050 for the third year, and \$1,875 for the fourth and later years in the recovery period.<sup>388</sup> This limitation is indexed for inflation and applies to the aggregate deduction provided under present law for depreciation and section 179 expensing. Hence, passenger automobiles subject to section 280F are eligible for section 179 expensing only to the extent of the applicable limits contained in section 280F. For passenger automobiles eligible for the additional first-year depreciation allowance in 2017, the first-year limitation is increased by an additional \$8,000.<sup>389</sup>

For purposes of the depreciation limitation, passenger automobiles are defined broadly to include any four-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways and which are rated at 6,000 pounds unloaded gross vehicle weight or less.<sup>390</sup> In the case of a truck or a van, the depreciation limitation applies to vehicles that are rated at 6,000 pounds gross vehicle weight or less. Sport utility vehicles are treated as a truck for the purpose of applying the section 280F limitation.

Basis not recovered in the recovery period of a passenger automobile is allowable as an expense in subsequent taxable years.<sup>391</sup> The expensed amount is limited in each such subsequent taxable year to the amount of the limitation in the fourth year in the recovery period.

### **Listed property**

In the case of certain listed property, special rules apply. Listed property generally is defined as (1) any passenger automobile; (2) any other property used as a means of transportation;<sup>392</sup> (3) any property of a type generally used for purposes of entertainment, recreation, or amusement; (4) any computer or peripheral equipment;<sup>393</sup> and (5) any other property of a type specified in Treasury regulations.<sup>394</sup>

First, if for the taxable year in which the property is placed in service, the use of the property for trade or business purposes does not exceed 50 percent of the total use of the

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<sup>388</sup> Rev. Proc. 2017-29, Table 3, 2017-14 I.R.B. 1065.

<sup>389</sup> Sec. 168(k)(2)(F). For proposed changes to section 168(k), see section III.C.2. of this document (Temporary 100-percent expensing for certain business assets).

<sup>390</sup> Sec. 280F(d)(5). Exceptions are provided for any ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in a trade or business, or any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

<sup>391</sup> Sec. 280F(a)(1)(B).

<sup>392</sup> Property substantially all of the use of which is in a trade or business of providing transportation to unrelated persons for hire is not considered other property used as a means of transportation. Sec. 280F(d)(4)(C).

<sup>393</sup> Computer or peripheral equipment used exclusively at a regular business establishment and owned or leased by the person operating such establishment, however, is not listed property. Sec. 280F(d)(4)(B).

<sup>394</sup> Sec. 280F(d)(4)(A).

property, then the depreciation deduction with respect to such property is determined under the alternative depreciation system.<sup>395</sup> The alternative depreciation system generally requires the use of the straight-line method and a recovery period equal to the class life of the property.<sup>396</sup> Second, if an individual owns or leases listed property that is used by the individual in connection with the performance of services as an employee, no depreciation deduction, expensing allowance, or deduction for lease payments is available with respect to such use unless the use of the property is for the convenience of the employer and required as a condition of employment.<sup>397</sup> Both limitations apply for purposes of section 179 expensing.

For listed property, no deduction is allowed unless the taxpayer adequately substantiates the expense and business usage of the property.<sup>398</sup> A taxpayer must substantiate the elements of each expenditure or use of listed property, including (1) the amount (*e.g.*, cost) of each separate expenditure and the amount of business or investment use, based on the appropriate measure (*e.g.*, mileage for automobiles), and the total use of the property for the taxable period, (2) the date of the expenditure or use, and (3) the business purposes for the expenditure or use.<sup>399</sup> The level of substantiation for business or investment use of listed property varies depending on the facts and circumstances. In general, the substantiation must contain sufficient information as to each element of every business or investment use.<sup>400</sup>

### **Reasons for Change**

The Committee believes that increasing the amount a business can deduct for passenger vehicles, including light trucks or vans, will modernize the current and outdated depreciation rules for certain business vehicles.

In addition, the Committee believes that removing computers from the definition of listed property will reduce compliance burdens for businesses in the modern economy.

### **Explanation of Provision**

The provision increases the depreciation limitations under section 280F that apply to listed property. For passenger automobiles placed in service after December 31, 2017, and for which the additional first-year depreciation deduction under section 168(k) is not claimed, the

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<sup>395</sup> Sec. 280F(b)(1). If for any taxable year after the year in which the property is placed in service the use of the property for trade or business purposes decreases to 50 percent or less of the total use of the property, then the amount of depreciation allowed in prior years in excess of the amount of depreciation that would have been allowed for such prior years under the alternative depreciation system is recaptured (*i.e.*, included in gross income) for such taxable year.

<sup>396</sup> Sec. 168(g).

<sup>397</sup> Sec. 280F(d)(3).

<sup>398</sup> Sec. 274(d)(4).

<sup>399</sup> Temp. Reg. sec. 1.274-5T(b)(6).

<sup>400</sup> Temp. Reg. sec. 1.274-5T(c)(2)(ii)(C).

maximum amount of allowable depreciation is \$10,000 for the year in which the vehicle is placed in service, \$16,000 for the second year, \$9,600 for the third year, and \$5,760 for the fourth and later years in the recovery period.<sup>401</sup> The limitations are indexed for inflation for passenger automobiles placed in service after 2018.

The provision removes computer or peripheral equipment from the definition of listed property. Such property is therefore not subject to the heightened substantiation requirements that apply to listed property.

### Effective Date

The provision is effective for property placed in service after December 31, 2017, in taxable years ending after such date.

### **3. Modifications of treatment of certain farm property (sec. 13203 of the bill and sec. 168 of the Code)**

#### Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.<sup>402</sup> Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.<sup>403</sup>

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance.<sup>404</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

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<sup>401</sup> Rev. Proc. 2017-29, Table 3, 2017-14 I.R.B. 1065.

<sup>402</sup> See secs. 263(a) and 167. However, where property is not used exclusively in a taxpayer’s business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.*, section 280A.

<sup>403</sup> Sec. 168.

<sup>404</sup> Exercising authority granted by Congress, the Secretary issued Rev. Proc. 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 Rev. Proc. 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary’s authority to modify the class lives of depreciable property. Rev. Proc. 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.

are the 200-percent and 150-percent declining balance methods,<sup>405</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 yields 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. The straight line depreciation method is required for the aforementioned real property.

Property used in a farming business is assigned various recovery periods in the same manner as other business property. For example, depreciable assets used in agriculture activities that are assigned a recovery period of 7 years include machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agriculture, animal husbandry, and horticultural services.<sup>406</sup> Cotton ginning assets are also assigned a recovery period of 7 years.<sup>407</sup> Any single purpose agricultural or horticultural structure,<sup>408</sup> and any tree or vine bearing fruit or nuts are assigned a recovery period of 10 years.<sup>409</sup> Land improvements such as drainage facilities, paved lots, and water wells are assigned a recovery period of 15 years.<sup>410</sup>

A 5-year recovery period was assigned to new farm machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which was used in a

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<sup>405</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

<sup>406</sup> Rev. Proc. 87-56, Asset class 01.1, Agriculture.

<sup>407</sup> Rev. Proc. 87-56, Asset class 01.11, Cotton ginning assets.

<sup>408</sup> Within the meaning of section 168(i)(13). See also Rev. Proc. 87-56, Asset class 01.4, Single purpose agricultural or horticultural structures. Farm buildings that do not meet the definition of a single purpose agricultural or horticultural structure are assigned a recovery period of 20 years. Rev. Proc. 87-56, Asset class 01.3, Farm buildings except structures included in asset class 01.4.

<sup>409</sup> Sec. 168(e)(3)(D)(i) and (ii).

<sup>410</sup> Rev. Proc. 87-56, Asset class 00.3, Land improvements. See also, IRS Publication 225, Farmer's Tax Guide (2017).

farming business,<sup>411</sup> the original use of which commenced with the taxpayer after December 31, 2008, and which was placed in service before January 1, 2010.<sup>412</sup>

Any property (other than nonresidential real property,<sup>413</sup> residential rental property,<sup>414</sup> and trees or vines bearing fruits or nuts<sup>415</sup>) used in a farming business<sup>416</sup> is subject to the 150-percent declining balance method.<sup>417</sup>

Under a special accounting rule, certain taxpayers engaged in the business of farming who elect to deduct preproductive period expenditures are required to depreciate all farming assets using the alternative depreciation system (*i.e.*, using longer recovery periods and the straight line method).<sup>418</sup>

### **Reasons for Change**

The Committee believes that the depreciation incentives will provide important economic benefits to encourage development within the agricultural sector. The provision lowers the cost of capital for property used in agricultural trades or businesses which will lead to additional investment in more equipment and employment of more workers.

### **Explanation of Provision**

The provision shortens the recovery period from 7 to 5 years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business, the original use of which commences with the taxpayer and is placed in service after December 31, 2017.

The provision also repeals the required use of the 150-percent declining balance method for property used in a farming business (*i.e.*, for 3-, 5-, 7-, and 10-year property). The 150-percent declining balance method will continue to apply to any 15-year or 20-year property used in the farming business to which the straight line method does not apply, or to property for which the taxpayer elects the use of the 150-percent declining balance method.

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<sup>411</sup> As defined in section 263A(e)(4). See also Treas. Reg. sec. 1.263A-4(a)(4).

<sup>412</sup> Sec. 168(e)(3)(B)(vii).

<sup>413</sup> Sec. 168(b)(3)(A).

<sup>414</sup> Sec. 168(b)(3)(B).

<sup>415</sup> Sec. 168(b)(3)(E).

<sup>416</sup> Within the meaning of section 263A(e)(4). See also Treas. Reg. sec. 1.263A-4(a)(4).

<sup>417</sup> Sec. 168(b)(2)(B).

<sup>418</sup> Sec. 263A(d)(3) and (e)(2).

For these purposes, the term “farming business” means a farming business as defined in section 263A(e)(4). Thus, the term “farming business” means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity (e.g., the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals).<sup>419</sup> A farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products.<sup>420</sup> A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer.<sup>421</sup>

### **Effective Date**

The provision is effective for property placed in service after December 31, 2017, in taxable years ending after such date.

## **4. Applicable recovery period for real property (sec. 13204 of the bill and sec. 168 of the Code)**

### **Present Law**

#### **In general**

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.<sup>422</sup> Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.<sup>423</sup>

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<sup>419</sup> Treas. Reg. sec. 1.263A-4(a)(4)(i).

<sup>420</sup> Treas. Reg. sec. 1.263A-4(a)(4)(ii).

<sup>421</sup> Treas. Reg. sec. 1.263A-4(a)(4)(i).

<sup>422</sup> See secs. 263(a) and 167. However, where property is not used exclusively in a taxpayer’s business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, e.g., section 280A.

<sup>423</sup> Sec. 168.

### 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>424</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>425</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 yields 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. The straight line depreciation method is required for the aforementioned real property.

### Placed-in-service conventions

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention.<sup>426</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>427</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 to reflect the assumption that assets are placed

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<sup>424</sup> Exercising authority granted by Congress, the Secretary issued Rev. Proc. 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 Rev. Proc. 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary’s authority to modify the class lives of depreciable property. Rev. Proc. 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>425</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

<sup>426</sup> Treas. Reg. sec. 1.167(a)-10(b).

<sup>427</sup> Sec. 168(d)(2) and (d)(4)(B).



in service ratably throughout the year.<sup>428</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>429</sup> designed to prevent the recognition of disproportionately large amounts of first-year depreciation under the half-year convention.

#### Depreciation of additions or improvements to property

The recovery period for any addition or improvement to real or personal property begins on the later of (1) the date on which the addition or improvement is placed in service, or (2) the date on which the property with respect to which such addition or improvement is made is placed in service.<sup>430</sup> Any MACRS deduction for an addition or improvement to any property is to be computed in the same manner as the deduction for the underlying property would be if such property were placed in service at the same time as such addition or improvement. Thus, for example, the cost of an improvement to a building that constitutes nonresidential real property is recovered over 39 years using the straight line method and mid-month convention. Certain improvements to nonresidential real property are eligible for the additional first-year depreciation deduction if the other requirements of section 168(k) are met (*i.e.*, improvements that constitute “qualified improvement property”).<sup>431</sup>

#### Qualified improvement property

Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.<sup>432</sup> Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

#### Depreciation of leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.<sup>433</sup> This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an

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<sup>428</sup> Sec. 168(d)(1) and (d)(4)(A).

<sup>429</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. Sec. 168(d)(3) and (d)(4)(C).

<sup>430</sup> Sec. 168(i)(6).

<sup>431</sup> Sec. 168(k)(2)(A)(i)(IV) and (k)(3). See also section 13201 of the bill (Temporary 100-percent expensing for certain business assets).

<sup>432</sup> Sec. 168(k)(3).

<sup>433</sup> Sec. 168(i)(8).

addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions to the 39-year recovery period exist for certain qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property.

#### Qualified leasehold improvement property

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property. Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met.<sup>434</sup> The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. If a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified leasehold improvement property is generally recovered using the straight-line method and a half-year convention,<sup>435</sup> and is eligible for the additional first-year depreciation deduction if the other requirements of section 168(k) are met.<sup>436</sup>

#### Qualified restaurant property

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property. Qualified restaurant property is any section 1250 property that is a building or an improvement to a building, if more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals.<sup>437</sup> Qualified restaurant property is recovered using the straight-line method and a half-year convention.<sup>438</sup> Additionally, qualified restaurant property is not eligible for the additional first-

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<sup>434</sup> Sec. 168(e)(6).

<sup>435</sup> Sec. 168(b)(3)(G) and (d).

<sup>436</sup> Sec. 168(k)(2)(A)(i)(IV) and (k)(3). See section 13201 of the bill (Temporary 100-percent expensing for certain business assets).

<sup>437</sup> Sec. 168(e)(7).

<sup>438</sup> Sec. 168(b)(3)(H) and (d).

year depreciation deduction unless it also satisfies the definition of qualified improvement property.<sup>439</sup>

### Qualified retail improvement property

Section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period for qualified retail improvement property. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public<sup>440</sup> and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service.<sup>441</sup> Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.<sup>442</sup> In the case of an improvement made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.<sup>443</sup>

Retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores, and convenience stores. Establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. Generally, it is intended that businesses defined as a store retailer under the current North American Industry Classification System (industry sub-sectors 441 through 453) qualify while those in other industry classes do not qualify.<sup>444</sup>

Qualified retail improvement property is recovered using the straight-line method and a half-year convention,<sup>445</sup> and is eligible for the additional first-year depreciation deduction if the other requirements of section 168(k) are met.<sup>446</sup>

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<sup>439</sup> Sec. 168(e)(7)(B).

<sup>440</sup> Improvements to portions of a building not open to the general public (e.g., stock room in back of retail space) do not qualify under the provision.

<sup>441</sup> Sec. 168(e)(8).

<sup>442</sup> Sec. 168(e)(8)(C).

<sup>443</sup> Sec. 168(e)(8)(B). Rules similar to section 168(e)(6)(B) apply in the case of death and certain transfers of property that qualify for non-recognition treatment.

<sup>444</sup> Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110<sup>th</sup> Congress* (JCS-1-09), March 2009, p. 402.

<sup>445</sup> Sec. 168(b)(3)(I) and (d).

### Alternative depreciation system

The alternative depreciation system (“ADS”) is required to be used for tangible property used predominantly outside the United States, certain tax-exempt use property, tax-exempt bond financed property, and certain imported property covered by an Executive order.<sup>447</sup> An election to use ADS is available to taxpayers for any class of property for any taxable year.<sup>448</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>449</sup> For example nonresidential real and residential rental property have a 40-year ADS recovery period, while qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property have a 39-year ADS recovery period.<sup>450</sup>

### **Reasons for Change**

The Committee believes that shortening the recovery period for nonresidential real and residential rental property will promote capital investment in such real estate assets.

The Committee believes that taxpayers should not be required to recover the costs of certain building and leasehold improvements beyond the useful life of the investment. The 39-year and 15-year recovery periods for certain types of building and leasehold improvements extend beyond the useful life of many such investments. Additionally, the Committee believes that taxpayers should not be treated differently based on whether the building in which they operate is owned or leased. In the interests of simplicity and administrability, a uniform definition and period for the recovery of certain building improvements is desirable. Therefore, the provision provides a uniform definition and 10-year recovery period for qualified improvement property.

The Committee recognizes that certain types of trades or businesses have particular characteristics that warrant special rules related to interest deductibility and the related cost recovery of property used in such trades or businesses.

### **Explanation of Provision**

The provision shortens the recovery period for determining the depreciation deduction with respect to nonresidential real and residential rental property to 25 years. As a conforming

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<sup>446</sup> Sec. 168(k)(2)(A)(i)(IV) and (k)(3). See section 13301 of the bill (Temporary 100-percent expensing for certain business assets).

<sup>447</sup> Sec. 168(g).

<sup>448</sup> Sec. 168(g)(7).

<sup>449</sup> Sec. 168(g)(2) and (3).

<sup>450</sup> Sec. 168(g)(3).

amendment, the provision changes the statutory recovery period for nonresidential real and residential rental property to 25 years for purposes of determining whether a rental agreement is a long-term agreement under the section 467 rules applicable to certain payments for the use of property or services.<sup>451</sup> The provision also shortens the ADS recovery period for residential rental property from 40 years to 30 years.

The provision eliminates the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property, and provides a general 10-year recovery period for qualified improvement property,<sup>452</sup> and a 20-year ADS recovery period for such property. Thus, for example, qualified improvement property placed in service after December 31, 2017, is generally depreciable over 10 years using the straight line method and half-year convention, without regard to whether the improvements are property subject to a lease, placed in service more than three years after the date the building was first placed in service, or made to a restaurant building. Restaurant building property placed in service after December 31, 2017, that does not meet the definition of qualified improvement property is depreciable over 25 years as nonresidential real property, using the straight line method and the mid-month convention.

As a conforming amendment, the provision replaces the references in section 179(f) to qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property with a reference to qualified improvement property.<sup>453</sup> Thus, for example, the provision allows section 179 expensing for improvement property without regard to whether the improvements are property subject to a lease, placed in service more than three years after the date the building was first placed in service, or made to a restaurant building. Restaurant building property placed in service after December 31, 2017, that does not meet the definition of qualified improvement property is not eligible for section 179 expensing.

The provision also requires a real property trade or business<sup>454</sup> electing out of the limitation on the deduction for interest to use ADS to depreciate any of its nonresidential real property, residential rental property, and qualified improvement property.<sup>455</sup>

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<sup>451</sup> A long-term section 467 rental agreement is a lease of property for a term in excess of 75 percent of the property's statutory recovery period. Sec. 467(b)(4)(A) and (e)(3)(A). A disqualified long-term agreement is one that has as one of its principal purposes the avoidance of taxes. Sec. 467(b)(4)(B).

<sup>452</sup> Described in present law section 168(k)(3).

<sup>453</sup> For additional changes to section 179, see section 13101 of the bill (Modifications of rules for expensing depreciable business assets).

<sup>454</sup> As defined in section 13301 of the bill (Limitation on deduction for interest), by cross reference to section 469(c)(7)(C) (*i.e.*, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business). Note that a mortgage broker who is a broker of financial instruments is not in a real property trade or business for this purpose. See, *e.g.*, CCA 201504010 (December 17, 2014).

<sup>455</sup> The Committee intends that an election out of the interest limitation and resulting required use of ADS be treated as a change in use. See Treas. Reg. sec. 1.168(i)-4

## Effective Date

The provision is effective for property placed in service after December 31, 2017.

### **5. Use of alternative depreciation system for electing farming businesses (sec. 13205 of the bill and sec. 168 of the Code)**

#### Present Law

##### In general

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.<sup>456</sup> Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.<sup>457</sup>

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance.<sup>458</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>459</sup> switching to the straight line

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<sup>456</sup> See secs. 263(a) and 167. However, where property is not used exclusively in a taxpayer’s business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, e.g., section 280A.

<sup>457</sup> Sec. 168.

<sup>458</sup> Exercising authority granted by Congress, the Secretary issued Rev. Proc. 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 Rev. Proc. 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary’s authority to modify the class lives of depreciable property. Rev. Proc. 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>459</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

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 yields 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.<sup>460</sup> The straight line depreciation method is required for the aforementioned real property.

Property used in a farming business is assigned various recovery periods in the same manner as other business property. For example, depreciable assets used in agriculture activities that are assigned a recovery period of 7 years include machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agriculture, animal husbandry, and horticultural services.<sup>461</sup> Cotton ginning assets are also assigned a recovery period of 7 years.<sup>462</sup> Any single purpose agricultural or horticultural structure,<sup>463</sup> and any tree or vine bearing fruit or nuts are assigned a recovery period of 10 years.<sup>464</sup> Land improvements such as drainage facilities, paved lots, and water wells are assigned a recovery period of 15 years.<sup>465</sup>

A 5-year recovery period was assigned to new farm machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which was used in a farming business,<sup>466</sup> the original use of which commenced with the taxpayer after December 31, 2008, and which was placed in service before January 1, 2010.<sup>467</sup>

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<sup>460</sup> However, section 13204 of the bill (Applicable recovery period for real property) reduces the recovery period to 25 years for both nonresidential real property and residential rental property.

<sup>461</sup> Rev. Proc. 87-56, Asset class 01.1, Agriculture.

<sup>462</sup> Rev. Proc. 87-56, Asset class 01.11, Cotton ginning assets.

<sup>463</sup> Within the meaning of section 168(i)(13). See also Rev. Proc. 87-56, Asset class 01.4, Single purpose agricultural or horticultural structures. Farm buildings that do not meet the definition of a single purpose agricultural or horticultural structure are assigned a recovery period of 20 years. Rev. Proc. 87-56, Asset class 01.3, Farm buildings except structures included in asset class 01.4.

<sup>464</sup> Sec. 168(e)(3)(D)(i) and (ii).

<sup>465</sup> Rev. Proc. 87-56, Asset class 00.3, Land improvements. *See also*, IRS Publication 225, Farmer's Tax Guide (2017).

<sup>466</sup> As defined in section 263A(e)(4).

<sup>467</sup> Sec. 168(e)(3)(B)(vii). However, section 13203 of the bill (Modifications of treatment of certain farm property) also shortens the recovery period from 7 to 5 years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business, the original use of which commences with the taxpayer and is placed in service after December 31, 2017.

Any property (other than nonresidential real property,<sup>468</sup> residential rental property,<sup>469</sup> and trees or vines bearing fruits or nuts<sup>470</sup>) used in a farming business<sup>471</sup> is subject to the 150-percent declining balance method.<sup>472</sup>

### **Alternative depreciation system**

The alternative depreciation system (“ADS”) is required to be used for tangible property used predominantly outside the United States, certain tax-exempt use property, tax-exempt bond financed property, and certain imported property covered by an Executive order.<sup>473</sup> An election to use ADS is available to taxpayers for any class of property for any taxable year.<sup>474</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>475</sup> For example, any single purpose agricultural or horticultural structure has a 15-year ADS recovery period,<sup>476</sup> while any tree or vine bearing fruit or nuts has a 20-year ADS recovery period.<sup>477</sup> Similarly, land improvements such as drainage facilities, paved lots, and water wells have an ADS recovery period of 20 years.<sup>478</sup>

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<sup>468</sup> Sec. 168(b)(3)(A).

<sup>469</sup> Sec. 168(b)(3)(B).

<sup>470</sup> Sec. 168(b)(3)(E).

<sup>471</sup> Within the meaning of section 263A(e)(4).

<sup>472</sup> Sec. 168(b)(2)(B). However, section 13203 of the bill (Modifications of treatment of certain farm property) repeals the required use of the 150-percent declining balance method for property used in a farming business (*i.e.*, for 3-, 5-, 7-, and 10-year property). The 150-percent declining balance method will continue to apply to any 15-year or 20-year property used in the farming business to which the straight line method does not apply, or to property for which the taxpayer elects the use of the 150-percent declining balance method.

<sup>473</sup> Sec. 168(g).

<sup>474</sup> Sec. 168(g)(7).

<sup>475</sup> Sec. 168(g)(2) and (3).

<sup>476</sup> Sec. 168(g)(3)(B). Farm buildings that do not meet the definition of a single purpose agricultural or horticultural structure have an ADS recovery period of 25 years. Rev. Proc. 87-56, Asset class 01.3, Farm buildings except structures included in asset class 01.4.

<sup>477</sup> Sec. 168(g)(3)(B).

<sup>478</sup> Rev. Proc. 87-56, Asset class 00.3, Land improvements.



Under a special accounting rule, certain taxpayers engaged in the business of farming who elect to deduct preproductive period expenditures under the uniform capitalization rules are required to depreciate all farming assets using ADS.<sup>479</sup>

### **Reasons for Change**

The Committee recognizes that certain types of trades or businesses have particular characteristics that warrant special rules related to interest deductibility and the related cost recovery of property used in such trades or businesses.

### **Explanation of Provision**

The provision requires an electing farming business,<sup>480</sup> *i.e.*, a farming business electing out of the limitation on the deduction for interest,<sup>481</sup> to use ADS to depreciate any property with a recovery period of 10 years or more (*e.g.*, property such as single purpose agricultural or horticultural structures, trees or vines bearing fruit or nuts, farm buildings, and certain land improvements).<sup>482</sup>

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

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<sup>479</sup> Sec. 263A(d)(3) and (e)(2).

<sup>480</sup> As defined in section 13301 of the bill (Limitation on deduction for interest), by cross reference to section 263A(e)(4) (*i.e.*, farming business means the trade or business of farming and includes the trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots)). Treas. Reg. sec. 1.263A-4(a)(4) further defines a farming business as a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples of a farming business include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. A farming business also includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products. See Treas. Reg. sec. 1.263A-4(a)(4)(i) and (ii). A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer. See Treas. Reg. sec. 1.263A-4(a)(4)(i).

<sup>481</sup> See section 13301 of the bill (Limitation on deduction for interest). Section 13301 of the bill also includes an exception from the limitation on the deduction for interest for taxpayers meeting the \$15 million gross receipts test.

<sup>482</sup> The Committee intends that an election out of the interest limitation and resulting required use of ADS be treated as a change in use. See Treas. Reg. sec. 1.168(i)-4.

## 6. Amortization of research and experimental expenditures (sec. 13206 of the bill 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>483</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>484</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>485</sup> Taxpayers, alternatively, may elect to amortize their research expenditures over a period of 10 years.<sup>486</sup> Research and experimental expenditures deductible under section 174 are not subject to capitalization under either section 263(a)<sup>487</sup> or section 263A.<sup>488</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>489</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>490</sup> Uncertainty exists when information available to the taxpayer is not sufficient to ascertain the capability or method for developing, improving, and/or

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<sup>483</sup> Secs. 167 and 263(a).

<sup>484</sup> Secs. 174(a) and (e).

<sup>485</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>486</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>487</sup> Sec. 263(a)(1)(B).

<sup>488</sup> Sec. 263A(c)(2).

<sup>489</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. Treas. Reg. sec. 1.174-2(a)(11), Example 10, provides an example of new process development costs eligible for section 174 treatment.

<sup>490</sup> Treas. Reg. sec. 1.174-2(a)(1).

appropriately designing the product.<sup>491</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 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>492</sup> In addition, under administrative guidance, the costs of developing computer software have been accorded treatment similar to research expenditures.<sup>493</sup>

Research or experimental expenditures under section 174 do not include expenditures for quality control testing; efficiency surveys; management studies; consumer surveys; advertising or promotions; the acquisition of another's patent, model, production or process; or research in connection with literary, historical, or similar projects.<sup>494</sup> For purposes of section 174, quality control testing means testing to determine whether particular units of materials or products conform to specified parameters, but does not include testing to determine if the design of the product is appropriate.<sup>495</sup>

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>496</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>497</sup>

### **Reasons for Change**

The Committee recognizes that research and experimentation expenditures have a useful life beyond the tax year in which the expenditures are incurred, and that the tangible and intangible property created through research and experimentation activities provide value to a business beyond a single tax year. The Committee also acknowledges that the costs of

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<sup>491</sup> *Ibid.*

<sup>492</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>493</sup> Rev. Proc. 2000-50, 2000-2 C.B. 601.

<sup>494</sup> Treas. Reg. sec. 1.174-2(a)(6).

<sup>495</sup> Treas. Reg. sec. 1.174-2(a)(7).

<sup>496</sup> Sec. 174(c).

<sup>497</sup> Sec. 174(d). Special rules apply with respect to geological and geophysical costs (section 167(h)), qualified tertiary injectant expenses (section 193), intangible drilling costs (sections 263(c) and 291(b)), and mining exploration and development costs (sections 616 and 617).

developing software closely resemble the types of research and experimental expenditures that fall within the purview of section 174, and therefore should be accorded similar treatment. For these reasons, the Committee believes research expenditures, including software development costs, should be amortized over a period beyond the current year. Further, the Committee believes that research and experimentation expenditures that are attributable to research conducted outside of the United States should be amortized over a longer period so as to encourage research and experimental activities inside the United States.

### **Explanation of Provision**

Under the provision, amounts defined as specified research or experimental expenditures are required to be capitalized and amortized ratably 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>498</sup> are required to be capitalized and amortized ratably 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.

Specified research or experimental expenditures do not include expenditures for land or for depreciable or depletable property used in connection with the research or experimentation, but do include the depreciation and depletion allowances of such property. Also excluded are exploration expenditures incurred for ore or other minerals (including oil and gas).

In the case of retired, abandoned, or disposed property with respect to which specified research or experimental 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 application of this rule is treated as a change in the taxpayer's method of accounting for purposes of section 481, initiated by the taxpayer, and made with the consent of the Secretary. This rule is applied on a cutoff basis to research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2025 (hence there is no adjustment under section 481(a) for research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2026).

### **Effective Date**

The provision applies to amounts paid or incurred in taxable years beginning after December 31, 2025.

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<sup>498</sup> For this purpose, the term "United States" includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States.

## **7. Expensing of certain costs of replanting citrus plants lost by reason of casualty (sec. 13207 of the bill 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>499</sup> require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be either capitalized into the basis of such property or included in inventory, as applicable.<sup>500</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 either capitalized into the basis of such property or included in inventory, as applicable.

Section 263A generally requires the capitalization of the direct and indirect costs allocable to the production of any property in a farming business, including animals and plants without regard to the length of their preproductive period.<sup>501</sup> The costs of a plant generally required to be capitalized under section 263(a) include preparatory costs incurred so that the plant’s growing process may begin, such as the acquisition costs of the seed, seedling, or plant. Under section 263A, the costs of producing a plant generally required to be capitalized also include the preproductive period costs of planting, cultivating, maintaining, and developing the plant during the preproductive period.<sup>502</sup> Preproductive period costs may include management, irrigation, pruning, soil and water conservation, fertilizing, frost protection, spraying, harvesting, storage and handling, upkeep, electricity, tax depreciation and repairs on buildings and equipment used in raising the plants, farm overhead, taxes, and interest, as applicable.<sup>503</sup>

#### **Special rules for plant farmers**

Section 263A provides an exception to the general capitalization requirements for taxpayers who raise, harvest, or grow trees.<sup>504</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 any plant having a preproductive period of two years or less, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an

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<sup>499</sup> Sec. 803(a) of Pub. L. No. 99-514 (1986).

<sup>500</sup> Sec. 263A.

<sup>501</sup> Treas. Reg. sec. 1.263A-4(b)(1).

<sup>502</sup> Treas. Reg. sec. 1.263A-4(b)(1)(i).

<sup>503</sup> *Ibid.*

<sup>504</sup> Sec. 263A(c)(5).

accrual method of accounting under section 447 or 448(a)(3)).<sup>505</sup> Hence, in general, the UNICAP rules apply to the production of plants that have a preproductive period of more than two years, and to taxpayers required to use an accrual method of accounting.

Plant farmers otherwise required to capitalize preproductive period costs may elect to deduct such costs currently, provided the alternative depreciation system described in section 168(g)(2) is used on all farm assets and the preproductive period costs are recaptured upon disposition of the product.<sup>506</sup> The election is not available to taxpayers required to use the accrual method of accounting. Moreover, the election is not available with respect to certain costs attributable to planting, cultivating, maintaining, or developing citrus or almond groves.

Section 263A does not apply to costs incurred in replanting edible crops for human consumption following loss or damage due to freezing temperatures, disease, drought, pests, or casualty.<sup>507</sup> The same type of crop as the lost or damaged crop must be replanted. However, the exception to capitalization still applies if the replanting occurs on a parcel of land other than the land on which the damage occurred provided the acreage of the new land does not exceed that of the land to which the damage occurred and the new land is located in the United States. This exception may also apply to costs incurred by persons other than the taxpayer who incurred the loss or damage, provided (1) the taxpayer who incurred the loss or damage retains an equity interest of more than 50 percent in the property on which the loss or damage occurred at all times during the taxable year in which the replanting costs are paid or incurred, and (2) the person holding a minority equity interest and claiming the deduction materially participates in the planting, maintenance, cultivation, or development of the property during the taxable year in which the replanting costs are paid or incurred.<sup>508</sup>

### **Reasons for Change**

The Committee believes the special rule for farmers under the UNICAP rules should be expanded temporarily to apply to costs incurred by persons other than the taxpayer in connection with replanting citrus plants following a casualty. This change will encourage investment necessary to replace diseased citrus trees and ensure the continuity of citrus crops in the United States.

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<sup>505</sup> Sec. 263A(d).

<sup>506</sup> Sec. 263A(d)(3), (e)(1), and (e)(2).

<sup>507</sup> Sec. 263A(d)(2). Such replanting costs generally include costs attributable to the replanting, cultivating, maintaining, and developing of the plants that were lost or damaged that are incurred during the preproductive period. Treas. Reg. sec. 1.263A-4(e)(1). The acquisition costs of the replacement trees or seedlings must still be capitalized under section 263(a) (see, e.g., T.D. 8897, 65 FR 50638, Treas. Reg. sec. 1.263A-4(e)(3), Examples 1 - 3, and TAM 9547002 (July 18, 1995)), potentially subject to the special bonus depreciation deduction in the year of planting under section 168(k)(5).

<sup>508</sup> Sec. 263A(d)(2)(B). Material participation for this purpose is determined in a similar manner as under section 2032A(e)(6) (relating to qualified use valuation of farm property upon death of the taxpayer).

### **Explanation of Provision**

The provision modifies the special rule for costs incurred by persons other than the taxpayer in connection with replanting an edible crop for human consumption following loss or damage due to casualty. Under the provision, with respect to replanting costs paid or incurred after the date of enactment, but no later than a date which is ten years after such date of enactment, for citrus plants lost or damaged due to casualty, such replanting costs may also be deducted by a person other than the taxpayer if (1) the taxpayer has an equity interest of not less than 50 percent in the replanted citrus plants at all times during the taxable year in which the replanting costs are paid or incurred and such other person holds any part of the remaining equity interest, or (2) such other person acquires all of the taxpayer's equity interest in the land on which the lost or damaged citrus plants were located at the time of such loss or damage, and the replanting is on such land.

### **Effective Date**

The provision is effective for costs paid or incurred after the date of enactment.

## **8. Certain special rules for taxable year of inclusion (sec. 13221 of the bill 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>509</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>510</sup>

In general, for a cash basis taxpayer, an amount is included in income when actually or constructively received. For an accrual basis taxpayer, an amount is included in income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (*i.e.*, when the "all events test" is met), unless an exception permits deferral or exclusion.<sup>511</sup>

A number of exceptions that exist to permit deferral of income relate to advance payments. An advance payment is when a taxpayer receives payment before the taxpayer provides goods or services to its customer. The exceptions often allow tax deferral to mirror

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<sup>509</sup> Sec. 451(a).

<sup>510</sup> See Treas. Reg. sec. 1.451-2.

<sup>511</sup> See Treas. Reg. secs. 1.446-1(c)(1)(ii) and 1.451-1(a).

financial accounting deferral (*e.g.*, income is recognized as the goods are provided or the services are performed).<sup>512</sup>

### **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>513</sup>

### **Original issue discount**

The holder of a debt instrument with original issue discount (“OID”) generally accrues and includes the OID in gross income as interest over the term of the instrument, regardless of when the stated interest (if any) is paid.<sup>514</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>515</sup> The stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments.<sup>516</sup> The holder includes in gross income an amount equal to the sum of the daily portions of the OID for each day during the taxable year the holder held such debt instrument. The daily portion is determined by allocating to each day in any accrual period its ratable portion of the increase during such accrual period in the adjusted issue price of the debt instrument.<sup>517</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, to compute the amount of OID and the portion of OID allocable to a period, the stated redemption price at maturity and the term 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>518</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. If a borrower can reduce the yield on a debt by

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<sup>512</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>513</sup> Secs. 61(a)(4) and 451.

<sup>514</sup> Sec. 1272.

<sup>515</sup> Sec. 1273(a)(1).

<sup>516</sup> Sec. 1273(a)(2) and Treas. Reg. sec. 1.1273-1(b).

<sup>517</sup> Sec. 1272(a)(1) and (3).

<sup>518</sup> Sec. 163(e).



exercising a prepayment option, the OID rules assume that the borrower will prepay the debt.<sup>519</sup> In addition, in the case of (1) any regular interest in a real estate mortgage investment conduit (“REMIC”) or qualified mortgages held by a REMIC or (2) 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 determined by taking into account an assumption regarding the prepayment of principal for such instruments.<sup>520</sup>

The Taxpayer Relief Act of 1997<sup>521</sup> extended these rules to any pool of debt instruments the payments on which may be accelerated by reason of prepayments.<sup>522</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>523</sup> cash-advance fees,<sup>524</sup> and interchange fees,<sup>525</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>526</sup>

### **Reasons for Change**

The Committee believes that with respect to the recognition of income under the accrual method of accounting, book-tax conformity may promote simplification and reduced compliance costs. In addition, the Committee believes that such conformity will create a healthy tension between a taxpayer’s desire to have high book income and its desire to have low taxable income. Thus, the Committee believes that it is appropriate to generally require certain accrual method taxpayers to recognize items of income no later than when recognized in an applicable financial statement. The Committee also believes that it is not always appropriate to defer the recognition of income over a lengthy period of time, regardless of when such income was received. Thus, the Committee believes it is appropriate to apply the book-tax conformity income recognition provision before the original issue discount rules.

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<sup>519</sup> Treas. Reg. sec. 1.1272-1(c)(5).

<sup>520</sup> Sec. 1272(a)(6).

<sup>521</sup> Pub. L. No. 105-34, sec. 1004(a).

<sup>522</sup> Sec. 1272(a)(6)(C)(iii).

<sup>523</sup> Rev. Proc. 2004-33, 2004-1 C.B. 989.

<sup>524</sup> Rev. Proc. 2005-47, 2005-2 C.B. 269.

<sup>525</sup> *Capital One Financial Corp. and Subsidiaries v. Commissioner*, 133 T.C. No. 8 (2009); IRS Chief Counsel Notice CC-2010-018, September 27, 2010.

<sup>526</sup> See also Rev. Proc. 2013-26, 2013-22 I.R.B. 1160, for a safe harbor method of accounting for OID on a pool of credit card receivables for purposes of section 1272(a)(6).

The Committee believes it is important to reconcile the Federal income tax and financial accounting treatment of advance payments received by accrual method taxpayers for goods, services and other items identified by the Secretary, that are properly includible in gross income without permitting extended deferral of the inclusion of those payments in gross income for Federal income tax purposes. Such reconciliation will facilitate reporting and verification of such items by both the taxpayers affected and the IRS. The Committee also believes that it is appropriate to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income for Federal income tax purposes of payments received (or amounts due and payable) in one taxable year for goods, services, and other specified items to be provided by the end of the next succeeding taxable year. In the interest of reducing controversy and providing a limited deferral of advance payments that are otherwise properly includible in income, the Committee believes that it is appropriate to codify the current deferral method of accounting for advance payments provided by the IRS under Rev. Proc. 2004-34.

### **Explanation of Provision**

The provision revises the rules associated with the recognition of income. Specifically, the provision requires an accrual method taxpayer subject to the all events test for an item of gross income to recognize such income no later than the taxable year in which such income is taken into account as income on an applicable financial statement<sup>527</sup> or another financial statement under rules specified by the Secretary, but provides an exception for taxpayers without an applicable or other specified financial statement.<sup>528</sup> In the case of a contract which contains

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<sup>527</sup> For purposes of the provision, the term “applicable financial statement” means: (A) a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is (i) a 10-K (or successor form), or annual statement to shareholders, required to be filed by the taxpayer with the United States Securities and Exchange Commission (“SEC”), (ii) an audited financial statement of the taxpayer which is used for (I) credit purposes, (II) reporting to shareholders, partners, or other proprietors, or to beneficiaries, or (III) any other substantial nontax purpose, but only if there is no statement of the taxpayer described in clause (i), or (iii) filed by the taxpayer with any other Federal agency for purposes other than Federal tax purposes, but only if there is no statement of the taxpayer described in clause (i) or (ii); (B) a financial statement which is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government which is equivalent to the SEC and which has reporting standards not less stringent than the standards required by such Commission, but only if there is no statement of the taxpayer described in subparagraph (A); or (C) a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Secretary, but only if there is no statement of the taxpayer described in subparagraph (A) or (B).

<sup>528</sup> The Committee intends that the provision apply to items of gross income for which the timing of income inclusion is determined using the all events test under present law. Under the provision, an accrual method taxpayer with an applicable financial statement will include an item in income under section 451 upon the earlier of when the all events test is met or when the taxpayer includes such item in revenue in an applicable financial statement. For example, under the provision, any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes. However, accrual method taxpayers without an applicable or other specified financial statement will continue to determine income inclusion under the all events test, unless an exception permits deferral or exclusion. See sec. 451(a) and Treas. Reg. sec. 1.451-1(a). The Committee intends that the financial statement conformity requirement added to section 451 not be construed as preventing the use of special methods of accounting provided elsewhere in the Code, other than part V of subchapter P (special rules for bonds and other debt instruments). For example, it does not preclude the use of the installment method under section 453 or the use of long-term contract methods under section 460. See Treas. Reg. sec. 1.446-1(c)(1)(iii).

multiple performance obligations, the provision allows the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement.

In addition, the provision directs accrual method taxpayers with an applicable financial statement to apply the revenue recognition rules under section 451 before applying the special rules under part V of subchapter P, which, in addition to the OID rules, also includes rules regarding the treatment of market discount on bonds, discounts on short-term obligations, OID on tax-exempt bonds, and stripped bonds and stripped coupons.<sup>529</sup> 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, or interchange fees), such amounts generally are includable in income at such time in accordance with the general recognition principles under section 451.

The provision also codifies the current deferral method of accounting for advance payments for goods, services, and other specified items provided by the IRS under Revenue Procedure 2004-34.<sup>530</sup> That is, the provision allows accrual method taxpayers to elect<sup>531</sup> 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>532</sup> In the case of advance payments received for a combination of services, goods, and/or other specified items, the provision allows the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement. The provision requires the inclusion in gross income of a deferred advance payment if the taxpayer ceases to exist.

In the case of any taxpayer required by this provision to change its method of accounting for its first taxable year beginning after December 31, 2017, such change is treated as initiated by the taxpayer and made with the consent of the Secretary.

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017, and application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

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<sup>529</sup> Secs. 1271 – 1288.

<sup>530</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>531</sup> The election shall be made at such time, in such form and manner, and with respect to such categories of advance payments as the Secretary may provide. For these purposes, the recognition of income under such election is treated as a method of accounting.

<sup>532</sup> Thus, the provision is intended to override the deferral method provided by Treasury Regulation section 1.451-5 for advance payments received for goods.

## **PART IV – BUSINESS-RELATED EXCLUSIONS AND DEDUCTIONS**

### **1. Limitation on deduction for interest (sec. 13301 of the bill and sec. 163 of the Code)**

#### **Present Law**

##### **Interest deduction**

Interest paid or accrued by a business generally is deductible in the computation of taxable income subject to a number of limitations.<sup>533</sup>

Interest is generally deducted by a taxpayer as it is paid or accrued, depending on the taxpayer's method of accounting. For all taxpayers, if an obligation is issued with original issue discount ("OID"), a deduction for interest is allowable over the life of the obligation on a yield to maturity basis.<sup>534</sup> Generally, OID arises where interest on a debt instrument is not calculated based on a qualified rate and required to be paid at least annually.

##### **Investment interest expense**

In the case of a taxpayer other than a corporation, the deduction for interest on indebtedness that is allocable to property held for investment ("investment interest") is limited to the taxpayer's net investment income for the taxable year.<sup>535</sup> Disallowed investment interest is carried forward to the next taxable year.

Net investment income is investment income net of investment expenses. Investment income generally consists of gross income from property held for investment, and investment expense includes all deductions directly connected with the production of investment income (*e.g.*, deductions for investment management fees) other than deductions for interest.

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>536</sup> Miscellaneous itemized

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<sup>533</sup> Sec. 163(a). In addition to the limitations discussed herein, other limitations include: denial of the deduction for the disqualified portion of the original issue discount on an applicable high yield discount obligation (sec. 163(e)(5)), denial of deduction for interest on certain obligations not in registered form (sec. 163(f)), reduction of the deduction for interest on indebtedness with respect to which a mortgage credit certificate has been issued under section 25 (sec. 163(g)), disallowance of deduction for personal interest (sec. 163(h)), disallowance of deduction for interest on debt with respect to certain life insurance contracts (sec. 264), and disallowance of deduction for interest relating to tax-exempt income (sec. 265). Interest may also be subject to capitalization. See, *e.g.*, sections 263A(f) and 461(g).

<sup>534</sup> Sec. 163(e). But see section 267 (dealing in part with interest paid to a related or foreign party).

<sup>535</sup> Sec. 163(d).

<sup>536</sup> Sec. 67(a).

deductions<sup>537</sup> that are not investment expenses are disallowed first before any investment expenses are disallowed.<sup>538</sup>

### **Earnings stripping**

Section 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1.0 (the 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, domestic production activities under section 199, depreciation, amortization, and depletion). Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest;<sup>539</sup> (2) unrelated parties in certain instances in which a related party guarantees the debt; or (3) to a real estate investment trust ("REIT") by a taxable REIT subsidiary of that trust.<sup>540</sup> Interest amounts disallowed under these rules can be carried forward indefinitely.<sup>541</sup> 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.<sup>542</sup>

### **Reasons for Change**

The Committee believes that the general deductibility of interest payments on debt may result in businesses undertaking more leverage than they would in the absence of the tax system. The effective marginal tax rate on debt-financed investment is lower than that on equity-financed investment.<sup>543</sup> Limiting the deductibility of interest along with reducing the corporate tax rate narrows the disparity in the effective marginal tax rates applicable to different sources of

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<sup>537</sup> Miscellaneous itemized deductions include itemized deductions of individuals other than certain specific itemized deductions. Sec. 67(b). 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>538</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.").

<sup>539</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 by the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

<sup>540</sup> Sec. 163(j)(3).

<sup>541</sup> Sec. 163(j)(1)(B).

<sup>542</sup> Sec. 163(j)(2)(B)(ii).

<sup>543</sup> For a discussion of effective marginal tax rates on investment, see Joint Committee on Taxation, *Economic Growth and Tax Policy* (JCX-19-17), May 16, 2017, p. 15ff.

financing. This leads to a more efficient capital structure for firms. The Committee believes that it is necessary to apply the limitation on the deductibility of interest to businesses regardless of the form in which such businesses are organized so as not to create distortions in the choice of entity.

The Committee believes that limitations on the deductibility of interest should be applied to those businesses with the greatest levels of leverage. Such firms may pose the greatest societal costs in times of financial distress. Smaller firms are likely to impose smaller costs on the economy than larger firms. Additionally, smaller firms have limited access to public equity capital markets as compared to larger firms. Thus, the Committee believes it is appropriate to limit the interest deduction of only the largest taxpayers.

The Committee understands that some taxpayers who do not consistently incur excessive amounts of leverage may nonetheless at times incur an amount of interest expense that is large in relation to its taxable income. For instance, a bad year in a business cycle might reduce taxable income to the point where a limitation based on taxable income takes effect. Furthermore, earnings attributable to investments financed by debt and interest payments associated with such debt may arise in different periods. For that reason, the Committee believes taxpayers should be able to average annual results, and so believes the carryforward of denied interest deductions is appropriate.

Finally, the Committee recognizes that certain types of trades or businesses have particular characteristics that warrant special rules related to interest deductibility.

### **Explanation of Provision**

#### **In general**

In the case of any taxpayer for any taxable year, the deduction for business interest is limited to the sum of business interest income plus 30 percent of the adjusted taxable income of the taxpayer for the taxable year. The amount of any interest not allowed as a deduction for any taxable year may be carried forward indefinitely. The limitation applies at the taxpayer level. In the case of a group of affiliated corporations that file a consolidated return, it applies at the consolidated tax return filing level.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for purposes of the Internal Revenue Code is interest for purposes of the provision. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Business interest does not include investment interest, and business interest income does not include investment income, within the meaning of section 163(d).

By including business interest income in the limitation, the rule operates to limit the deduction for net interest expense to 30 percent of adjusted taxable income. That is, a deduction for business interest is permitted to the full extent of business interest income. To the extent that business interest exceeds business interest income, the deduction for the net interest expense is limited to 30 percent of adjusted taxable income.

Adjusted taxable income means the taxable income of the taxpayer computed without regard to: (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the deduction under section 199 for income attributable to domestic production activities;<sup>544</sup> (4) the 17.4 percent deduction for certain pass-through income;<sup>545</sup> and (5) the amount of any net operating loss deduction. The Secretary may provide other adjustments to the computation of adjusted taxable income.

### **Carryforward of disallowed business interest**

The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Business interest may be carried forward indefinitely. It is intended that the provision be administered in a way to prevent trafficking in carryforwards. With respect to the limitation on deduction of interest by domestic corporations which are United States shareholders that are members of worldwide affiliated groups with excess domestic indebtedness,<sup>546</sup> whichever rule imposes the lower limitation on the deduction of interest with respect to the taxable year (and therefore the greatest amount of interest to be carried forward) governs.

Any carryforward of disallowed interest is an item taken into account in the case of certain corporate acquisitions described in section 381 and is subject to limitation under section 382.

### **Application to pass-through entities**

#### **In general**

In the case of any partnership, the limitation is applied at the partnership level. Any deduction for business interest is taken into account in determining the nonseparately stated taxable income or loss of the partnership.<sup>547</sup> To prevent double counting, special rules are provided for the determination of the adjusted taxable income of each partner of the partnership. Similarly, to allow for additional interest deduction by a partner in the case of an excess amount of unused adjusted taxable income limitation of the partnership, special rules apply. Similar rules apply with respect to any S corporation and its shareholders.

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<sup>544</sup> The deduction for income attributable to domestic production activities is repealed effective for taxable years beginning after December 31, 2018. *See* section 13305 of the bill (Repeal of deduction for income attributable to domestic production activities).

<sup>545</sup> *See* section 11011 of the bill (Deduction for qualified business income).

<sup>546</sup> *See* section 14221 of the bill (Denial of deduction for interest expense of United States shareholders which are members of worldwide affiliated groups with excess domestic indebtedness).

<sup>547</sup> This amount is the “Ordinary business income or loss” reflected on Form 1065 (U.S. Return of Partnership Income). The partner’s distributive share is reflected in Box 1 of Schedule K-1 (Form 1065).

Special rules for partners and partnerships also apply in the case of a carryforward of disallowed business interest. These rules (described below) require that the carryforward be allocated to partners (rather than remaining an attribute of the partnership) and that a partner's basis is reduced in respect of such a carryforward allocation. These rules do not apply in the case of an S corporation.

#### Double counting rule

The adjusted taxable income of each partner (or shareholder, as the case may be) is determined without regard to such partner's distributive share of the nonseparately stated income or loss of such partnership. In the absence of such a rule, the same dollars of adjusted taxable income of a partnership could generate additional interest deductions as the income is passed through to the partners.

Example 1.—ABC is a partnership owned 50-50 by XYZ Corporation and an individual. ABC generates \$200 of noninterest income. Its only expense is \$60 of business interest. Under the provision the deduction for business interest is limited to 30 percent of adjusted taxable income, that is, 30 percent \* \$200 = \$60. ABC deducts \$60 of business interest and reports ordinary business income of \$140. XYZ's distributive share of the ordinary business income of ABC is \$70. XYZ has net taxable income of zero from its other operations, none of which is attributable to interest income and without regard to its business interest expense. XYZ has business interest expense of \$25. In the absence of a double counting rule, the \$70 of taxable income from XYZ's distributive share of ABC's income would permit XYZ to deduct up to an additional \$21 of interest (30 percent \* \$70 = \$21), and XYZ's \$100 share of ABC's adjusted taxable income would generate \$51 of interest deductions, well in excess of the intended 30% limitation. If XYZ were a pass-through entity rather than a corporation, additional deductions might be available to its partners as well, and so on.

The double counting rule prevents this result by providing that XYZ has adjusted taxable income computed without regard to the \$70 distributive share of the nonseparately stated income of ABC. As a result it has adjusted taxable income of \$0. XYZ's deduction for business interest is limited to 30 percent \* \$0 = \$0, resulting in a deduction disallowance of \$25.

#### Additional deduction limit

The limit on the amount allowed as a deduction for business interest is increased by a partner's distributive share of the partnership's excess taxable income. The excess taxable income with respect to any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30 percent of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership exceeds the business interest income of the partnership bears to 30 percent of the adjusted taxable income of the partnership. This allows a partner of a partnership to deduct additional interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest. The provision requires that excess taxable income be allocated in the same manner as nonseparately stated income and loss.



Example 2.—The facts are the same as in Example 1 except ABC has only \$40 of business interest. As in Example 1, ABC has a limit on its interest deduction of \$60. The excess of this limit over the business interest of the partnership is  $\$60 - \$40 = \$20$ . The excess taxable income for ABC is  $\$20 / \$60 * \$200 = \$66.67$ . XYZ's distributive share of the excess taxable income from ABC partnership is \$33.33. XYZ's deduction for business interest is limited to 30 percent of the sum of its adjusted taxable income plus its distributive share of the excess taxable income from ABC partnership (30 percent \*  $(\$0 + \$33.33) = \$10$ ). As a result of the rule, XYZ may deduct \$10 of business interest and has an interest deduction disallowance of \$15.

#### Special carryforward rule for partnerships

In the case of an S corporation, the general carryforward rule applies. In the case of a partnership, the general carryforward rule described above does not apply. Instead, any business interest that is not allowed as a deduction to the partnership for the taxable year is allocated to each partner in the same manner as nonseparately stated taxable income or loss of the partnership. The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership the activities of which gave rise to the excess business interest carryforward. Any such deduction requires a corresponding reduction in excess taxable income. Additionally, when excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest. In the event the partner disposes of a partnership interest the basis of which has been so reduced, the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of excess interest expense that has been treated as paid by the partner (*i.e.*, excess interest expense that has been deducted by the partner against excess taxable income of the same partnership).

#### Exceptions

The limitation does not apply to any taxpayer that meets the \$15 million gross receipts test of section 448(c), that is, if the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed \$15 million.<sup>548</sup>

The trade or business of performing services as an employee is not treated as a trade or business for purposes of the limitation. As a result, for example, the wages of an employee are not counted in the adjusted taxable income of the taxpayer for purposes of determining the limitation.

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<sup>548</sup> See section 13102 of the bill (Modifications of gross receipts test for use of cash method of accounting by corporations and partnerships). In the case of a sole proprietorship, the \$15 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership.

The limitation also does not apply to certain regulated public utilities or electric cooperatives. Specifically, the trade or business of the furnishing<sup>549</sup> or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative, is not treated as a trade or business for purposes of the limitation.

At the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.<sup>550</sup> Similarly, at the taxpayer's election, any farming business<sup>551</sup> is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trade or business.

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017.

## **2. Modification of net operating loss deduction (sec. 13302 of the bill and sec. 172 of the Code)**

### **Present Law**

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<sup>549</sup> The term "furnishing" includes generation, transmission, and distribution activities.

<sup>550</sup> It is intended that any such real property trade or business, including such a trade or business conducted by a corporation or real estate investment trust, be included. Because this description of a real property trade or business refers only to the section 469(c)(7)(C) description, and not to other rules of section 469 (such as the rule of section 469(c)(2) that passive activities include rental activities or the rule of section 469(a) that a passive activity loss is limited under section 469), the other rules of section 469 are not made applicable by this reference. It is further intended that a real property operation or a real property management trade or business includes the operation or management of a lodging facility.

<sup>551</sup> As defined in section 263A(e)(4) (*i.e.*, farming business means the trade or business of farming and includes the trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots)). Treas. Reg. sec. 1.263A-4(a)(4) further defines a farming business as a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples of a farming business include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. A farming business also includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products. See Treas. Reg. sec. 1.263A-4(a)(4)(i) and (ii). A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer. See Treas. Reg. sec. 1.263A-4(a)(4)(i).

A net operating loss (“NOL”) generally means the amount by which a taxpayer’s business deductions exceed its gross income.<sup>552</sup> In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years.<sup>553</sup> NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.<sup>554</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 certain casualty and disaster losses.<sup>555</sup> Limitations are placed on the carryback of excess interest losses attributable to corporate equity reduction transactions.<sup>556</sup>

### **Reasons for Change**

The Committee believes that, except in limited circumstances of disaster losses for farms, NOLs should be carried forward, but not back. The Committee also believes that taxpayers should pay some income tax in years in which the taxpayer has taxable income (determined without regard to the NOL deduction). Therefore, the Committee believes that the NOL deduction should be limited to a certain percentage of taxable income (determined without regard to the deduction).

### **Explanation of Provision**

The provision generally limits the NOL deduction to 90 percent of taxable income (determined without regard to the deduction) and to 80 percent of taxable income (determined without regard to the deduction) in taxable years beginning after December 31, 2022. Carryovers to other years are adjusted to take account of this limitation, and may be carried forward indefinitely.

The provision repeals the two-year carryback and the special carryback provisions, but provides a two-year carryback in the case of certain losses incurred in the trade or business of farming.

The provision adds a special rule for the NOLs of property and casualty insurance companies, which may be carried back two years and carried over 20 years to offset 100 percent of taxable income in such years.

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<sup>552</sup> Sec. 172(c).

<sup>553</sup> Sec. 172(b)(1)(A).

<sup>554</sup> Sec. 172(b)(2).

<sup>555</sup> Sec. 172(b)(1)(C) and (E).

<sup>556</sup> Sec. 172(b)(1)(D).

### Effective Date

The provision allowing indefinite carryovers and modifying carrybacks applies to losses arising in taxable years beginning after December 31, 2017.

The provision limiting the NOL deduction applies to losses arising in taxable years beginning after December 31, 2017.

### **3. Like-kind exchanges of real property (sec. 13303 of the bill 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 business or for investment.<sup>557</sup> In general, section 1031 does not apply to any exchange of stock in trade (*i.e.*, inventory) 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>558</sup> Section 1031 also does not apply to certain exchanges involving livestock<sup>559</sup> or foreign property.<sup>560</sup>

For purposes of section 1031, the determination of whether property is of a “like kind” relates to the nature or character of the property and not its grade or quality, *i.e.*, the nonrecognition rules do not apply to an exchange of one class or kind of property for property of a different class or kind (*e.g.*, section 1031 does not apply to an exchange of real property for personal property).<sup>561</sup> The different classes of property are: (1) depreciable tangible personal property,<sup>562</sup> (2) intangible or nondepreciable personal property,<sup>563</sup> and (3) real property.<sup>564</sup>

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<sup>557</sup> Sec. 1031(a)(1).

<sup>558</sup> Sec. 1031(a)(2). A chose in action is a right that can be enforced by legal action.

<sup>559</sup> Sec. 1031(e).

<sup>560</sup> Sec. 1031(h).

<sup>561</sup> Treas. Reg. sec. 1.1031(a)-1(b).

<sup>562</sup> For example, an exchange of a personal computer classified under asset class 00.12 of Rev. Proc. 87-56, 1987-2 C.B. 674, for a printer classified under the same asset class of Rev. Proc. 87-56 would be treated as property of a like kind. However, an exchange of an airplane classified under asset class 00.21 of Rev. Proc. 87-56 for a heavy general purpose truck classified under asset class 00.242 of Rev. Proc. 87-56 would not be treated as property of a like kind. See Treas. Reg. sec. 1.1031(a)-2(b)(7).

<sup>563</sup> For example, an exchange of a copyright on a novel for a copyright on a different novel would be treated as property of a like kind. See Treas. Reg. sec. 1.1031(a)-2(c)(3). However, the goodwill or going concern value of one business is not of a like kind to the goodwill or going concern value of a different business. See Treas. Reg. sec. 1.1031(a)-2(c)(2). The Internal Revenue Service (“IRS”) has ruled that intangible assets such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued

However, the rules with respect to whether real estate is “like kind” are applied more liberally than the rules governing like-kind exchanges of depreciable, intangible, or nondepreciable personal property. For example, improved real estate and unimproved real estate generally are considered to be property of a “like kind” as this distinction relates to the grade or quality of the real estate,<sup>565</sup> while depreciable tangible personal properties must be either within the same General Asset Class<sup>566</sup> or within the same Product Class.<sup>567</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 non-qualifying property or money (“additional consideration”), then the gain to the recipient of the other property or money is required to be recognized, but not in an amount exceeding the fair market value of such other property or money.<sup>568</sup> Additionally, any such gain realized on a section 1031 exchange as a result of additional consideration being involved

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apart from goodwill qualify as property of a like kind under section 1031. See Chief Counsel Advice 200911006, February 12, 2009.

<sup>564</sup> Treas. Reg. sec. 1.1031(a)-1(b) and (c).

<sup>565</sup> Treas. Reg. sec. 1.1031(a)-1(b).

<sup>566</sup> Treasury Regulation section 1.1031(a)-2(b)(2) provides the following list of General Asset Classes, based on asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674: (i) Office furniture, fixtures, and equipment (asset class 00.11), (ii) Information systems (computers and peripheral equipment) (asset class 00.12), (iii) Data handling equipment, except computers (asset class 00.13), (iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21), (v) Automobiles, taxis (asset class 00.22), (vi) Buses (asset class 00.23), (vii) Light general purpose trucks (asset class 00.241), (viii) Heavy general purpose trucks (asset class 00.242), (ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25), (x) Tractor units for use over-the-road (asset class 00.26), (xi) Trailers and trailer-mounted containers (asset class 00.27), (xii) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and (xiii) Industrial steam and electric generation and/or distribution systems (asset class 00.4).

<sup>567</sup> Property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System (“NAICS”), set forth in Executive Office of the President, Office of Management and Budget, *North American Industry Classification System*, United States, 2002 (NAICS Manual), as periodically updated. Treas. Reg. sec. 1.1031(a)-2(b)(3).

<sup>568</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.

constitutes ordinary income to the extent that the gain is subject to the recapture provisions of sections 1245 and 1250.<sup>569</sup> No losses may be recognized from a like-kind exchange.<sup>570</sup>

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred. This basis is increased to the extent of any gain recognized as a result of 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>571</sup> The holding 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>572</sup>

A like-kind exchange also does not require that the properties be exchanged simultaneously. Rather, 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). 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.<sup>573</sup>

The Treasury Department has issued regulations<sup>574</sup> and revenue procedures<sup>575</sup> providing guidance and safe harbors for taxpayers engaging in deferred like-kind exchanges.

### **Reasons for Change**

The definition of like-kind property has been modified legislatively over the years to address issues relating to targeted types of property. With the provisions in the bill of increased and expanded expensing under sections 168(k) and 179 for tangible personal property and

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<sup>569</sup> Secs. 1245(b)(4) and 1250(d)(4). For example, if a taxpayer holding section 1245 property A with an original cost basis of \$11,000, an adjusted basis of \$10,000, and a fair market value of \$15,000 exchanges the property for section 1245 property B with a fair market value of \$14,000 plus \$1,000 in cash, the taxpayer would recognize \$1,000 of ordinary income on the transaction. The remaining \$4,000 of gain would be deferred until the taxpayer disposes of section 1245 property B in a taxable sale or exchange.

<sup>570</sup> Sec. 1031(c).

<sup>571</sup> Sec. 1031(d). Thus, in the example in footnote 567, the taxpayer's basis in land B would be \$40,000 (the taxpayer's basis in land A of \$40,000, increased by \$10,000 in gain recognized, and decreased by \$10,000 in money received).

<sup>572</sup> Sec. 1223(1).

<sup>573</sup> Sec. 1031(a)(3).

<sup>574</sup> Treas. Reg. sec. 1.1031(k)-1(a) through (o).

<sup>575</sup> See Rev. Proc. 2000-37, 2000-40 I.R.B. 308, as modified by Rev. Proc. 2004-51, 2004-33 I.R.B. 294.

certain building improvements,<sup>576</sup> the Committee believes that section 1031 should be limited to exchanges of real property not held primarily for sale.

### **Explanation of Provision**

The provision modifies the provision providing for nonrecognition of gain in the case of like-kind exchanges by limiting its application to real property that is not held primarily for sale.

A special rule treats shares in a mutual ditch, reservoir, or irrigation company as real property if at the time of the exchange (1) the mutual ditch, reservoir, or irrigation company is an organization described in section 501(c)(12)(A) (determined without regard to the percentage of its income that is collected from its members for the purpose of meeting losses and expenses) and (2) such shares have been recognized by the highest court of the State in which such company was organized or by applicable State statute as constituting or representing real property or an interest in real property.

### **Effective Date**

The provision generally applies to exchanges completed after December 31, 2017. However, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or the property received by the taxpayer in the exchange is received on or before such date.

## **4. Limitation on deduction by employers of expenses for fringe benefits (sec. 13304 of the bill and sec. 274 of the Code)**

### **Present Law**

#### **In general**

No deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement, or recreation (“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>577</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.<sup>578</sup> Similarly, a deduction for any expense for food or beverages generally is limited to 50 percent of the amount otherwise deductible.<sup>579</sup> In

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<sup>576</sup> See sections 13201 (Temporary 100-percent expensing for certain business assets) and 13101 (Modifications of rules for expensing depreciable business assets) of the bill.

<sup>577</sup> Sec. 274(a)(1).

<sup>578</sup> Sec. 274(n)(1)(B).

<sup>579</sup> Sec. 274(n)(1)(A).

addition, no deduction is allowed for membership dues with respect to any club organized for business, pleasure, recreation, or other social purpose.<sup>580</sup>

There are a number of exceptions to the general rule disallowing deduction of entertainment expenses and the rules limiting deductions to 50 percent of the otherwise deductible amount. Under one such exception, those 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 as wages to an employee.<sup>581</sup> Those rules also do not apply to expenses 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>582</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>583</sup>

Those deduction disallowance 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 employer), under a reimbursement or other expense allowance arrangement if the taxpayer accounts for the expenses to such person.<sup>584</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>585</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>586</sup>

### **Expenses treated as compensation**

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.<sup>587</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 sum of the amount (if any) paid by the individual and the amount

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<sup>580</sup> Sec. 274(a)(3).

<sup>581</sup> Sec. 274(e)(2)(A). See below for a discussion of the recent modification of this rule for certain individuals.

<sup>582</sup> Sec. 274(e)(9).

<sup>583</sup> Treas. Reg. sec. 1.162-25T(a).

<sup>584</sup> Sec. 274(e)(3).

<sup>585</sup> Sec. 274(e)(4).

<sup>586</sup> Sec. 274(n)(2)(E).

<sup>587</sup> Sec. 61(a)(1).



(if any) specifically excluded from gross income.<sup>588</sup> Treasury regulations provide detailed rules regarding the valuation of certain fringe benefits, including flights on an employer-provided aircraft. 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>589</sup> If the SIFL valuation rules do not apply, the value of a flight on an employer-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>590</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 has been 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.<sup>591</sup> The result of that interpretation is often a deduction several times larger than the amount required to be included in income. Further, 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 for expenses treated as compensation or otherwise includible income were subsequently modified in the case of specified individuals such that the exceptions apply only to the extent of the amount of expenses treated as compensation or includible in income of the specified individual.<sup>592</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>593</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>588</sup> Treas. Reg. sec. 1.61-21(b)(1).

<sup>589</sup> Treas. Reg. sec. 1.61-21(g)(5).

<sup>590</sup> Treas. Reg. sec. 1.61-21(b)(6).

<sup>591</sup> *Sutherland Lumber-Southwest, Inc. v. Commissioner*, 114 T.C. 197 (2000), *aff’d*, 255 F.3d 495 (8th Cir. 2001).

<sup>592</sup> Sec. 274(e)(2)(B)(i). See also Treas. Reg. sec. 1.274-9(a).

<sup>593</sup> Sec. 274(e)(2)(B)(ii). See also Treas. Reg. sec. 1.274-9(b).

employees or service providers, the company's deduction is not limited to the amount treated as compensation or includible in income.<sup>594</sup>

### **Excludable fringe benefits**

Certain employer-provided fringe benefits are excluded from an employee's gross income and wages for employment tax purposes, including, but not limited to, *de minimis* fringes, qualified transportation fringes, and meals provided for the "convenience of the employer."<sup>595</sup>

A *de minimis* fringe generally means any property or service 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>596</sup> and also includes food and beverages provided to employees through an eating facility operated by the employer that is located on or near the employer's business premises and meets certain requirements.<sup>597</sup>

Qualified transportation fringes include qualified parking (parking 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>598</sup>

The value of meals furnished to an employee or the employee's spouse or dependents by or on behalf of an employer for the convenience of the employer is excludible from the employee's gross income, but only if such meals are provided on the employer's business premises.<sup>599</sup>

### **Reasons for Change**

The Committee believes that the difficulty in determining whether entertainment expenses are directly related to, or associated with, a trade or business creates uncertainty for taxpayers and the potential for significant abuse, and therefore permits a tax deduction for

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<sup>594</sup> See Treas. Reg. sec. 1.274-10(a)(2).

<sup>595</sup> Secs. 132(a), 119(a), 3121(a)(19) and (20), 3231(e)(5) and (9), 3306(b)(14) and (16), and 3401(a)(19).

<sup>596</sup> Sec. 132(e)(1). Examples include occasional personal use of an employer's copying machine, occasional parties or meals for employees and their guests, local telephone calls, and coffee, doughnuts and soft drinks. Treas. Reg. sec. 1.132-6(e)(1).

<sup>597</sup> Sec. 132(e)(2). Revenue derived from such a facility must normally equal or exceed the direct operating costs of the facility. Employees who are entitled, under Section 119, to exclude the value of a meal provided at such a facility are treated as having paid an amount for the meal equal to the direct operating costs of the facility attributable to such meal.

<sup>598</sup> Sec. 132(f)(1), (5). The qualified transportation fringe exclusions are subject to monthly limits. Sec. 132(f)(2).

<sup>599</sup> Sec. 119(a).

entertainment-related expenses only to the extent such items are reported as employee compensation. The Committee also aligns the treatment of the employer's deduction for qualified transportation fringes with other similar taxable items, such that a deduction is permitted if included in the employee's reported compensation. In addition, the Committee generally disallows or limits deductions in connection with commuting benefits and providing meals to employees for the convenience of the employer.

### **Explanation of Provision**

The provision 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, or (3) a facility or portion thereof used in connection with any of the above items. Thus, the provision 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).

In addition, the provision disallows a deduction for expenses associated with providing any qualified transportation fringe to employees of the taxpayer, and except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment.

Taxpayers may still generally deduct 50 percent of the food and beverage expenses associated with operating their trade or business (*e.g.*, meals consumed by employees on work travel). For amounts incurred and paid after December 31, 2017 and until December 31, 2025, the provision expands this 50 percent limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer. Such amounts incurred and paid after December 31, 2025 are not deductible.

### **Effective Date**

The provision generally applies to amounts paid or incurred after December 31, 2017. However, for expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer, amounts incurred and paid after December 31, 2025 will not be deductible.

## 5. Repeal of deduction for income attributable to domestic production activities (sec. 13305 of the bill and sec. 199 of the Code)

### Present Law

Section 199 provides a deduction from taxable income (or, in the case of an individual, adjusted gross income<sup>600</sup>) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income (determined without regard to the section 199 deduction) for the taxable year.<sup>601</sup> For corporations subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to slightly less than 32 percent on qualified production activities income.<sup>602</sup> A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

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>603</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>604</sup> that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States;<sup>605</sup> (2) any sale, exchange, or

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<sup>600</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).

<sup>601</sup> Sec. 199(a). In the case of oil related qualified production activities income, the deduction from taxable income is equal to six percent of the lesser of the taxpayer's oil related qualified production activities income, qualified production activities income, or taxable income. Sec. 199(d)(9).

<sup>602</sup> This example assumes the deduction does not exceed the wage limitation discussed below.

<sup>603</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>604</sup> Qualifying production property generally includes any tangible personal property, computer software, and sound recordings. Sec. 199(c)(5).

<sup>605</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, 2017, 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).

other disposition, or any lease, rental, or license, of qualified film<sup>606</sup> produced by the taxpayer; (3) any sale, exchange, or other disposition, or any lease, rental, or license, 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 business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.<sup>607</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>608</sup>

### **Reasons for Change**

The Committee believes the reduction in corporate rate and creation of a 17.4 percent deduction for business income of individuals will enhance the ability of all domestic businesses to compete in the global marketplace and enable small businesses to maintain their position as the primary source of new jobs in this country. Therefore, while the Committee believes that the deduction for income attributable to domestic production activities has generally helped domestic manufacturing firms by improving the cash flow of domestic manufacturers and making investments in domestic manufacturing facilities more attractive, there is no longer a need for such deduction. Finally, the Committee believes that elimination of the deduction for income attributable to domestic production activities furthers the Committee's general goal of simplification of the tax code.

### **Explanation of Provision**

The provision repeals the deduction for income attributable to domestic production activities.

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2018.

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<sup>606</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).

<sup>607</sup> Sec. 199(c)(4)(A).

<sup>608</sup> Sec. 199(b)(1). 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 designated Roth contributions as defined in section 402A. See sec. 199(b)(2)(A). 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).

## **6. Denial of deduction for certain fines, penalties, and other amounts (sec. 13306 of the bill and sec. 162(f) and new sec. 6050X of the Code)**

### **Present Law**

The Code denies a deduction for fines or penalties paid to a government for the violation of any law.<sup>609</sup>

### **Reasons for Change**

The Committee believes that taxpayers should not be able to deduct as normal business expenses settlement payments that are intended to punish bad behavior. Allowing these deductions forces other taxpayers to subsidize a part of their wrongdoing and blunts the deterrent effect of the penalty. The Committee believes denying these deductions will help deter taxpayers from violating the standards Congress has enacted to protect the American public, and ensure that wrongdoers fully pay their penalties.

### **Explanation of Provision**

The provision denies deductibility for any otherwise deductible amount paid or incurred (whether by suit, agreement, or otherwise) to or at the direction of a government or specified nongovernmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property) or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement as restitution, remediation, or required to come into compliance. In the case of any amount of restitution for failure to pay any tax and assessed as restitution under the Code, such restitution is deductible only to the extent it would have been allowed as a deduction if it had been timely paid. The IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made. Restitution or included remediation of property does not include reimbursement of government investigative or litigation costs.

The provision applies only where a government (or other entity treated in a manner similar to a government under the provision) is a complainant or investigator with respect to the violation or potential violation of any law.<sup>610</sup> An exception also applies to any amount paid or incurred as taxes due.

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<sup>609</sup> Sec. 162(f).

<sup>610</sup> Thus, for example, the provision does not apply to payments made by one private party to another in a lawsuit between private parties, merely because a judge or jury acting in the capacity as a court directs the payment to be made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause the payment to be made “at the direction of a government” for purposes of the provision.

The provision requires government agencies (or entities treated as such agencies under the provision) to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least \$600 (or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure the efficient administration of the Internal Revenue laws). The report must separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The report must be made at the time the agreement is entered into, as determined by the Secretary of the Treasury.

### **Effective Date**

The provision denying the deduction and the reporting provision are effective for amounts paid or incurred after the date of enactment, except that it would not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Such exception does not apply to an order or agreement requiring court approval unless the approval was obtained before such date.

## **7. Denial of deduction for settlements subject to nondisclosure agreements paid in connection with sexual harassment or sexual abuse (sec. 13307 of the bill and new sec. 162(q) of the Code)**

### **Present Law**

A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.<sup>611</sup> 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.

### **Reasons for Change**

The Committee believes that taxpayers should not be able to deduct as normal business expenses settlement payments subject to nondisclosure agreements that relate to sexual harassment or sexual abuse. Allowing these deductions forces other taxpayers to subsidize a part of their wrongdoing or the wrongdoing of their employees. The Committee also believes that this provision will discourage the use of nondisclosure agreements in these circumstances.

### **Explanation of Provision**

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<sup>611</sup> Sec. 162(a).

Under the provision, no deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.

### **Effective Date**

The provision is effective for expenses and costs paid or incurred in taxable years beginning after the date of enactment.

## **8. Uniform treatment of expenses in contingency fee cases (sec. 13308 of the bill and new sec. 162(r) of the Code)**

### **Present Law**

The Code provides that a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.<sup>612</sup>

A current deduction for an expense for which there is a right or expectation of reimbursement may be disallowed because these payments are not expenses of the taxpayer and are instead in the nature of an advance or a loan. The extent to which the right must be established has varied. Some cases have denied the current deduction because the right of reimbursement was fixed,<sup>613</sup> others have allowed the current deduction because the right of reimbursement was uncertain,<sup>614</sup> and other cases have denied the current deduction if the taxpayer's right to reimbursement was subject to a contingency.

Courts have held that an attorney representing clients on a contingent fee basis may not currently deduct advances to or expenses paid on behalf of the clients as ordinary and necessary business expenses.<sup>615</sup> The amounts in these cases were to be repaid from any recovery. Courts have also held that even if reimbursement is due only under certain circumstances, generally no immediate deduction is allowable.<sup>616</sup>

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<sup>612</sup> Sec. 162(a); Treas. Reg. sec. 1.162-1(a).

<sup>613</sup> *Charles Baloian Company, Inc. v. Commissioner*, 68 T.C. 620, 626, 628 (1977); *Manocchio v. Commissioner*, 710 F.2d 1400, 1402 (9th Cir. 1983); *Glendinning, McLeish & Co. v. Commissioner*, 61 F.2d 950, 952 (2d Cir. 1932); *Webbe v. Commissioner*, T.C. Memo. 1987-426, aff'd, 902 F.2d 688 (8th Cir. 1990).

<sup>614</sup> *George K. Herman Chevrolet, Inc. v. Commissioner*, 39 T.C. 846, 853 (1963); *Allegheny Corporation v. Commissioner*, 28 T.C. 298, 305 (1957), acq., 1957-2 C.B. 3; *Electric Tachometer Corporation v. Commissioner*, 37 T.C. 158, 161-162 (1961), acq., 1962-2 C.B. 4.

<sup>615</sup> *Burnett v. Commissioner*, 356 F.2d 755, 760 (5th Cir.), cert. denied, 385 U.S. 832 (1966); *Herrick v. Commissioner*, 63 T.C. 562, 567, 568 (1975); *Canelo v. Commissioner*, 53 T.C. 217, 225 (1969), aff'd, 447 F.2d 484 (9th Cir. 1971), acq. 1971-2 C.B. 2, nonacq. in part, 1982-2 C.B. 2; *Silverton v. Commissioner*, T.C. Memo. 1977-198, aff'd, 647 F.2d 172 (9th Cir.), cert. denied, 454 U.S. 1033 (1981); *Watts v. Commissioner*, T.C. Memo. 1968-183.

<sup>616</sup> *Boccardo v. Commissioner*, 12 Cl Ct. 184 (1987); *Boccardo v. Commissioner*, 65 T.C.M. 2739 (1993).



However, the Ninth Circuit reached the opposite conclusion and held that attorneys who represent clients in “gross fee” contingency fee cases are not extending loans to clients and therefore may treat litigation costs, such as court fees and witness expenses, as deductible business expenses under the Code.<sup>617</sup> The IRS does not follow this decision, except in the Ninth Circuit, based on the fact that amounts advanced by attorneys will be reimbursed by the client and therefore are not deductible business expenses.<sup>618</sup>

### **Reasons for Change**

The Committee believes that amounts advanced by attorneys in “gross fee” cases are loans and therefore should not be treated as deductible expenses. The Committee further believes this change is necessary to provide uniform treatment of expenses in contingency fee cases.

### **Explanation of Provision**

The proposal denies attorneys an otherwise-allowable deduction for litigation costs paid under arrangements that are primarily on a contingent fee basis until the contingency ends. The proposal effects a legislative override of the opinion in the Ninth Circuit Court of Appeals in *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995). No inference regarding the tax treatment of these costs under present law is intended.

### **Effective Date**

The proposal applies to expenses and costs paid or incurred in taxable years beginning after the date of enactment.

## **9. Repeal of deduction for local lobbying expenses (sec. 13309 of the bill 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>619</sup> However, section 162(e) denies a deduction for amounts paid or incurred in connection with (1) influencing legislation,<sup>620</sup> (2) participation in, or

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<sup>617</sup> *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995), rev’g 65 T.C.M. 2739 (1993).

<sup>618</sup> 1997 FSA LEXIS 442 (June 2, 1997).

<sup>619</sup> Sec. 162(a).

<sup>620</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

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>621</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>622</sup>

## **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 (“local legislation”).<sup>623</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, submission of statements to, or sending communications to the committees or individual members of such council or body 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 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>624</sup>

For purposes of this exception, legislation of an Indian tribal government is treated in the same manner as local legislation.<sup>625</sup>

### **De minimis**

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body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure. Secs. 162(e)(4) and 4911(e)(2).

<sup>621</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, (5) any other individual designated by the President as having Cabinet-level status, and (6) any immediate deputy of an individual described in (4) or (5). Sec. 162(e)(6).

<sup>622</sup> Sec. 162(e)(5)(C).

<sup>623</sup> Sec. 162(e)(2)(A).

<sup>624</sup> Sec. 162(e)(2)(B).

<sup>625</sup> Sec. 162(e)(7).

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>626</sup>

### **Reasons for Change**

The Committee believes that Federal tax law should not draw a distinction between the deductibility of local and non-local lobbying expenses. The Committee further believes that ending the deductibility of local lobbying expenses eliminates a Federal tax subsidy for efforts to influence local legislation. Finally, the Committee believes that elimination of this distinction furthers its general goal of simplification of Federal tax law.

### **Explanation of Provision**

The provision 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 provision applies to amounts paid or incurred on or after the date of enactment.

## **10. Recharacterization of certain gains in the case of partnership profits interests held in connection with performance of investment services (sec. 13310 of the bill and secs. 1061 and 83 of the Code)**

### **Present Law**

#### **Partnership profits interest for services**

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxed upon the receipt of the partnership interest.<sup>627</sup>

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<sup>626</sup> Sec. 162(e)(5)(B).

<sup>627</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)).

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>628</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>629</sup> clarifies that this treatment applies with respect to substantially unvested profits interests 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>630</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>631</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>632</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 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).<sup>633</sup> The

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<sup>628</sup> Rev. Proc. 93-27 (1993-2 C.B. 343), citing the *Diamond* and *Campbell* cases, *supra*.

<sup>629</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>630</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>631</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>632</sup> Rev. Proc. 93-27, 1993-2 C.B. 343.

<sup>633</sup> The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. 70 Fed. Reg. 29675 (May 24, 2005). The proposed regulations provide that a partnership interest is "property" for purposes of section 83. Thus, a compensatory transfer of a partnership interest is includable 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

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>634</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.

#### Pass-through 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>635</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

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fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, in the case of a true profits interest in a partnership (one under which the partner would be entitled to nothing if the partnership were liquidated immediately following the grant), under the proposed regulations, the grant of a substantially vested profits interest (or, if a section 83(b) election is made, the grant of a substantially nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

<sup>634</sup> Sec. 83(h).

<sup>635</sup> Sec. 702.

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 pass-through 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.

### **Net long-term capital gain**

In the case of an individual, estate, or trust, any adjusted net capital gain which otherwise would be taxed at the 10- or 15-percent rate is not taxed. Any adjusted net capital gain which otherwise would be taxed at rates over 15 percent and below 39.6 percent is taxed at a 15-percent rate. Any adjusted net capital gain which otherwise would be taxed at a 39.6-percent rate is taxed at a 20-percent rate.<sup>636</sup>

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset,<sup>637</sup> any gain generally is included in income.

Short-term capital gain means gain from the sale or exchange of a capital asset held for not more than one year, if and to the extent such gain is taken into account in computing gross income. Net short-term capital loss means the excess of short term capital losses for the taxable year over the short-term capital gains for the taxable year.

Net long-term capital gain means the excess of long-term capital gains for the taxable year over the long-term capital losses for the taxable year.

Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

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<sup>636</sup> Sec. 1. Other rates apply to certain types of gain. The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate. In addition, a tax is imposed on net investment income in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income, which includes gains and dividends, or the excess of modified adjusted gross income over the threshold amount. The threshold amount is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in the case of any other individual.

<sup>637</sup> Sec. 1221. A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

The adjusted net capital gain of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation.<sup>638</sup>

### **Reasons for Change**

The Committee is concerned about Federal tax issues arising from the use of carried interests in asset management businesses. In these arrangements, the investment fund typically is a partnership. The investors are limited partners that contribute capital to acquire fund assets, and the fund manager is the general partner of the investment fund partnership. The general partner is itself a partnership of individuals with investment management expertise. The fund manager receives management fees along with a carried interest. The arrangement requires the performance of services by individuals whose professional skill as fund managers generates capital income for investors in the fund.

Because the character of a partnership's income passes through to partners, income from a carried interest may take the form of long-term or short-term capital gain realized by the underlying investment fund as the fund sells off investment assets. Long-term capital gain allocated to individual partners may represent compensation for their services as fund managers.

The Committee believes that the lower rates that apply to long-term capital gain from sales or exchanges of capital assets of partnerships should not be available to holders of applicable partnership interests unless an extended holding period requirement has been met. Therefore, the Committee bill imposes a three-year holding period (not the generally applicable one-year holding period) in the case of long-term capital gain from applicable partnership interests. If the holder of an applicable partnership interest is allocated gain from the sale of property held for less than three years, that gain is treated as short-term capital gain and is subject to tax at the rates applicable to ordinary income. The Committee believes that providing a three-year holding period requirement on certain capital gains for holders of applicable partnership interests strikes the right balance for economic growth and fairness without stifling investment.

### **Explanation of Provision**

#### **General rule**

The provision provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer, notwithstanding the rules of section 83 or any election in effect under section 83(b).

#### **Short-term capital gain**

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<sup>638</sup> Sec. 163(d).

The provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

A special rule provides that, as provided in regulations or other guidance issued by the Secretary, this rule does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third party investors. Third party investor means a person (1) who holds an interest in the partnership that is not property held in connection with an applicable trade or business (defined below) with respect to that person, and (2) who is not and has not been actively engaged in directly or indirectly providing substantial services for the partnership or any applicable trade or business (and is (or was) not related to a person so engaged). A related person for this purpose is a family member (within the meaning of attribution rules<sup>639</sup>) 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.

### **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 related person or persons in any applicable trade or business. 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. An applicable partnership interest does not include an interest held by a person who is employed by another entity that is conducting a trade or business (which is not an applicable trade or business) and who provides services only to the other entity.

An applicable partnership interest does not include an interest in a partnership directly or indirectly held by a corporation. For example, if two corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not applicable partnership interests.

An applicable partnership interest does not include any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed (as of the time the partnership interest was received), or commensurate with the value of the partnership interest that is taxed under section 83 on receipt or vesting of the partnership interest. For example, in the case of a partner who holds a capital interest in the partnership with respect to capital he or she contributed to the partnership, if the partnership agreement provides that the partner's share of partnership capital is commensurate with the

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<sup>639</sup> Sec. 318(a)(1).



amount of capital he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent.

#### Applicable trade or business

An applicable trade or business means any activity (regardless of whether the activity are conducted in one or more entities) that consists in whole or in part of the following: (1) raising or returning capital, and either (2) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition), or (3) developing specified assets.

Developing specified assets 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.

#### Specified assets

Under the provision, specified assets means securities (generally as defined under rules for mark-to-market accounting for securities dealers), commodities (as defined under rules for mark-to-market accounting for commodities dealers), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means any (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified. For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm.

A partnership interest, for purposes of determining the proportionate interest of a partnership in any specified asset, includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a hedge fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision.

### **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 short-term capital gain so much of the taxpayer's net long-term capital gain attributable to the sale or exchange of an asset held for not more than three years as is allocable to the interest. The amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of the provision (that is, amounts are not double-counted). A related person for this purpose is a family member (within the meaning of attribution rules<sup>640</sup>) 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**

The Secretary is directed to require reporting (at the time in the manner determined by the Secretary) necessary to carry out the purposes of the provision. 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 provision. Such guidance is to address prevention of the abuse of the purposes of the provision, including through the allocation of income to tax-indifferent parties. Guidance is also to provide for the application of the provision in the case of tiered structures of entities.

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017.

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<sup>640</sup> Sec. 318(a)(1).

## PART V – BUSINESS CREDITS

### 1. Modification of orphan drug credit (sec. 13401 of the bill and sec. 45C of the Code)

#### Present Law

A 50-percent business tax credit is available for qualified clinical testing expenses incurred in the testing of certain drugs to treat rare diseases or conditions.<sup>641</sup> Such drugs are generally referred to as “orphan drugs” and the credit is generally referred to as the “orphan drug credit.” 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>642</sup> A rare disease or condition is defined as one that (1) affects fewer 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>643</sup>

Amounts included in computing the credit under this section are excluded from the computation of the research credit under section 41.<sup>644</sup> Deductions allowed to a taxpayer are reduced by an amount equal to 100 percent of the taxpayer’s orphan drug credit determined for the taxable year.<sup>645</sup>

#### Reasons for Change

The Committee believes that the reform of many existing tax incentives, including the orphan drug credit, makes the system simpler and fairer for all individuals, families, and businesses, and allows for lower tax rates. The Committee further believes that the reform of this provision is an important part of its larger tax reform effort.

#### Explanation of Provision

The provision reduces the credit rate to 27.5 percent of qualified clinical testing expenses. The proposal also adds a disclosure requirement, requiring the Secretary of the Treasury to disclose the name of the orphan drug, the amount of credits claimed with respect to the drug, the name of the orphan disease being treated by the drug, and the name of the taxpayer claiming the credits.

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<sup>641</sup> Sec. 45C.

<sup>642</sup> Sec. 45C(b).

<sup>643</sup> Sec. 45C(d).

<sup>644</sup> Sec. 45C(c).

<sup>645</sup> Sec. 280C(b).

### Effective Date

The provision applies to amounts paid or incurred in taxable years beginning after December 31, 2017.

## **2. Rehabilitation credit limited to certified historic structures (sec. 13402 of the bill and sec. 47 of the Code)**

### Present Law

Section 47 provides a two-tier tax credit for rehabilitation expenditures.

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.

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. A 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.

### Reasons for Change

The Committee believes that limiting the rehabilitation credit to certified historic structures targets this incentive more effectively to what the Committee believes is its core purpose, encouraging the preservation and rehabilitation of historic structures. Furthermore, limiting the credit contributes to the effort to lower tax rates.

### Explanation of Provision

The provision repeals the 10-percent credit for pre-1936 buildings. The provision retains the 20-percent credit for qualified rehabilitation expenditures with respect to a certified historic structure, with a modification. Under the provision, the credit allowable for a taxable year during the five-year period beginning in the taxable year in which the qualified rehabilitated building is placed in service is an amount equal to the ratable share. The ratable share for a taxable year during the five-year period is amount equal to 20 percent of the qualified rehabilitation expenditures for the building, as allocated ratably to each taxable year during the five-year period. It is intended that the sum of the ratable shares for the taxable years during the

five-year period does not exceed 100 percent of the credit for qualified rehabilitation expenditures for the qualified rehabilitated building.

### **Effective Date**

The provision applies to amounts paid or incurred after December 31, 2017. A transition rule provides that in the case of qualified rehabilitation expenditures (for either a certified historic structure or a pre-1936 building), with respect to any building owned or leased (as provided under present law) by the taxpayer at all times on and after January 1, 2018, the 24-month period selected by the taxpayer (under section 47(c)(1)(C)) is to begin not later than the end of the 180-day period beginning on the date of the enactment of the Act, and the amendments made by the provision apply to such expenditures paid or incurred after the end of the taxable year in which such 24-month period ends.

### **3. Repeal of deduction for certain unused business credits (sec. 13403 of the bill 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>646</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>647</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>648</sup>

#### **Reasons for Change**

The Committee believes that the repeal of many existing tax incentives, including the deduction for certain unused business credits, makes the system simpler and fairer for all individuals, families, and businesses, and allows for lower tax rates. The Committee further believes that the repeal of this provision is a necessary part of its larger tax reform effort.

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<sup>646</sup> Sec. 38.

<sup>647</sup> Sec. 39.

<sup>648</sup> Sec. 196(d).

### **Explanation of Provision**

This provision repeals the deduction for certain unused business credits.

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017.

## **4. Employer credit for paid family and medical leave (sec. 13404 of the bill and new sec. 45S of the Code)**

### **Present Law**

Present law does not provide a credit to employers for compensation paid to employees while on leave.

### **Reasons for Change**

The Committee believes this provision offers employers incentives to voluntarily provide paid family or medical leave to their employees who face complicated demands of caring for aging parents and young children while managing careers and workplace schedules. By improving flexibility for working families, the Committee believes this provision strengthens the workforce and its ability to compete in a global economy.

### **Explanation of Provision**

This provision allows eligible employers to claim a general business credit equal to 12.5 percent of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave if the rate of payment under the program is 50 percent of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25 percent) for each percentage point by which the rate of payment exceeds 50 percent. The maximum amount of family and medical leave that may be taken into account with respect to any employee in a taxable year for purposes of the credit is 12 weeks.

An eligible employer is one that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and who allows all less-than-full-time, qualifying employees a commensurate amount of leave on a pro rata basis. For purposes of this requirement, leave paid for or required by a State or local government is not taken into account. A qualifying employee is an employee as defined in section 3(e) of the Fair Labor Standards Act of 1938 who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60 percent of the compensation threshold for highly compensated employees.<sup>649</sup>

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<sup>649</sup> Sec. 414(g)(1)(B) (\$120,000 for 2017).

Family and medical leave is defined as leave described under section 102(a)(1)(A)-(E) or 102(a)(3) of the Family and Medical Leave Act of 1993.<sup>650</sup> If an employer provides paid leave as vacation leave, personal leave, or other medical or sick leave, this paid leave would not be considered to be family and medical leave.

This provision would not apply to wages paid in taxable years beginning after December 31, 2019.

### **Effective Date**

The provision is generally effective for wages paid in taxable years beginning after December 31, 2017.

## **5. Low-income housing credit modifications (secs. 13411 through 13416 of the bill and sec. 42 of the Code)**

### **Present Law**

#### **In general**

The low-income housing credit may be claimed over a 10-year period for the cost of building rental housing a sufficient portion of which is rent restricted and occupied by tenants having incomes below specified levels.<sup>651</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 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 credit, the incomes of the tenants must satisfy certain targeting rules. A project is a qualified low-income housing project if 20 percent or more of the residential units in such project are both rent-restricted and 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 both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income (the “40-60 test”). A unit is rent-restricted if the gross rent does not exceed 30 percent of the applicable income limitation. The owner must elect to apply

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<sup>650</sup> In order to be an eligible employer, an employer must provide certain protections applicable under the Family and Medical Leave Act of 1993, regardless of whether they otherwise apply. Specifically, the employer must provide paid family and medical leave in compliance with a policy which ensures that the employer will not interfere with, restrain, or deny the exercise of or the attempt to exercise, any right provided under the policy and will not discharge or in any other manner discriminate against any individual for opposing any practice prohibited by the policy.

<sup>651</sup> Sec. 42.

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. For many projects every unit satisfies the income targeting rules such that the applicable fraction is 100 percent, and the eligible basis of the entire project qualifies for the credit.

### **Qualified allocation plan**

Each State housing credit agency must have a qualified allocation plan for allocating low-income housing credits.<sup>652</sup> First, the qualified action plan must give preference in allocating housing credit dollar amounts among project candidates: (1) serving the lowest income tenants, (2) obligated to serve qualified tenants for the longest periods, and (3) which are located in qualified census tracts and the development of which contributes to a concerted community revitalization plan. The qualified allocation plan must also set forth selection criteria to be used to determine housing priorities of the housing credit agency that are appropriate to local conditions.<sup>653</sup> Third, the qualified allocation plan must provide a procedure that the agency will follow in monitoring for, and notifying the IRS of, noncompliance with section 42 and in monitoring for noncompliance with habitability standards through regular site visits.

### **Recapture**

To avoid adverse tax consequences, a building must remain in compliance with the 20-50 test or the 40-60 test, as applicable, for 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.

If as of the close of any taxable year in the 15-year compliance period, the amount of qualified basis of any building with respect to the taxpayer is less than the amount of such basis as of the close of the preceding taxable year, the excess portion of the accelerated credit is recaptured, with interest, for all prior years.

The recapture does not apply to a reduction in qualified basis by reason of a casualty loss to the extent such loss is restored by reconstruction or replacement within a reasonable period established by the Secretary.

The owner of a building that is beyond the first year of the credit period, and that, because of a disaster that caused the President to issue a major disaster declaration, has suffered a reduction in qualified basis that would cause it to be subject to recapture or loss of credit will not be subject to recapture or loss if the building's qualified basis is restored within a reasonable

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<sup>652</sup> Sec. 42(m)(1)(B).

<sup>653</sup> The selection criteria set forth in a qualified allocation plan must include: (1) project location; (2) housing needs characteristics; (3) project characteristics, including whether the project includes the use of existing housing as part of a community revitalization plan; (4) sponsor characteristics; (5) tenant populations with special housing needs; (6) public housing waiting lists; (7) tenant populations of individuals with children; (8) projects intended for eventual tenant ownership; (9) the energy efficiency of the project; and (10) the historic nature of the project. Sec. 42(m)(1)(C).



period.<sup>654</sup> The housing agency that monitors the project for compliance may determine what constitutes a reasonable period, but in no instance is it allowed to extend beyond the end of the 25th month following the close of the month of the major disaster declaration. To determine the credit amount allowable during the reconstruction or replacement period, an owner of the building must use the building's qualified basis at the end of the taxable year that preceded the President's major disaster declaration. These rules only apply to property located in an area designated as a major disaster area by the President of the United States. These rules do not apply to casualty losses in general.

### **Rights of first refusal**

Under present law, any determination as to whether Federal income tax benefits are allowable to a taxpayer with respect to a qualified low income building is made without regard to whether the tenants (or certain other entities) are given the right of first refusal to purchase the property after the end of the compliance period. Tenants (in cooperative form or otherwise), the resident management corporation of the building, a qualified nonprofit organization, or government agency may exercise the right of first refusal to purchase the property at a minimum purchase price after the end of the compliance period.<sup>655</sup>

### **Reasons for Change**

The low income housing credit is an important tool in providing affordable housing. The Committee believes making certain modifications to the credit to preserve and encourage such housing are appropriate. For example, the committee understands from stakeholders that the rule relating to the right of first refusal is not operating as intended and therefore believes it is appropriate to make modifications to allow for a purchase option with respect to the property or a partnership interest relating to the property.

### **Explanation of Provision**

The provision incorporates several provisions of S.548, the Affordable Housing Credit Improvement Act of 2017:

**Reconstruction or replacement period after casualty loss:** The provision provides that the determination of recapture will not be made with respect to a property the basis of which is affected by a casualty loss until a reasonable period established by the applicable housing agency has expired. The period established by the applicable housing is not to exceed 25 months from the date of the casualty.

**Modification of rights relating to building purchase:** The provision changes the right of first refusal (held by tenants, resident management corporation, qualified nonprofit organization, or government agency) to a purchase option for the property or related partnership interest. The

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<sup>654</sup> Rev. Proc. 2014-49, 2014-37 I.R.B. 535 (9/08/2014).

<sup>655</sup> Sec. 42(i)(7).

determination of whether Federal income tax benefits are allowable to a taxpayer with respect to a qualified low income building is made without regard to such a purchase option at the present law minimum purchase price.

Determination of community revitalization plan to be made by State housing credit agency: The provision provides that the criteria established by a housing credit agency for determining whether the development of a project contributes to a concerted community development plan is to take into account any factors the agency deems appropriate, including the extent to which the proposed plan (1) is geographically specific; (2) outlines a clear plan for implementation and goals for outcomes; (3) includes a strategy for applying for or obtaining commitments of public or private investment (or both) in nonhousing infrastructure, amenities, or services; and (4) demonstrates the need for community revitalization.

Prohibition of local approval and contribution requirements: Under the provision, the selection criteria under a qualified allocation plan shall not include consideration of (1) any support or opposition with respect to the project from local or elected leaders, or (2) any local government contribution to the project, except to the extent such contribution is taken into account as part of a broader consideration of the project's ability to leverage outside funding sources, and is not prioritized over any other source of outside funding.

Selection criteria under qualified allocation plans: The provision requires that qualified allocation plans include selection criteria that take into consideration of the affordable housing needs of individuals in the State who are members of Indian tribes.

Affordable housing credit: The provision renames the "Low Income Housing Credit" the "Affordable Housing Credit".

### **Effective Date**

Section 13411 of the bill (reconstruction or replacement period after casualty loss) applies to casualty losses arising after the date of enactment.

Section 13412 of the bill (modification of rights relating to building purchase) applies to agreements entered into or amended after the date of enactment.

Section 13413 of the bill (determination of community revitalization plan to be made by housing credit agency) applies to allocations of housing credit dollar amounts made under qualified allocation plans adopted after December 31, 2017.

Section 13414 of the bill (prohibition of local approval and contribution requirements) applies to allocations of housing credit dollar amounts made after December 31, 2017.

Section 13415 of the bill (selection criteria under qualified allocation plans) applies to allocations of credit made after December 31, 2017.

Section 13416 (change in name to affordable housing credit) is effective on the date of enactment.



## PART VI – PROVISIONS RELATED TO SPECIFIC ENTITIES AND INDUSTRIES

### 1. Treatment of gain or loss of foreign persons from sale or exchange of interests in partnerships engaged in trade or business within the United States (sec. 13501 of the bill and secs. 864(c) and 1446 of the Code)

#### Present Law

##### In general

A partnership generally is not treated as a taxable entity, but rather, income of the partnership is taken into account on the tax returns of the partners. The character (as capital or ordinary) of partnership items passes through to the partners as if the items were realized directly by the partners.<sup>656</sup> 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, and deducts its distributive share of partnership items of deduction and loss. A partner's basis in the partnership interest is increased by any amount of gain and decreased by any amount of losses thus included. These basis adjustments prevent double taxation of partnership income to the partner. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

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>657</sup> However, the amount of money and the fair market value of property received in the exchange that represent the partner's share of certain ordinary income-producing assets of the partnership give rise to ordinary income rather than capital gain.<sup>658</sup> 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 to do so,<sup>659</sup> or the partnership has a substantial built-in loss immediately after the transfer.<sup>660</sup> If an election is in effect or the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner. These adjustments are to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee partner's basis in its partnership

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<sup>656</sup> Sec. 702.

<sup>657</sup> Sec. 741; *Pollack v. Commissioner*, 69 T.C. 142 (1977).

<sup>658</sup> Sec. 751(a). These ordinary income-producing assets are unrealized receivables of the partnership or inventory items of the partnership ("751 assets").

<sup>659</sup> Sec. 754.

<sup>660</sup> Sec. 743(a).

interest.<sup>661</sup> The effect of the adjustments on the basis of partnership property is to approximate the result of a direct purchase of the property by the transferee partner.

### **Source of gain or loss on transfer of a partnership interest**

A foreign person that is engaged in a trade or business in the United States is taxed on income that is “effectively connected” with the conduct of that trade or business (“effectively connected gain or loss”).<sup>662</sup> Partners in a partnership are treated as engaged in the conduct of a trade or business within the United States if the partnership is so engaged.<sup>663</sup> Any gross income derived by the foreign person that is not effectively connected with the person’s U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person’s income from the business.<sup>664</sup>

Among the factors taken into account in determining whether income, gain, or loss is effectively connected gain or loss are the extent to which the income, gain, or loss is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the income, gain, or loss (the “asset use” and “business activities” tests).<sup>665</sup> In determining whether the asset use or business activities tests are met, due regard is given to whether such assets or such income, gain, or loss were accounted for through such trade or business. Thus, notwithstanding the general rule that source of gain or loss from the sale or exchange of personal property is generally determined by the residence of the seller,<sup>666</sup> a foreign partner may have effectively connected income by reason of the asset use or business activities of the partnership in which he is an investor.

Special rules apply to treat gain or loss from disposition of U.S. real property interests as effectively connected with the conduct of a U.S. trade or business.<sup>667</sup> To the extent that consideration received by the nonresident alien or foreign corporation for all or part of its interest in a partnership is attributable to a U.S. real property interest, that consideration is considered to be received from the sale or exchange in the United States of such property.<sup>668</sup> In certain

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<sup>661</sup> Sec. 743(b).

<sup>662</sup> Secs. 871(b), 864(c), 882.

<sup>663</sup> Sec. 875.

<sup>664</sup> Secs. 871(b)(2), and 882(a)(2). Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, and is collected by withholding at the source of the payment. The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30-percent is fixed, determinable, annual or periodical income that is not effectively connected with the conduct of a U.S. trade or business.

<sup>665</sup> Sec. 864(c)(2).

<sup>666</sup> Sec. 865(a).

<sup>667</sup> Sec. 897(a), (g).

<sup>668</sup> Sec. 897(g).

circumstances, gain attributable to sales of U.S. real property interests may be subject to withholding tax of ten percent of the amount realized on the transfer.<sup>669</sup>

Under a 1991 revenue ruling, in determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS applied the asset-use test and business activities test at the partnership level to determine the extent to which income derived from the sale or exchange is effectively connected with that U.S. business.<sup>670</sup> Under the ruling, if there is unrealized gain or loss in partnership assets that would be treated as effectively connected with the conduct of a U.S. trade or business if those assets were sold by the partnership, some or all of the foreign person's gain or loss from the sale or exchange of a partnership interest may be treated as effectively connected with the conduct of a U.S. trade or business. However, a 2017 Tax Court case rejects the logic of the ruling and instead holds that, generally, gain or loss on sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business is foreign-source.<sup>671</sup>

### **Reasons for Change**

The Committee believes that where a partnership has built-in gain or loss on assets that, if sold by the partnership, would give rise to effectively connected gain or loss to a foreign partner, gain or loss on sale or exchange by that foreign partner of an interest in that partnership should not be ignored by the U.S. Federal income tax system. Nonetheless, the Committee does not believe that a foreign partner's entire gain or loss on such a sale necessarily should be treated as effectively connected with the conduct of a U.S. trade or business. Instead, the Committee believes it is appropriate to look through the partnership interest to the assets of the partnership, and treat gain or loss on sale or exchange of an interest in the partnership as effectively connected to a U.S. trade or business to the extent that gain or loss on sale of partnership assets would have been so treated.

### **Explanation of Provision**

Under the provision, gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as nonseparately stated income and loss.

The provision also requires the transferee of a partnership interest to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. If the

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<sup>669</sup> Sec. 1445(e)(5). Temp. Treas. Reg. sec. 1.1445-11T(b),(d).

<sup>670</sup> Rev. Rul. 91-32, 1991-1 C.B. 107.

<sup>671</sup> See *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017).

transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.

The provision provides the Secretary of the Treasury with specific regulatory authority to address coordination with the nonrecognition provisions of the Code.

### **Effective Date**

The provision is effective for sales and exchanges on or after November 27, 2017.

## **2. Modification of the definition of substantial built-in loss in the case of transfer of partnership interest (sec. 13502 of the bill 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>672</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. These adjustments are to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.<sup>673</sup> 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.

Under the provision, 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>674</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>675</sup> For electing investment partnerships, in lieu of the partnership basis adjustments, a partner-level loss limitation rule applies.<sup>676</sup>

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<sup>672</sup> Sec. 743(a).

<sup>673</sup> Sec. 743(b).

<sup>674</sup> Sec. 743(d).

<sup>675</sup> See sec. 743(e) (alternative rules for electing investment partnerships) and sec. 743(f) (exception for securitization partnerships).

<sup>676</sup> Unlike in the case of an electing investment partnership, the partner-level loss limitation rule does not apply for a securitization partnership.

### **Reasons for Change**

The Committee is concerned that the present-law definition of a substantial built-in loss for purposes of requiring adjustments to the basis of partnership property on the transfer of a partnership interest is too narrow and does not address situations in which the partnership's basis should be adjusted to prevent loss shifting or loss duplication.

### **Explanation of Provision**

The provision modifies the definition of a substantial built-in loss for purposes of section 743(d), affecting transfers of partnership interests. Under the provision, in addition to the present-law definition, a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of \$250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

For example, a partnership of three taxable partners (partners A, B, and C) has not made an election pursuant to section 754. The partnership has two assets, one of which, Asset X, has a built-in gain of \$1 million, while the other asset, Asset Y, has a built-in loss of \$900,000. Pursuant to the partnership agreement, any gain on sale or exchange of Asset X is specially allocated to partner A. The three partners share equally in all other partnership items, including in the built-in loss in Asset Y. In this case, each of partner B and partner C has a net built-in loss of \$300,000 (one third of the loss attributable to asset Y) allocable to his partnership interest. Nevertheless, the partnership does not have an overall built-in loss, but a net built-in gain of \$100,000 (\$1 million minus \$900,000). Partner C sells his partnership interest to another person, D, for \$33,333. Under the provision, the test for a substantial built-in loss applies both at the partnership level and at the transferee partner level. If the partnership were to sell all its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of \$300,000 (one third of the built-in loss of \$900,000 in Asset Y). A substantial built-in loss exists under the partner-level test added by the provision, and the partnership adjusts the basis of its assets accordingly with respect to D.

### **Effective Date**

The provision applies to transfers of partnership interests after December 31, 2017.

### **3. Charitable contributions and foreign taxes taken into account in determining limitation on allowance of partner's share of loss (sec. 13503 of the bill and sec. 704 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>677</sup>

A partner's basis in its partnership interest is increased by its distributive share of income (including tax exempt income). A partner's basis in its partnership interest 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>678</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>679</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>680</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>681</sup>

However, in applying the basis limitation on partner losses, Treasury regulations do not take into account the partner's share of partnership charitable contributions and foreign taxes paid or accrued.<sup>682</sup> The IRS has taken the position in a private letter ruling that the basis limitation on partner losses does not apply to limit the partner's deduction for its share of the partnership's charitable contributions.<sup>683</sup> While the regulations relating to the loss limitation do

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<sup>677</sup> Sec. 704(d) and Treas. Reg. sec. 1.704-1(d)(1).

<sup>678</sup> Sec. 705(a).

<sup>679</sup> Rev. Rul. 96-11, 1996-1 C. B. 140.

<sup>680</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>681</sup> Sec. 702.

<sup>682</sup> The regulation provides 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." The regulation does not refer to section 702(a)(4) (charitable contributions) and 702(a)(6) (foreign taxes paid or accrued). Treas. Reg. sec. 1.704-1(d)(2).

<sup>683</sup> Priv. Ltr. Rul. 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.").

not mention the foreign tax credit, a taxpayer may choose the foreign tax credit in lieu of deducting foreign taxes.<sup>684</sup>

By contrast, under S corporation rules limiting 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, the shareholder's pro rata share of charitable contributions and foreign taxes are taken into account.<sup>685</sup> In the case of charitable contributions, a special rule is provided prorating the amount of appreciation not subject to the limitation in the case of charitable contributions of appreciated property by the S corporation.<sup>686</sup>

### **Reasons for Change**

The Committee has become aware of a flaw in the operation of the basis limitation on partner losses: the limitation fails to take into account partnership charitable contributions and foreign taxes. Because deductions for partnership charitable contributions and foreign taxes are allowable at the partner level, they are specifically excluded from the computation of partnership taxable income. In the interests of accurate income measurement under the income tax, the Committee believes partnership charitable contributions and foreign taxes should be taken into account for purposes of the basis limitation on partner losses.

At the same time, the Committee wishes to provide parity as between partners in partnerships and shareholders in S corporations with respect to present-law tax treatment of charitable contributions of appreciated property. Thus, in the case of a partnership charitable contribution of appreciated property, the bill provides that the basis limitation on partner losses does not apply to the extent of the partner's distributive share of the excess of the fair market value over the adjusted basis of the contributed property.

### **Explanation of Provision**

The provision modifies the basis limitation on partner losses to provide that the limitation takes into account a partner's distributive share of partnership charitable contributions (as defined in section 170(c)) and taxes (described in section 901) paid or accrued to foreign countries and to possessions of the United States. Thus, the amount of the basis limitation on partner losses is decreased to reflect these items. In the case of a charitable contribution by the partnership, the amount of the basis limitation on partner losses is decreased by the partner's distributive share of the adjusted basis of the contributed property. In the case of a charitable contribution by the partnership of property whose fair market value exceeds its adjusted basis, a special rule provides that the basis limitation on partner losses does not apply to the extent of the partner's distributive share of the excess.

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<sup>684</sup> Sec. 901.

<sup>685</sup> Sec. 1366(d) and sec. 1366(a)(1). 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 (sec. 1367(a)(2)).

<sup>686</sup> Sec. 1366(d)(4).

### Effective Date

The provision applies to partnership taxable years beginning after December 31, 2017.

#### **4. Net operating losses of life insurance companies (sec. 13511 of the bill and sec. 810 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>687</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>688</sup>

In the case of a life insurance company, a deduction is allowed in the taxable year for operations loss carryovers and carrybacks, in lieu of the deduction for net operation losses allowed to other corporations.<sup>689</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>690</sup>

### Reasons for Change

The Committee believes that the treatment of loss carryovers of life insurance companies should not differ from the treatment of NOL carryovers of other corporations. Consequently, the Committee bill eliminates the separate life insurer carryover rules and applies the generally applicable NOL rules to life insurance companies.

### Explanation of Provision

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 other corporations. The provision thus limits the companies’ NOL deduction to 90 percent of taxable income (determined without regard to the deduction), provides that carryovers to other years are adjusted to take account of this limitation

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<sup>687</sup> Sec. 172(b)(2).

<sup>688</sup> Sec. 56(d).

<sup>689</sup> Secs. 810, 805(a)(5).

<sup>690</sup> Sec. 810(b)(1).

and may be carried forward indefinitely. The NOL deduction of a life insurance company 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, 2017.

### **5. Repeal of small life insurance company deduction (sec. 13512 of the bill 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 LICIT over \$3 million. The maximum deduction that can be claimed by a small company is \$1.8 million, and a company with a tentative LICIT 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.

#### **Reasons for Change**

The Committee believes that the small life insurance company deduction may have served as a transition rule effectively providing a corporate tax rate reduction to small life insurers in connection with 1984 changes to the rules governing life insurance company taxation. However, that purpose has been obviated by the passage of time. The Committee believes that in light of the reduction in the corporate income tax rate to 20 percent, it is appropriate to eliminate the small life insurance company deduction.

#### **Explanation of Provision**

The provision repeals the small life insurance company deduction.

#### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017.

### **6. Adjustment for change in computing reserves (sec. 13513 of the bill 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 (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>691</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.

### **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>692</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>693</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.

### **Reasons for Change**

The Committee believes that the treatment of changes to the method of computing reserves of life insurance companies should not differ from the treatment of changes to the method of accounting in the case of other corporations. Consequently, the Committee bill eliminates the separate rule providing a 10-year period for taking into account a change in the method of computing reserves of a life insurer.

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<sup>691</sup> See, *e.g.*, Rev. Proc. 2015-13, 2015-5 I.R.B. 419, and Rev. Proc. 2017-30, 2017-18 I.R.B. 1131.

<sup>692</sup> Sec. 807.

<sup>693</sup> Sec. 807(f).

### **Explanation of Provision**

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 provision applies to taxable years beginning after December 31, 2017.

## **7. Repeal of special rule for distributions to shareholders from pre-1984 policyholders surplus account (sec. 13514 of the bill 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>694</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.<sup>695</sup>

Any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company is subject to tax at the corporate rate in the taxable year of the distribution. Present law (like prior law) provides that any distribution to shareholders is treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.

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<sup>694</sup> Pub. L. No. 98-369.

<sup>695</sup> Sec. 815.

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.

### **Reasons for Change**

The Committee believes it is appropriate to require life insurers with a policyholders surplus account to be subject to current income taxation on any remaining amounts of income deferred from periods before 1984.

### **Explanation of Provision**

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, 2017. 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, 2017. 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, 2017. 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, 2017.

## **8. Modification of proration rules for property and casualty insurance companies (sec. 13515 of the bill 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>696</sup> This proration rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from deductible dividends, and from other untaxed amounts.

### **Reasons for Change**

The Committee believes that the rate of proration applicable to property and casualty insurers with respect to untaxed income should be adjusted to take account of the tax rate reduction to 20 percent that applies to income of corporations, including property and casualty insurers. The Committee bill therefore modifies the percentage applicable under the proration rule.

### **Explanation of Provision**

The provision replaces the 15-percent reduction under present law with a reduction equal to 5.25 percent divided by the top corporate tax rate. For 2018, the top corporate tax rate is 35 percent, and the percentage reduction is 15 percent. For 2019 and thereafter, the corporate tax rate is 20 percent, and the percentage reduction is 26.25 percent under the proration rule for property and casualty insurance companies. The proration percentage will be automatically adjusted in the future if the top corporate tax rate is changed, so that the product of the proration percentage and the top corporate tax rate always equals 5.25 percent.

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017.

## **9. Repeal of special estimated tax payments (sec. 13516 of the bill 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.<sup>697</sup> The 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 16<sup>th</sup> year after the year for which the special estimated tax payment was made.

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<sup>696</sup> Sec. 832(b)(5).

<sup>697</sup> Sec. 847.



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 16<sup>th</sup> 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 as a result of a reduction in the taxpayer's special loss discount account or the liquidation or termination 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>698</sup> indicates that it is intended that the taxpayer may apply the amount of an overpayment of any 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 16<sup>th</sup> 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

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<sup>698</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.

payments credited against tax liability for such 16<sup>th</sup> 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 Treasury 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 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 15<sup>th</sup> 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.

### **Reasons for Change**

The Committee believes that the special estimated tax payment rules add complexity to the tax law and do not improve the accuracy of income measurement of property and casualty insurers. The Committee bill therefore repeals these rules.

### **Explanation of Provision**

The provision repeals section 847. Thus, the election to apply section 847, the additional deduction, special loss discount account, special estimated tax payment, and refundable amount rules of present law are eliminated.

The entire balance of an existing account is included in income of the taxpayer for the first taxable year beginning after 2017, and the entire amount of existing special estimated tax payments are applied against the amount of additional tax attributable to this inclusion. Any special estimated tax payments in excess of this amount are treated as estimated tax payments under section 6655.

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017.

## **10. Capitalization of certain policy acquisition expenses (sec. 13517 of the bill 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 generally are amortized over the 120-month period beginning with the first month in the second half of the taxable year.<sup>699</sup>

A special rule provides for 60-month amortization of the first \$5 million of specified policy acquisition expenses with a phase-out. The phase-out reduces the amount amortized over 60 months by the excess of the insurance company's specified policy acquisition expenses for the taxable year over \$10 million.

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 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.

### **Reasons for Change**

In connection with the reduction in the corporate tax rate, the Committee believes it is timely and appropriate to update present-law tax provisions governing capitalization of policy acquisition expenses. The provision therefore increases the amortization period and percentages relating to policy acquisition expenses.

### **Explanation of Provision**

The provision extends the amortization period for specified policy acquisition expenses from a 120-month period to the 600-month period beginning with the first month in the second half of the taxable year. The provision does not change the special rule providing for 60-month amortization of the first \$5 million of specified policy acquisition expenses (with phaseout). The provision provides that for annuity contracts, the percentage is 3.17; for group life insurance contracts, the percentage is 3.72; and for all other specified insurance contracts, the percentage is 13.97.

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<sup>699</sup> Sec. 848.

## Effective Date

The provision applies to taxable years beginning after December 31, 2017.

### **11. Tax reporting for life settlement transactions, clarification of tax basis of life insurance contracts, and exception to transfer for valuable consideration rules (secs. 13518 through 13520 of the bill and secs. 101, 1016, and 6050X 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>700</sup>

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>701</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>702</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>703</sup>

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<sup>700</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 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>701</sup> Sec. 101(a)(2).

<sup>702</sup> Sec. 101(a)(2)(A).

<sup>703</sup> Sec. 101(a)(2)(B).

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>704</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>705</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 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.

### **Reasons for Change**

Sales of life insurance contracts on the secondary market have grown in recent years. Though there has been some administrative guidance in the area, the Committee believes it is useful to buyers, sellers, and issuers of these contracts, as well as the payors and recipients of death benefits under the contracts, for the law to provide clarity about the determination of the basis of property changing hands and the measurement of gain and income with respect to the contract. Further, efficient tax administration is improved, and a reduction in the number of disputes between taxpayers and government is achieved, by requiring reporting with respect to transfers of life insurance contracts to which the provision applies.

### **Explanation of Provision**

#### **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.

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<sup>704</sup> 2009-21 I.R.B. 1029.

<sup>705</sup> 2009-21 I.R.B. 1031.

## **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, (4) the name of the issuer, and (5) 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 name, address, and TIN of the seller or the transferor to a foreign person, (2) the basis of the contract (i.e., the investment in the contract within the meaning of section 72(e)(6)), 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 name, address and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of a payment, (3) the date of each such payment, (4) the gross amount of the payment (5) 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, 2017, and reportable death benefits paid after December 31, 2017. 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, 2017.

## **12. Limitation on deduction for FDIC premiums (sec. 13531 of the bill and sec. 162 of the Code)**

### **Present Law**

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>706</sup> generally comprises 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>707</sup>

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<sup>706</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>707</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.

Corporations that make a valid election pursuant to section 1362 of subchapter S of the Code, referred to as S corporations, generally are 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.

## **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>708</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>709</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>710</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, repealed in 1986<sup>711</sup> for most taxpayers, 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 is 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

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<sup>708</sup> Sec. 581. See also Treas. Reg. sec. 1.581-1(a).

<sup>709</sup> While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, and a cooperative bank, there are certain exceptions and special rules for such institutions. Treas. Reg. sec. 1.581-2(a).

<sup>710</sup> Sec. 1361(b)(2)(A).

<sup>711</sup> Tax Reform Act of 1986, Pub. L. No. 99-514.



under an experience method that generally looks to the ratio of (1) the total bad debts sustained during the taxable year and the five preceding taxable years to (2) the sum of the loans outstanding at the close of such taxable years.<sup>712</sup>

### Credit unions

Credit unions are exempt from Federal income taxation.<sup>713</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 use of credit unions.<sup>714</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>715</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>716</sup>

### Reasons for Change

The Committee believes that this provision is necessary to correct for the fact that, when the FDIC determines the assessments necessary to maintain an adequate balance in the Deposit Insurance Fund (“DIF”), it does so on a pretax basis and does not take into account the deductibility of the premium payments. These deductions diminish the General Fund and effectively result in a General Fund transfer to the DIF.

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<sup>712</sup> Sec. 585(b)(2).

<sup>713</sup> Sec. 501(c)(14)(A). 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 <https://www.treasury.gov/press-center/press-releases/Documents/report30702.doc>.

<sup>714</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>715</sup> The Treasury Department has concluded that any remaining regulatory differences do not raise competitive equity concerns between credit unions and banks. United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions*, Report 3070, January 15, 2001, p. 2, available at <https://www.treasury.gov/press-center/press-releases/Documents/report30702.doc>.

<sup>716</sup> Technical Advice Memorandum 199924060, March 5, 1999, and Rev. Rul. 80-230, 1980-2 C.B. 169, 1980.

### **Explanation of Provision**

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 provision 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>717</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>718</sup>

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), 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 provision applies to taxable years beginning after December 31, 2017.

## **13. Repeal of advance refunding bonds (sec. 13532 of the bill 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>719</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.

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<sup>717</sup> 12 U.S.C. sec. 1817(b).

<sup>718</sup> Pub. L. No. 111-203.

<sup>719</sup> Sec. 141.

The exclusion for income for interest on State and local bonds applies to refunding bonds but there are limits on advance refunding bonds. A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). Different rules apply to 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>720</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 and qualified 501(c)(3) bonds may be advance refunded one time.<sup>721</sup> Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all.<sup>722</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.<sup>723</sup>

### **Reasons for Change**

The ability to issue advance refunding bonds allows State and local governments to issue and have outstanding two sets of Federally subsidized debt associated with the same activity. The Committee believes that a single activity should have a maximum of only one set of Federally subsidized debt, and so believes removing the ability to issue tax-advantaged advance refunding bonds is appropriate.

### **Explanation of Provision**

The provision repeals the exclusion from gross income for interest on a bond issued to advance refund another bond.

### **Effective Date**

The provision applies to advance refunding bonds issued after December 31, 2017.

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<sup>720</sup> Sec. 149(d)(5).

<sup>721</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>722</sup> Sec. 149(d)(2).

<sup>723</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.

## **14. Cost basis of specified securities determined without regard to identification (sec. 13533 of the bill 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, as the result of sale of property). The taxpayer's gain or loss on a disposition of property is the difference between the amount realized on the sale and the taxpayer's adjusted basis in the property disposed of.<sup>724</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>725</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 improvements 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 sold are deemed to be drawn from the earliest acquired shares (the "first-in-first-out rule").<sup>726</sup> However, 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>727</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>728</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>729</sup> To facilitate the determination of the cost of RIC stock under the average basis

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<sup>724</sup> Sec. 1001.

<sup>725</sup> Sec. 1016.

<sup>726</sup> Treas. Reg. sec. 1.1012-1(c)(1).

<sup>727</sup> Treas. Reg. sec. 1.1012-1(c)(2).

<sup>728</sup> Treas. Reg. sec. 1.1012-1(e).

<sup>729</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>730</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>731</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>732</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>733</sup>

### **Reasons for Change**

The Committee believes that the specific identification method is inappropriate for taxpayers other than RICs. FIFO and, where permitted, average basis, provide accurate measures of income and are less prone to manipulation than specific identification. Nonetheless, the Committee believes that RICs should continue to be able to use specific identification so as to avoid (1) undermining a RICs ability to attract new investors (who may not want to be taxed on gain that accrued prior to their purchase of an interest in the RIC) and (2) harming less wealthy investors in RICs, who would be less able to mitigate the impact of the change than their wealthier counterparts.

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<sup>730</sup> Sec. 1012(c)(2).

<sup>731</sup> Sec. 1012(d)(1). Other special rules apply to DRP stock. See sec. 1012(d)(2) and (3).

<sup>732</sup> Sec. 6045(g); Treas. Reg. sec. 1.6045-1(d).

<sup>733</sup> See sec. 6045(g)(2).

### **Explanation of Provision**

The provision requires that the cost of any specified security sold, exchanged, or otherwise disposed of on or after January 1, 2018, 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 a taxpayer holding shares in a RIC). The provision does not apply to sales, exchanges, or other dispositions of specified securities by RICs.

The provision 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.

### **Effective Date**

The provision applies to sales, exchanges, and other dispositions after December 31, 2017.

## **15. Expansion of qualifying beneficiaries of an electing small business trust (sec. 13541 of the bill and sec. 1361 of the Code)**

### **Present Law**

An electing small business trust ("ESBT") may be a shareholder of an S corporation.<sup>734</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>735</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. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

### **Reasons for Change**

An ESBT that is an S corporation shareholder is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. For that reason, the Committee believes that allowing a nonresident alien individual to be a potential current beneficiary of an ESBT presents little risk of tax avoidance.

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<sup>734</sup> Sec. 1361(c)(2)(A)(v).

<sup>735</sup> Sec. 1361(b)(1)(C) and (c)(2)(B)(v).

### **Explanation of Provision**

The provision allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

### **Effective Date**

The provision takes effect on January 1, 2018.

## **16. Charitable contribution deduction for electing small business trusts (sec. 13542 of the bill and sec. 642(c) of the Code)**

### **Present Law**

An electing small business trust (“ESBT”) may be a shareholder of an S corporation.<sup>736</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. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT. In addition to nonseparately computed income or loss, an S corporation reports to its shareholders their pro rata share of certain separately stated items of income, loss, deduction, and credit.<sup>737</sup> For this purpose, charitable contributions (as defined in section 170(c)) of an S corporation are separately stated and taken by the shareholder.

The treatment of a charitable contribution passed through by an S corporation depends on the shareholder. Because an ESBT is a trust, the deduction for charitable contributions applicable to trusts,<sup>738</sup> rather than the deduction applicable to individuals,<sup>739</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.

### **Reasons for Change**

When an S corporation makes a charitable contribution, the rules governing the timing and extent of the shareholder’s deduction depend on the type of shareholder. The Committee believes that a single set of rules should govern when S corporation shareholders may deduct charitable contributions passed through to them.

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<sup>736</sup> Sec. 1361(c)(2)(A)(v).

<sup>737</sup> Sec. 1366(a)(1).

<sup>738</sup> Sec. 642(c).

<sup>739</sup> Sec. 170.

### **Explanation of Provision**

The provision provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by 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 provision applies to taxable years beginning after December 31, 2017.



## PART VII - EMPLOYMENT

### 1. Modification of limitation on excessive employee remuneration (sec. 13601 of the bill 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 publicly traded corporate employers. The otherwise allowable deduction for compensation with respect to a covered employee of a publicly held corporation<sup>740</sup> is limited to no more than \$1 million per year.<sup>741</sup> The deduction limitation applies when the deduction attributable to the compensation 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) any employee whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934 (“Exchange Act”) by reason of being among the corporation’s four most highly compensated officers for the taxable year (other than the chief executive officer).<sup>742</sup> 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 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 such capacity), and (3) the three most highly compensated officers, other than the principal executive officer or principal 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>743</sup> The new guidance provides that “covered employee” means any employee

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<sup>740</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. Section 162(m)(2).

<sup>741</sup> Sec. 162(m). This deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.

<sup>742</sup> Sec. 162(m)(3).

<sup>743</sup> Notice 2007-49, 2007-25 I.R.B. 1429.

who is (1) as of the close of the taxable year, 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<sup>744</sup> for the taxable year (other than the principal executive officer or principal financial 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>745</sup>

### **Definition of publicly held corporation**

For purposes of the deduction disallowance of section 162(m), a publicly held corporation means any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934.<sup>746</sup> All U.S. publicly traded companies are subject to this registration requirement, including their foreign affiliates. A foreign company publicly traded through American depository receipts (“ADRs”) is also subject to this registration requirement if more than 50 percent of the issuer’s outstanding voting securities are held, directly or indirectly, by residents of United States and either (i) the majority of the executive officers or directors are United States citizens or residents, (ii) more than 50 percent of the assets of the issuer are located in the United States, or (iii) the business of the issuer is administered principally in the United States. Other foreign companies are not subject to the registration requirement.

### **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.<sup>747</sup>

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

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<sup>744</sup> By reason of being among the officers whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934.

<sup>745</sup> Treas. Reg. sec. 1.162-27(c)(2).

<sup>746</sup> Sec. 162(m)(2).

<sup>747</sup> Sec. 162(m)(4)(F).

basis<sup>748</sup>; (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”)<sup>749</sup>; (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>750</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.

### 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>751</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 majority-approved 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 (“SARs”)) 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. A stock option or SAR with an exercise price not less than the fair market value, on the date the option or SAR is granted, of the stock subject to the option or SAR, generally is 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). This is the case because the amount of compensation attributable to the options or SARs received by the executive is based solely on an increase in the corporation’s stock price. Stock-based compensation is not treated as performance-based if it depends on factors other than corporate performance.

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<sup>748</sup> Sec. 162(m)(4)(B).

<sup>749</sup> Sec. 162(m)(4)(C).

<sup>750</sup> Secs. 105, 106, and 132.

<sup>751</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.

## **Reasons for Change**

The Committee believes that the significant exceptions to the limit on deductible executive compensation by publicly traded corporations have resulted in a shift away from cash compensation paid to senior executives in favor of stock options and other forms of performance pay. The Committee further believes this shift has led to perverse consequences resulting from the focus of such executives and businesses on quarterly results, rather than the long-term success of the company and its rank-and-file workers. Additionally, the Committee believes that aligning the deductibility limit between domestically traded publicly traded corporations and all foreign companies that trade ADRs in the United States, as well as certain private C corporations and S corporations, promotes fair tax treatment across similarly situated businesses. The Committee believes the law should be clarified to override administrative guidance, Notice 2007-49, 2007-25 I.R.B. 1429, which, contrary to the statute, limits the number of covered employees to four.

## **Explanation of Provision**

### **Definition of covered employee**

The provision revises the definition of covered employee to include both the principal executive officer and the principal financial officer. Further, an individual is a covered employee if the individual holds one of these positions at any time during the taxable year. The provision also defines as a covered employee the three (rather than four) most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer) who are required to be reported on the company's proxy statement (*i.e.*, the statement required pursuant to executive compensation disclosure rules promulgated under the Exchange Act) for the taxable year (or who would be required to be reported on such a statement for a company not required to make such a report to shareholders). This includes such officers of a corporation not required to file a proxy statement but which otherwise falls within the revised definition of a publicly held corporation, as well as such officers of a publicly traded corporation that would otherwise have been required to file a proxy statement for the year (for example, but for the fact that the corporation delisted its securities or underwent a transaction that resulted in the nonapplication of the proxy statement requirement).

In addition, if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, 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.

## **Definition of publicly held corporation**

The provision extends the applicability of section 162(m) to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs. The proposed definition may include certain additional corporations that are not publicly traded, such as large private C or S corporations.

## **Performance-based compensation and commissions exceptions**

The provision eliminates the exceptions for commissions and performance-based compensation from the definition of compensation subject to the deduction limit. 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.

### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017. A transition rule applies to remuneration which is pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date.

## **2. Excise tax on excess tax-exempt organization executive compensation (sec. 13602 of the bill and new sec. 4960 of the Code)**

### **Present Law**

Taxable employers and other service recipients generally may deduct reasonable compensation expenses.<sup>752</sup> However, in some cases, compensation in excess of specific levels is not deductible.

A publicly held corporation generally cannot deduct more than \$1 million of compensation (that is not compensation otherwise excepted from this limit) in a taxable year for each “covered employee.”<sup>753</sup> For this purpose, a covered employee is the corporation’s principal executive officer (or an individual acting in such capacity) defined in reference to the Securities Exchange Act of 1934 (“Exchange Act”) as of the close of the taxable year, or any employee whose total compensation is required to be reported to shareholders under the Exchange Act by reason of being among the corporation’s three most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer).<sup>754</sup>

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<sup>752</sup> Sec. 162(a)(1).

<sup>753</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>754</sup> Notice 2007-49, 2007-2 I.R.B. 1429.

Unless an exception applies, generally a corporation cannot deduct that portion of the aggregate present value of a “parachute payment” which equals or exceeds three times the “base amount” of certain service providers. The nondeductible excess is an “excess parachute payment.”<sup>755</sup> A parachute payment is generally a payment of compensation that is contingent on a change in corporate ownership or control made to certain officers, shareholders, and highly compensated individuals.<sup>756</sup> An individual’s base amount is the average annualized compensation includible in the individual’s gross income for the five taxable years ending before the date on which the change in ownership or control occurs.<sup>757</sup> Certain amounts are not considered parachute payments, including payments under a qualified retirement plan, a simplified employee pension plan, or a simple retirement account.<sup>758</sup>

These deduction limits generally do not affect a tax-exempt organization.

### **Reasons for Change**

The Committee believes that tax-exempt organizations enjoy a tax subsidy from the Federal government because contributions to such organizations are generally deductible and such organizations are generally not subject to tax (except on unrelated business income). As a result, such organizations are subject to the requirement that they use their resources for specific purposes, and the Committee believes that excessive compensation (including excessive severance packages) paid to senior executives of such organizations diverts resources from those particular purposes. The Committee further believes that alignment of the tax treatment of excessive executive compensation between for-profit and tax-exempt employers furthers the Committee’s broader tax reform effort of making the system fairer for all businesses.

### **Explanation of Provision**

Under the provision, an employer is liable for an excise tax equal to 20 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 (under a new definition for this purpose that relates solely to separation pay) 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 provision, 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

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<sup>755</sup> Sec. 280G(a) and (b)(1).

<sup>756</sup> Sec. 280G(b)(2) and (c).

<sup>757</sup> Sec. 280G(b)(3).

<sup>758</sup> Secs. 401(a), 403(a), 408(k), and 408(p).

the organization (or a predecessor) for any preceding taxable year beginning after December 31, 2016. An “applicable tax-exempt organization” is an organization exempt from tax under section 501(a), an exempt farmers’ cooperative,<sup>759</sup> a Federal, State or local governmental entity with excludable income,<sup>760</sup> or a political organization.<sup>761</sup>

Remuneration means wages as defined for income tax withholding purposes,<sup>762</sup> but does not include any designated Roth contribution<sup>763</sup> and includes amounts required to be included in gross income under section 457(f).<sup>764</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>765</sup> during the taxable year with respect to the organization, (4) is a supporting organization<sup>766</sup> during the taxable year with respect to the organization, or (5) in the case of a voluntary employees’ beneficiary association (“VEBA”),<sup>767</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 provision.

Under the provision, 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

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<sup>759</sup> Sec. 521(b).

<sup>760</sup> Sec. 115(1).

<sup>761</sup> Sec. 527(e)(1).

<sup>762</sup> Sec. 3401(a).

<sup>763</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>764</sup> Sec. 457(f) applies to an “ineligible” deferred compensation plan of a State and local government and tax-exempt employer (that is, a plan that does not meet the requirements to be an eligible plan under section 457(b)). Under an ineligible plan, deferred amounts are treated as nonqualified deferred compensation and includible in income for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation. 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. Earnings post vesting are generally taxed when paid.

<sup>765</sup> Sec. 509(f)(3).

<sup>766</sup> Sec. 509(a)(3).

<sup>767</sup> Sec. 501(c)(9).

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>768</sup> or an eligible deferred compensation plan of a State or local government employer.<sup>769</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 provision applies to taxable years beginning after December 31, 2017.

## **3. Treatment of qualified equity grants (sec. 13603 of the bill and new sec. 83(i) of the Code)**

### **Present Law**

#### **Income tax treatment of employer stock transferred to an employee**

Specific rules apply to property, including employer stock, transferred to an employee in connection with the performance of services.<sup>770</sup> These rules govern the amount and timing of income inclusion by the employee and the amount and timing of the employer's compensation deduction.

Under these rules, an employee generally must recognize income in the taxable year in which the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier (referred to herein as "substantially vested"). Thus, if the employee's right to the stock is substantially vested when the stock is transferred to the employee, the employee recognizes income in the taxable year of such transfer, in an amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). If at the time the stock is transferred to the employee, the employee's right to the stock is not substantially vested (referred to herein as "nonvested"), the employee does not recognize income attributable to the stock transfer until the taxable year in which the employee's right becomes substantially vested. In this case, the amount includible in the employee's income is

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<sup>768</sup> Sec. 403(b).

<sup>769</sup> Sec. 457(b).

<sup>770</sup> Sec. 83. Section 83 applies generally to transfers of any property, not just employer stock, in connection with the performance of services by any service provider, not just an employee. However, the provision described herein applies only with respect to certain employer stock transferred to employees.



the fair market value of the stock as of the date that the employee's right to the stock is substantially vested (less any amount paid for the stock). However, if the employee's right to the stock is nonvested at the time the stock is transferred to employee, under section 83(b), the employee may elect within 30 days of transfer to recognize income in the taxable year of transfer, referred to as a "section 83(b)" election.<sup>771</sup> If a proper and timely election under section 83(b) is made, the amount of compensatory income is capped at the amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). A section 83(b) election is available with respect to grants of "restricted stock" (nonvested stock), and does not generally apply to the grant of options.

In general, an employee's right to stock or other property is subject to a substantial risk of forfeiture if the employee's right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services.<sup>772</sup> An employee's right to stock or other property is transferable if the employee can transfer an interest in the property to any person other than the transferor of the property.<sup>773</sup> Thus, generally, employer stock transferred to an employee by an employer is not transferable merely because the employee can sell it back to the employer.

In the case of stock transferred to an employee, the employer is allowed a deduction (to the extent a deduction for a business expense is otherwise allowable) equal to the amount included in the employee's income as a result of transfer of the stock.<sup>774</sup> The employer deduction generally is permitted in the employer's taxable year in which or with which ends the employee's taxable year when the amount is included and properly reported in the employee's income.<sup>775</sup>

These rules do not apply to the grant of a nonqualified option on employer stock unless the option has a readily ascertainable fair market value.<sup>776</sup> Instead, these rules apply to the transfer of employer stock by the employee on exercise of the option. That is, if the right to the stock is substantially vested on transfer (the time of exercise), income recognition applies for the taxable year of transfer. If the right to the stock is nonvested on transfer, the timing of income inclusion is determined under the rules applicable to the transfer of nonvested stock. In either

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<sup>771</sup> Under Treas. Reg. sec. 1.83-2, the employee makes an election by filing with the Internal Revenue Service 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 employee must also provide a copy of the statement to the employer.

<sup>772</sup> See section 83(c)(1) and Treas. Reg. sec. 1.83-3(c) for the definition of substantial risk of forfeiture.

<sup>773</sup> Treas. Reg. sec. 1.83-3(d). In addition, under section 83(c)(2), the right to stock is transferable only if any transferee's right to the stock would not be subject to a substantial risk of forfeiture.

<sup>774</sup> Sec. 83(h).

<sup>775</sup> Treas. Reg. sec. 1.83-6.

<sup>776</sup> See section 83(e)(3) and Treas. Reg. sec. 1.83-7. A nonqualified option is an option on employer stock that is not a statutory option, discussed below.

case, the amount includible in income by the employee is the fair market value of the stock as of the required time of income inclusion, less the exercise price paid by the employee. A section 83(b) election generally does not apply to the grant of options. If upon the exercise of an option, nonvested stock is transferred to the employee, a section 83(b) election may apply. The employer's deduction is generally determined under the rules that apply to transfers of restricted stock, but a special accrual rule may apply under Treasury regulations when the transferred stock is substantially vested.<sup>777</sup>

### **Employment taxes and reporting**

Employment taxes generally consist of taxes under the Federal Insurance Contributions Act ("FICA"), tax under the Federal Unemployment Tax Act ("FUTA"), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").<sup>778</sup> Unless an exception applies under the applicable rules, compensation provided to an employee constitutes wages subject to these taxes.

FICA imposes tax on employers and employees, generally based on the amount of wages paid to an employee during the year. Special rules as to the timing and amount of FICA taxes apply in the case of nonqualified deferred compensation, as defined for FICA purposes.<sup>779</sup>

The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the OASDI wage base (\$127,200 for 2017); and (2) the Medicare or hospital insurance ("HI") tax equal to 1.45 percent of all covered wages.<sup>780</sup> The employee portion of FICA tax generally must be withheld and, along with the employer portion, remitted to the Federal government by the employer. FICA tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.<sup>781</sup>

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<sup>777</sup> Treas. Reg. sec. 1.83-6(a)(3).

<sup>778</sup> Secs. 3101-3128 (FICA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Instead of FICA taxes, railroad employers and employees are subject, under the Railroad Retirement Tax Act ("RRTA"), sections 3201-3241, to taxes equivalent to FICA taxes with respect to compensation as defined for RRTA purposes. Sections 3501-3510 provide additional rules relating to all these taxes.

<sup>779</sup> Sec. 3121(v); Treas. Reg. sec. 31.3121(v)(2).

<sup>780</sup> The employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. The threshold amount is \$250,000 in the case of a joint return, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case.

<sup>781</sup> Under section 3501(b), employment taxes with respect to noncash fringe benefits are to be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary of the Treasury ("Treasury"). Announcement 85-113, 1985-31 I.R.B. 31, provides guidance on the application of employment taxes with respect to noncash fringe benefits.

FUTA imposes a tax on employers of six percent of wages up to the FUTA wage base of \$7,000.

Income tax withholding generally applies when wages are paid by an employer to an employee, based on graduated withholding rates set out in tables published by the Internal Revenue Service (“IRS”).<sup>782</sup> Like FICA tax withholding, income tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.

An employer is required to furnish each employee with a statement of compensation information for a calendar year, including taxable compensation, FICA wages, and withheld income and FICA taxes.<sup>783</sup> In addition, information relating to certain nontaxable items must be reported, such as certain retirement and health plan contributions. The statement, made on Form W-2, Wage and Tax Statement, must be provided to each employee by January 31 of the succeeding year.<sup>784</sup>

### **Statutory options**

Two types of statutory options apply with respect to employer stock: incentive stock options (“ISOs”) and options provided under an employee stock purchase plan (“ESPP”).<sup>785</sup> Stock received pursuant to a statutory option is subject to special rules, rather than the rules for nonqualified options, discussed above. No amount is includible in an employee’s income on the grant, vesting, or exercise of a statutory option.<sup>786</sup> In addition, generally no deduction is allowed to the employer under section 162 with respect to the option or the stock transferred to an employee.

If a holding requirement is met with respect to the stock transferred on exercise of a statutory option and the employee later disposes of the stock, the employee’s gain generally is treated as capital gain rather than ordinary income. Under the holding requirement, the employee must not dispose of the stock within two years after the date the option is granted and also must not dispose of the stock within one year after the date the option is exercised. If a disposition occurs before the end of the required holding period (a “disqualifying disposition”), the employee recognizes ordinary income in the taxable year in which the disqualifying

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<sup>782</sup> Sec. 3402. Specific withholding rates apply in the case of supplemental wages.

<sup>783</sup> Secs. 6041 and 6051.

<sup>784</sup> Employers send Form W-2 information to the Social Security Administration, which records information relating to Social Security and Medicare and forwards the Form W-2 information to the IRS. Employees include a copy of Form W-2 with their income tax returns.

<sup>785</sup> Sections 421-424 govern statutory options. Section 423(b)(5) requires that, under the terms of an ESPP, all employees granted options generally must have the same rights and privileges.

<sup>786</sup> Under section 56(b)(3), this income tax treatment with respect to stock received on exercise of an ISO does not apply for purposes of the alternative minimum tax under section 55.

disposition occurs and the employer may be allowed a corresponding deduction in the taxable year in which such disposition occurs. The amount of ordinary income recognized when a disqualifying disposition occurs generally equals the fair market value of the stock on the date of exercise (that is, when the stock was transferred to the employee) less the exercise price paid.

Employment taxes do not apply with respect to the grant or vesting of a statutory option, transfer of stock pursuant to the option, or a disposition (including a disqualifying disposition) of the stock.<sup>787</sup> However, certain special reporting requirements apply.

### **Nonqualified deferred compensation**

Compensation is generally includible in an employee's income when paid to the employee. However, in the case of a nonqualified deferred compensation plan,<sup>788</sup> unless the arrangement either is exempt from or meets the requirements of section 409A, the amount of deferred compensation is first includible in income for the taxable year when not subject to a substantial risk of forfeiture (as defined<sup>789</sup>), even if payment will not occur until a later year.<sup>790</sup> In general, to meet the requirements of section 409A, the time when nonqualified deferred compensation will be paid, as well as the amount, must be specified at the time of deferral with limits on further deferral after the time for payment. Various other requirements apply, including that payment can only occur on specific defined events.

Various exemptions from section 409A apply, including transfers of property subject to section 83.<sup>791</sup> Nonqualified options are not automatically exempt from section 409A, but may be structured so as not to be considered nonqualified deferred compensation.<sup>792</sup> A restricted stock unit ("RSU") is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain

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<sup>787</sup> Secs. 3121(a)(22), 3306(b)(19), and the last sentence of section 421(b).

<sup>788</sup> Compensation earned by an employee is generally paid to the employee shortly after being earned. However, in some cases, payment is deferred to a later period, referred to as "deferred compensation." Deferred compensation may be provided through a plan that receives tax-favored treatment, such as a qualified retirement plan under section 401(a). Deferred compensation provided through a plan that is not eligible for tax-favored treatment is referred to as "nonqualified" deferred compensation.

<sup>789</sup> Treas. Reg. sec. 1.409A-1(d).

<sup>790</sup> Section 409A and the regulations thereunder provide rules for nonqualified deferred compensation. Compensation that fails to meet the requirements of section 409A is also subject to an additional income tax of 20% on amounts includible in income and a potential interest factor tax ("409A taxes"). Section 409A and the additional 409A taxes apply to increases in the value of the failed compensation each year until it is paid.

<sup>791</sup> Treas. Reg. sec. 1.409A-1(b)(6).

<sup>792</sup> Treas. Reg. sec. 1.409A-1(b)(5). In addition, statutory option arrangements are not nonqualified deferred compensation arrangements.

performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU. The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock (or either). An arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the limits, of section 409A. The employer deduction generally is permitted in the employer's taxable year in which or with which ends the employee's taxable year when the amount is included and properly reported in the employee's income.<sup>793</sup>

### **Reasons for Change**

Employer stock may provide a valuable form of employee compensation. In some cases, the transfer of employer stock with a high fair market value may result in compensation income, and a related tax liability, that is disproportionately large in comparison to an employee's regular salary or wages. In the case of publicly traded employer stock, an employee may sell some of the stock to provide funds to cover that tax liability. However, that approach often is not available in the case of a closely held company that restricts the transferability of its stock. This may make employer stock a less attractive form of compensation. In the case of stock options, the inability to pay the tax liability that would result from the stock received on exercise of the option may mean employees let options lapse, thus losing compensation they have already earned. The Committee wishes to address these situations by allowing employees to elect to defer recognition of income attributable to stock received on exercise of an option or settlement of an RSU until an opportunity to sell some of the stock arises, but in no event longer than five years from the date that the employee's right to the stock becomes substantially vested.

### **Explanation of Provision**

#### **In general**

The provision allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to qualified stock transferred to the employee by the employer. An election to defer income inclusion ("inclusion deferral election") with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

If an employee elects to defer income inclusion under the provision, the income must be included in the employee's income for the taxable year that includes the earliest of (1) the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer;<sup>794</sup> (2) the date the employee first becomes an excluded employee (as described below); (3) the first date on which any stock of the employer becomes readily tradable on an

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<sup>793</sup> Sec. 404(a)(5).

<sup>794</sup> Thus, for this purpose, the qualified stock is considered transferable if the employee has the ability to sell the stock to the employer (or any other person).

established securities market;<sup>795</sup> (4) the date five years after the first date the employee's right to the stock becomes substantially vested; or (5) the date on which the employee revokes her inclusion deferral election.<sup>796</sup>

An inclusion deferral election is made in a manner similar to the manner in which a section 83(b) election is made.<sup>797</sup> The provision does not apply to income with respect to nonvested stock that is includible as a result of a section 83(b) election. The provision clarifies that Section 83 (other than the provision), including subsection (b), shall not apply to RSUs. Therefore, RSUs are not eligible for a section 83(b) election. This is the case because, absent this provision, RSUs are nonqualified deferred compensation and therefore subject to the rules that apply to nonqualified deferred compensation.

An employee may not make an inclusion deferral election for a year with respect to qualified stock if, in the preceding calendar year, the corporation purchased any of its outstanding stock unless at least 25 percent of the total dollar amount of the stock so purchased is stock with respect to which an inclusion deferral election is in effect ("deferral stock") and the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis.<sup>798</sup> For purposes of this requirement, stock purchased from an individual is not treated as deferral stock (and the purchase is not treated as a purchase of deferral stock) if, immediately after the purchase, the individual holds any deferral stock with respect to which an inclusion deferral election has been in effect for a longer period than the election with respect to the purchased stock. Thus, in general, in applying the purchase requirement, an individual's deferral stock with respect to which an inclusion deferral election has been in effect for the longest periods must be purchased first. A corporation that has deferral stock outstanding as of the beginning of any calendar year and that purchases any of its outstanding stock during the calendar year must report on its income tax return for the taxable year in which, or with which, the calendar year ends the total dollar amount of the outstanding stock purchased during the calendar year and such other information as the Secretary may require for purposes of administering this requirement.

A qualified employee may make an inclusion deferral election with respect to qualified stock attributable to a statutory option.<sup>799</sup> In that case, the option is not treated as a statutory

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<sup>795</sup> An established securities market is determined for this purpose by the Secretary, but does not include any market unless the market is recognized as an established securities market for purposes of another Code provision.

<sup>796</sup> An inclusion deferral election is revoked at the time and in the manner as the Secretary provides.

<sup>797</sup> Thus, as in the case of a section 83(b) election under present law, the employee must file with the IRS the inclusion deferral election and provide the employer with a copy.

<sup>798</sup> This requirement is met if the stock purchased by the corporation includes all the corporation's outstanding deferral stock.

<sup>799</sup> For purposes of the requirement that an ESPP provide employees with the same rights and privileges, the rules of the provision apply in determining which employees have the right to make an inclusion deferral election with respect to stock received under the ESPP.

option and the rules relating to statutory options and related stock do not apply. In addition, an arrangement under which an employee may receive qualified stock is not treated as a nonqualified deferred compensation plan solely because of an employee's inclusion deferral election or ability to make an election.

Deferred income inclusion applies also for purposes of the employer's deduction of the amount of income attributable to the qualified stock. That is, if an employee makes an inclusion deferral election, the employer's deduction is deferred until the employer's taxable year in which or with which ends the taxable year of the employee for which the amount is included in the employee's income as described in (1)-(5) above.

### **Qualified employee and qualified stock**

Under the provision, a qualified employee means an individual who is not an excluded employee and who agrees, in the inclusion deferral election, to meet the requirements necessary (as determined by the Secretary) to ensure the income tax withholding requirements of the employer corporation with respect to the qualified stock (as described below) are met. For this purpose, an excluded employee with respect to a corporation is any individual (1) who was a one-percent owner of the corporation at any time during the 10 preceding calendar years,<sup>800</sup> (2) who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity, (3) who is a family member of an individual described in (1) or (2),<sup>801</sup> or (4) who has been one of the four highest compensated officers of the corporation for any of the 10 preceding taxable years.<sup>802</sup>

Qualified stock is any stock of a corporation if--

- an employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and
- the option or RSU was granted by the corporation to the employee in connection with the performance of services and in a year in which the corporation was an eligible corporation (as described below).

However, qualified stock does not include any stock if, at the time the employee's right to the stock becomes substantially vested, the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation. Qualified stock can only be such if it relates to stock received in connection with options or RSUs, and does not include stock received in

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<sup>800</sup> One-percent owner status is determined under the top-heavy rules for qualified retirement plans, that is, section 416(i)(1)(B)(ii).

<sup>801</sup> In the case of one-percent owners, this results from application of the attribution rules of section 318 under section 416(i)(1)(B)(i)(II). Family members are determined under section 318(a)(1) and generally include an individual's spouse, children, grandchildren and parents.

<sup>802</sup> These officers are determined on the basis of shareholder disclosure rules for compensation under the Securities Exchange Act of 1934, as if such rules applied to the corporation.

connection with other forms of equity compensation, including stock appreciation rights or restricted stock.

A corporation is an eligible corporation with respect to a calendar year if (1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year,<sup>803</sup> and (2) the corporation has a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the corporation in the United States (or any U.S. possession) are granted stock options, or restricted stock units (“RSUs”), with the same rights and privileges to receive qualified stock (“80-percent requirement”).<sup>804</sup> For this purpose, in general, the determination of rights and privileges with respect to stock is determined in a similar manner as provided under the present-law ESPP rules.<sup>805</sup> However, employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, provided that the number of shares available to each employee is more than a de minimis amount. In addition, rights and privileges with respect to the exercise of a stock option are not treated for this purpose as the same as rights and privileges with respect to the settlement of an RSU.<sup>806</sup>

For purposes of the provision, corporations that are members of the same controlled group<sup>807</sup> are treated as one corporation.

### **Notice, withholding and reporting requirements**

Under the provision, a corporation that transfers qualified stock to a qualified employee must provide a notice to the qualified employee at the time (or a reasonable period before) the employee’s right to the qualified stock is substantially vested (and income attributable to the stock would first be includible absent an inclusion deferral election). The notice must (1) certify to the employee that the stock is qualified stock, and (2) notify the employee (a) that the employee may be eligible to elect to defer income inclusion with respect to the stock and (b) that, if the employee makes an inclusion deferral election, the amount of income required to be included at the end of the deferral period will be based on the value of the stock at the time the

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<sup>803</sup> This requirement continues to apply up to the time an inclusion deferral election is made. That is, under the provision, no inclusion deferral election may be made with respect to qualified stock if any stock of the corporation is readily tradable on an established securities market at any time before the election is made.

<sup>804</sup> In applying the requirement that 80 percent of employees receive stock options or RSUs, excluded employees and part-time employees are not taken into account. For this purpose, part-time employee is defined under section 4980E(d)(4), as an employee who is customarily employed for fewer than 30 hours per week.

<sup>805</sup> Sec. 423(b)(5).

<sup>806</sup> Under a transition rule, in the case of a calendar year beginning before January 1, 2018, the 80-percent requirement is applied without regard to whether the rights and privileges with respect to the qualified stock are the same.

<sup>807</sup> As defined in sec. 414(b).



employee's right to the stock first becomes substantially vested, notwithstanding whether the value of the stock has declined during the deferral period (including whether the value of the stock has declined below the employee's tax liability with respect to such stock), and the amount of income to be included at the end of the deferral period will be subject to withholding as provided under the provision, as well as of the employee's responsibilities with respect to required withholding. Failure to provide the notice may result in the imposition of a penalty of \$100 for each failure, subject to a maximum penalty of \$50,000 for all failures during any calendar year.

An inclusion deferral election applies only for income tax purposes. The application of FICA and FUTA are not affected. The provision includes specific income tax withholding and reporting requirements with respect to income subject to an inclusion deferral election.

For the taxable year for which income subject to an inclusion deferral election is required to be included in income by the employee (as described above), the amount required to be included in income is treated as wages with respect to which the employer is required to withhold income tax at a rate not less than the highest income tax rate applicable to individual taxpayers.<sup>808</sup> The employer must report on Form W-2 the amount of income covered by an inclusion deferral election (1) for the year of deferral and (2) for the year the income is required to be included in income by the employee. In addition, for any calendar year, the employer must report on Form W-2 the aggregate amount of income covered by inclusion deferral elections, determined as of the close of the calendar year.

#### **Effective Date**

The provision generally applies with respect to stock attributable to options exercised or RSUs settled after December 31, 2017. Under a transition rule, until the Secretary (or the Secretary's delegate) issues regulations or other guidance implementing the 80-percent and employer notice requirements under the provision, a corporation will be treated as complying with those requirements (respectively) if it complies with a reasonable good faith interpretation of the requirements. The penalty for a failure to provide the notice required under the provision applies to failures after December 31, 2017.

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<sup>808</sup> That is, the maximum rate of tax in effect for the year under section 1. The provision specifies that qualified stock is treated as a noncash fringe benefit for income tax withholding purposes.

#### **4. Increase in excise tax rate for stock compensation of insiders in expatriated corporations (sec. 13604 of the bill and sec. 4985 of the Code)**

##### **Present Law**

##### **Income tax treatment of employee stock compensation**

###### **In general**

Employers may grant various forms of stock compensation to employees,<sup>809</sup> including nonstatutory and statutory stock options, restricted stock, restricted stock units, and stock appreciation rights. The tax treatment of these various forms of stock compensation depends on the specific terms and conditions of the arrangement and applicable rules.

###### **Stock compensation treated as property transferred in connection with the performance of services**

Section 83 generally governs the taxation of transfers of any property in connection with the performance of services by any service provider. Typically, this encompasses the transfer of stock to an employee which is subject to conditions that amount to a substantial risk of forfeiture, called “restricted stock.” Section 83 also generally governs the taxation of nonstatutory (or nonqualified) stock options. In general, an employee’s right to stock or other property is subject to a substantial risk of forfeiture if the employee’s right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services.<sup>810</sup>

Generally, an employee must recognize income in the taxable year in which the employee’s right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier (referred to herein as “substantially vested”). Thus, if the employee’s right to the stock is substantially vested when the stock is transferred to the employee, the employee recognizes income in the taxable year of such transfer, in an amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). If at the time the stock is transferred to the employee, the employee’s right to the stock is not substantially vested (referred to herein as “nonvested”), the employee does not recognize income attributable to the stock transfer until the taxable year in which the employee’s right becomes substantially vested. In this case, the amount includible in the employee’s income is the fair market value of the stock as of the date that the employee’s right to the stock is substantially vested (less any amount paid for the stock).<sup>811</sup>

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<sup>809</sup> The terms “employee” and “employer” are used, although the provision herein also applies to individuals who are not employees and the service recipients of such non-employee individuals.

<sup>810</sup> See section 83(c)(1) and Treas. Reg. sec. 1.83-3(c) for the definition of substantial risk of forfeiture.

<sup>811</sup> Under section 83(b), the employee may elect within 30 days of transfer to recognize income in the taxable year of transfer, referred to as a “section 83(b)” election. If a proper and timely election under section 83(b) is made, the amount of compensatory income is capped at the amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock).

These rules do not apply to the grant of a nonqualified option unless the option has a readily ascertainable fair market value.<sup>812</sup> Instead, these rules generally apply to the transfer of employer stock by the employee on exercise of the option. That is, if the right to the stock is substantially vested on transfer (the time of exercise), income recognition applies for the taxable year of transfer. If the right to the stock is nonvested on transfer, the timing of income inclusion is determined under the rules applicable to the transfer of nonvested stock. In either case, the amount includible in income by the employee is the fair market value of the stock as of the required time of income inclusion, less the exercise price paid by the employee.

### Statutory stock options

Two types of statutory options apply with respect to employer stock: incentive stock options (“ISOs”) and options provided under an employee stock purchase plan (“ESPP”).<sup>813</sup> Stock received pursuant to a statutory option is subject to special rules, rather than the rules for nonqualified options, discussed above. Unlike nonstatutory options, statutory options may only be considered as such if granted to employees.<sup>814</sup> No amount is includible in an employee’s income on the grant, vesting, or exercise of a statutory option.

If a holding requirement is met with respect to the stock transferred on exercise of a statutory option and the employee later disposes of the stock, the employee’s gain generally is treated as capital gain rather than ordinary income. Under the holding requirement, the employee must not dispose of the stock within two years after the date the option is granted and also must not dispose of the stock within one year after the date the option is exercised. If a disposition occurs before the end of the required holding period (a “disqualifying disposition”), the employee recognizes ordinary income in the taxable year in which the disqualifying disposition occurs. The amount of ordinary income recognized when a disqualifying disposition occurs generally equals the fair market value of the stock on the date of exercise (that is, when the stock was transferred to the employee) less the exercise price paid.

### Stock compensation treated as deferred compensation

A restricted stock unit (“RSU”) is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee’s right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU. The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock. An

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<sup>812</sup> See section 83(e)(3) and Treas. Reg. sec. 1.83-7. A nonqualified option is an option on employer stock that is not a statutory option, discussed below.

<sup>813</sup> Sections 421-424 govern statutory options. Section 423(b)(5) requires that, under the terms of an ESPP, all employees granted options generally must have the same rights and privileges.

<sup>814</sup> Secs. 422(a)(2) and 423(a)(2).

arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the limits, of section 409A,<sup>815</sup> unless it meets an exemption from section 409A. If the RSU either is exempt from or complies with section 409A, the employee is subject to income taxation on receipt of cash or the transfer of shares attributable to the RSU.

A stock appreciation right (“SAR”) is a term used for an arrangement under which an employee has the right to receive an amount (in the form of cash or stock) determined by reference to the appreciation in value of one or more shares of employer stock, based on the difference in the stock’s value when the employee chooses to exercise the right and the value of the stock on the date of grant of the SAR. An SAR is generally taxable at the time of exercise on the amount of cash or value of stock transferred at the time of exercise of the SAR.<sup>816</sup>

Various exemptions from section 409A apply, including transfers of property subject to section 83, such as restricted stock.<sup>817</sup> Nonqualified options and SARs are not automatically exempt from section 409A, but may be structured so as not to be considered nonqualified deferred compensation.<sup>818</sup> In addition, ISOs and ESPPs are exempt from section 409A.<sup>819</sup>

### **Section 4985 excise tax on stock compensation of insiders of expatriated corporations**

Under section 4985, certain holders of stock options and other stock-based compensation are subject to an excise tax upon certain transactions that result in an expatriated corporation<sup>820</sup> (also referred to as corporate inversions).<sup>821</sup> The provision imposes an excise tax, currently at the rate of 15 percent, on the value of specified stock compensation held (directly or indirectly)

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<sup>815</sup> Section 409A and the regulations thereunder provide rules for nonqualified deferred compensation. Unless an arrangement either is exempt from or meets the requirements of section 409A, the amount of deferred compensation is first includible in income for the taxable year when not subject to a substantial risk of forfeiture (as defined), even if payment will not occur until a later year. In general, to meet the requirements of section 409A, the time when nonqualified deferred compensation will be paid, as well as the amount, must be specified at the time of deferral with limits on further deferral after the time for payment. Various other requirements apply, including that payment can only occur on specific defined events. Compensation that fails to meet the requirements of section 409A is also subject to an additional income tax of 20% on amounts includible in income and a potential interest factor tax (“409A taxes”). Section 409A and the additional 409A taxes apply to increases in the value of the failed compensation each year until it is paid.

<sup>816</sup> Rev. Rul. 80-300, 1980-2 C.B. 165.

<sup>817</sup> Treas. Reg. sec. 1.409A-1(b)(6).

<sup>818</sup> Treas. Reg. sec. 1.409A-1(b)(5).

<sup>819</sup> Treas. Reg. sec. 1.409A-1(b)(5)(ii).

<sup>820</sup> Sec. 7874(a)(2).

<sup>821</sup> For further discussion of the tax treatment of expatriated entities before the effective date of section 7874 and concerns that led to the enactment of sections 7874 and 4985, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005.

by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's expatriation date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the expatriation date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,<sup>822</sup> or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),<sup>823</sup> directors, and 10-percent owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an expatriated corporation (as defined) only if gain (if any) is recognized in whole or part by any shareholder by reason of the acquisition resulting in the corporate inversion.<sup>824</sup>

Specified stock compensation subject to the excise tax includes any payment<sup>825</sup> (or right to payment) granted by the expatriated corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the corporate inversion. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, restricted stock units, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is

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<sup>822</sup> An expanded affiliated group is an affiliated group (under section 1504) except that such group is determined without regard to the exceptions for certain corporations and is determined applying a greater than 50 percent threshold, in lieu of the 80 percent test.

<sup>823</sup> An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

<sup>824</sup> As referred to in section 7874(a)(2)(B)(i).

<sup>825</sup> Under the provision, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

treated as though it were invested in stock or stock options of the expatriating corporation (or member). For example, the provision applies to a disqualified individual's nonqualified deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. A payment directly tied to the value of the stock is specified stock compensation.

The excise tax applies to any such specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the expatriation date, and to any specified stock compensation awarded in the six-month period beginning with the expatriation date. As a result, for example, if a corporation cancels outstanding options three months before the transaction and then reissue comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, or a simple retirement account. In addition, under the provision, the excise tax does not apply to any stock option that is exercised during the six-month period before the expatriation date or to any stock acquired pursuant to such exercise, if income is recognized under section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock compensation that is exercised, sold, exchanged, distributed, cashed out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

For specified stock compensation held on the expatriation date, the amount of the tax is determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the expatriation date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the expatriation date is valued on the date granted. Under the provision, the cancellation of a non-lapse restriction is treated as a grant.

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants and other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right is determined using an appropriate option-pricing model, as specified or permitted by the Treasury Secretary, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the provision. The value of other forms of compensation, such as phantom stock or restricted stock, is the fair market value of the stock as of the date of the expatriation transaction. The value of any deferred

compensation that can be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the expatriation transaction (or the date of cancellation or grant, if applicable).

The excise tax also applies to any payment by the expatriated corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax is determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied is a payment made in respect of the tax. This includes direct payments of the tax and payments to reimburse the individual for payment of the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

To the extent that a disqualified individual is also a covered employee under section 162(m), the limit on the deduction allowed for employee remuneration for such employee is reduced by the amount of any payment (including reimbursements) made in respect of the tax under the provision. As discussed above, this includes direct payments of the tax and payments to reimburse the individual for payment of the tax.

The payment of the excise tax has no effect on the subsequent tax treatment of any specified stock compensation. Thus, the payment of the tax has no effect on the individual's basis in any specified stock compensation and no effect on the tax treatment for the individual at the time of exercise of an option or payment of any specified stock compensation, or at the time of any lapse or forfeiture of such specified stock compensation. The payment of the tax is not deductible and has no effect on any deduction that might be allowed at the time of any future exercise or payment.

### **Reasons for Change**

The Committee notes that the rate of the excise tax imposed by section 4985 has not been updated since 2013, when the applicable tax rate for long term capital gains (the rate on which the excise tax is based) increased to 20 percent, and wishes to update the excise tax rate to reflect the applicable long term capital gains rate under present law.

### **Explanation of Provision**

The provision increases the 15 percent rate of excise tax, imposed on the value of stock compensation held by insiders of an expatriated corporation, to 20 percent.

### **Effective Date**

The provision applies to corporations first becoming expatriated corporations after the date of enactment.

## **5. Conformity of contribution limits for employer-sponsored retirement plans (sec. 13611 of the bill and secs. 402, 403, 415, and 457 of the Code)**

### **Present Law**

Account-based tax-favored employer-sponsored retirement plans include a qualified defined contribution plan, a tax-sheltered annuity plan (referred to as a “section 403(b) plan”), and an eligible deferred compensation plan of a State or local government (referred to as a “governmental section 457(b) plan”).<sup>826</sup> A qualified defined contribution plan may include a qualified cash or deferred arrangement (referred to as a “section 401(k) plan”), under which an employee elects to have contributions made to the plan (referred to as “elective deferrals”) rather than receiving the same amount as cash compensation.<sup>827</sup> Elective deferrals are generally made on a pretax basis unless designated by the employee as Roth contributions, which are made on an after-tax basis. A defined contribution plan may also provide for after-tax employee contributions and for employer nonelective contributions and matching contributions. A section 403(b) plan may also provide for these different types of contributions. Although a governmental section 457(b) plan may provide for employer contributions, these plans generally provide only for elective deferrals.

In the case of a section 401(k) plan or a section 403(b) plan, specific annual limits apply to elective deferrals by an employee and additional annual limits apply to aggregate contributions for the employee. For 2017, elective deferrals are generally limited to the lesser of (1) \$18,000 plus an additional \$6,000 catch-up contribution limit for employees at least age 50 and (2) the employee’s compensation.<sup>828</sup> If an employee participates in both a section 401(k) plan and a section 403(b) plan of the same employer, a single limit applies to elective deferrals under both plans. For this purpose, members of a controlled group or affiliated service group are treated as a single employer.<sup>829</sup> However, under a special rule, in the case of employees who have completed 15 years of service, additional elective deferrals are permitted under a section 403(b) plan maintained by an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches.<sup>830</sup> In this case, the annual limit is increased by the least of (1) \$3,000, (2) \$15,000 reduced by the employee’s additional elective deferrals for previous years, and (3) \$5,000 multiplied by the employee’s years of service and reduced by the employee’s elective deferrals for previous years.

For 2017, the limit on aggregate contributions to a qualified defined contribution plan (including a section 401(k) plan) or a section 403(b) plan is the lesser of (1) \$54,000 and (2) the

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<sup>826</sup> Secs. 401(a), 403(a), 403(b), 457(b).

<sup>827</sup> Sec. 401(k).

<sup>828</sup> Secs. 402(g) and 414(v).

<sup>829</sup> Secs. 414(b), (c), (m) and (o). Controlled group status under section 414(b) or (c) is generally based on ownership of at least 80 percent.

<sup>830</sup> Sec. 402(g)(7).



employee's compensation.<sup>831</sup> Because employees generally do not receive compensation for years after they have terminated employment, contributions generally cannot be made for former employees. However, under a special rule, employer contributions to a section 403(b) plan can be made for up to five years after termination of employment.<sup>832</sup>

The limit described above on aggregate contributions to a qualified defined contribution plan applies to contributions for an employee to any defined contribution plans maintained by the same employer (including any members of a controlled group or affiliated service group).<sup>833</sup> Similarly, the limit on aggregate contributions to a section 403(b) plan applies to contributions for an employee to any section 403(b) plan maintained by the same employer. However, contributions to a qualified defined contribution plan and to a section 403(b) plan maintained by the same employer are subject to separate limits unless the employee in the section 403(b) plan is in control of the employer maintaining the qualified defined contribution plan.<sup>834</sup> In addition, deferrals under a governmental section 457(b) plan are not taken into account in applying this limit.

In the case of a governmental section 457(b) plan, all contributions are subject to a single limit, generally for 2017, the lesser of (1) \$18,000 plus an additional \$6,000 catch-up contribution limit for employees at least age 50 and (2) the employee's compensation.<sup>835</sup> This limit is separate from the limit on elective deferrals to section 401(k) and section 403(b) plans. Thus, for example, if an employee participates in both a section 403(b) plan and a governmental section 457(b) plan of the same employer, the employee may contribute up to \$18,000 (plus \$6,000 catch-up contributions if at least age 50) to the section 403(b) plan and up to \$18,000 (plus \$6,000 catch-up contributions if at least age 50) to the section 457(b) plan. In addition, under a special rule, catch-up contributions may be made by an employee to a governmental section 457(b) for the last three years before attainment of normal retirement age. Additional contributions may be made up to the lesser of (1) two times the otherwise applicable dollar limit for the year (two times \$18,000 for 2017, or \$36,000) and (2) the employee's otherwise applicable limit for the year plus the amount by which the limit applicable to the employee for previous years exceeded the employee's deferrals for the previous years.<sup>836</sup> If a higher limit

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<sup>831</sup> Sec. 415(c). Employee contributions to qualified defined benefit plans are also taken into account in applying this limit.

<sup>832</sup> Sec. 403(b)(3), permitting compensation received up to five years previously to be treated as compensation for the current year. In addition, under a special rule in section 415(c)(7), certain contribution amounts are permitted for church employees and foreign missionaries.

<sup>833</sup> For this purpose, controlled group status is based on ownership of more than 50 percent, rather than at least 80 percent.

<sup>834</sup> This could occur, for example, if the employee in the section 403(b) plan owns a separate business that maintains a qualified defined contribution plan. In that case, a single limit applies to the contributions for the employee to the section 403(b) plan and the defined contribution plan.

<sup>835</sup> Secs. 414(v) and 457(b)(2) and (e)(15).

<sup>836</sup> Sec. 457(b)(3).

applies to an employee for a year under this special rule than under the general catch-up rule (\$6,000 for 2017), the general catch-up rule does not apply for the year.

### **Reasons for Change**

The rules for qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans developed separately over time, which led to discrepancies between the types of plans. These discrepancies can create complexity for employers and plan administrators, as well as confusion for employees, and result in disparate treatment of taxpayers. Legislation in recent years has therefore sought to bring greater consistency to the rules applicable to different types of plans. The Committee wishes to conform the rules further, and provide more consistent treatment of taxpayers, by applying the same contribution limits to all types of plans.

### **Explanation of Provision**

The provision applies a single aggregate limit to contributions for an employee in a governmental section 457(b) plan and elective deferrals for the same employee under a section 401(k) plan or a section 403(b) plan of the same employer. Thus, the limit for governmental section 457(b) plans is coordinated with the limit for section 401(k) and 403(b) plans in the same manner as the limits are coordinated under present law for elective deferrals to section 401(k) and section 403(b) plans.

The provision repeals the special rules allowing additional elective deferrals and catch-up contributions under section 403(b) plans and governmental section 457(b) plans. Thus, the same limits apply to elective deferrals and catch-up contributions under section 401(k) plans, section 403(b) plans and governmental section 457(b) plans.

The provision repeals the special rule allowing employer contributions to section 403(b) plans for up to five years after termination of employment.<sup>837</sup>

The provision also revises application of the limit on aggregate contributions to a qualified defined contribution plan or a section 403(b) plan (that is, the lesser of (1) \$54,000 (for 2017) and (2) the employee's compensation). As revised, a single aggregate limit applies to contributions for an employee to any defined contribution plans, any section 403(b) plans, and any governmental section 457(b) plans maintained by the same employer, including any members of a controlled group or affiliated service group.<sup>838</sup>

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<sup>837</sup> The provision does not repeal the special rule in section 415(c)(7), under which certain contribution amounts are permitted for church employees and foreign missionaries.

<sup>838</sup> As under present law, employee contributions to qualified defined benefit plans are also taken into account in applying this limit.

## Effective Date

The provision is effective for plan years and taxable years beginning after December 31, 2017.

## **6. Repeal of special rule permitting recharacterization of IRA contributions (sec. 13612 of the bill and sec. 408A of the Code)**

### Present Law

#### Individual retirement arrangements

There are two basic types of individual retirement arrangements (“IRAs”) under present law: traditional IRAs,<sup>839</sup> to which both deductible and nondeductible contributions may be made,<sup>840</sup> and Roth IRAs, to which only nondeductible contributions may be made.<sup>841</sup> The principal difference between these two types of IRAs is the timing of income tax inclusion.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual’s IRAs (both traditional and Roth) for a taxable year is the lesser of a certain dollar amount (\$5,500 for 2017) or the individual’s compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. The dollar limit is increased annually (“indexed”) as needed to reflect increases in the cost-of living. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions up to \$1,000 to an IRA. The IRA catch-up contribution limit is not indexed.

#### Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit (reduced by any contributions to Roth IRAs) if neither the individual nor the individual’s spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual’s spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income (“AGI”) for the taxable year over certain indexed levels.<sup>842</sup> To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible after-tax contributions to a traditional IRA (that is, no AGI limits apply), subject to the same contribution limits as the limits on deductible

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<sup>839</sup> Sec. 408.

<sup>840</sup> Sec. 219.

<sup>841</sup> Sec. 408A.

<sup>842</sup> Sec. 219(g).

contributions, including catch-up contributions. An individual who has attained age 70½ before the close of a year is not permitted to make contributions to a traditional IRA for that year.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of the individual's basis.<sup>843</sup> All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs.

### **Roth IRAs**

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels.

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

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

### **Separation of traditional and Roth IRA accounts and conversions**

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

Taxpayers generally may convert an amount in a traditional IRA to a Roth IRA (sometimes referred to as a "conversion contribution").<sup>844</sup> The amount converted is includible in the taxpayer's income as if a withdrawal had been made.<sup>845</sup> The conversion is accomplished by a trustee-to-trustee transfer of the amount from the traditional IRA to the Roth IRA, or by a distribution from the traditional IRA and contribution to the Roth IRA within 60 days.

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<sup>843</sup> Basis results from after-tax contributions to traditional IRAs or a rollovers to traditional IRAs of after-tax amounts from another eligible retirement plan.

<sup>844</sup> Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA.

<sup>845</sup> Subject to various exceptions, distributions from an IRA before age 59½ that are includible in income are subject to a 10-percent early withdrawal tax under section 72(t). An exception applies to an amount includible in income as a result of the conversion from a traditional IRA into a Roth IRA. However, under a recapture rule, the early withdrawal tax applies if the taxpayer withdraws the amount within five years of the conversion.

Rollovers to IRAs of distributions from tax-favored employer-sponsored retirement plans (that is, qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans) are also permitted. For tax-free rollovers, distributions from pretax accounts under an employer-sponsored plan generally must be contributed to a traditional IRA, and distributions from a designated Roth account under an employer-sponsored plan must be contributed only to a Roth IRA. However, a distribution from an employer-sponsored plan that is not from a designated Roth account is also permitted to be rolled over into a Roth IRA, subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, a rollover from a tax-favored employer-sponsored plan to a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions).<sup>846</sup>

### **Recharacterization of IRA contributions**

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize the contribution as a contribution to the other type of IRA (traditional or Roth) by making a trustee-to-trustee transfer to the other type of IRA before the due date for the individual's income tax return for that year.<sup>847</sup> In the case of a recharacterization, the contribution will be treated as having been made to the transferee IRA (and not the original, transferor IRA) as of the date of the original contribution. Both regular IRA contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA.

The amount transferred in a recharacterization must be accompanied by any net income allocable to the contribution. In general, even if a recharacterization is accomplished by transferring a specific asset, net income is calculated as a pro rata portion of income on the entire account rather than income allocable to the specific asset transferred. However, when doing a Roth conversion of an amount for a year, an individual may establish multiple Roth IRAs, for example, Roth IRAs with different investment strategies, and divide the amount being converted among the IRAs. The individual can then choose whether to recharacterize any of the Roth IRAs as a traditional IRA by transferring the entire amount in the particular Roth IRA to a traditional IRA.<sup>848</sup> For example, if the value of the assets in a particular Roth IRA declines after the conversion, the conversion can be reversed by recharacterizing that IRA as a traditional IRA. The individual may then later convert that traditional IRA to a Roth IRA (referred to as a reconversion), including only the lower value in income. Treasury regulations prevent the reconversion from taking place immediately after the recharacterization, by requiring a minimum period to elapse before the reconversion. Generally the reconversion cannot occur sooner than

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<sup>846</sup> As in the case of a conversion of an amount from a traditional IRA to a Roth IRA, the 10-percent early withdrawal tax does not apply to income resulting from a rollover from a tax-favored employer-sponsored plan to a Roth IRA, subject to the recapture rule for distributions made from the Roth IRA within five years of the rollover.

<sup>847</sup> Sec. 408A(d)(6).

<sup>848</sup> Treas. Reg. sec. 1.408A-5, Q&A-2(b).

the later of 30 days after the recharacterization or a date during the taxable year following the taxable year of the original conversion.<sup>849</sup>

### **Reasons for Change**

Recharacterization of IRA contributions may enable an individual to avoid tax by retroactively manipulating the amount of income that must be recognized for tax purposes. The Committee wishes to repeal the recharacterization rule in order to prevent such manipulation.

### **Explanation of Provision**

The provision repeals the special rule that allows IRA contributions to one type of IRA (either traditional or Roth) to be recharacterized as a contribution to the other type of IRA. Thus, for example, under the provision, a conversion contribution establishing a Roth IRA during a taxable year can no longer be recharacterized as a contribution to a traditional IRA (thereby unwinding the conversion).<sup>850</sup>

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **7. Modification of rules applicable to length of service award programs for bona fide public safety volunteers (sec. 13613 of the bill and sec. 457(e) of the Code)**

### **Present Law**

Special rules apply to deferred compensation plans of State and local government and private, tax-exempt employers.<sup>851</sup> However, an exception to these rules applies in the case of a plan paying solely length of service awards to bona fide volunteers (or their beneficiaries) on account of qualified services performed by the volunteers. For this purpose, qualified services consist of firefighting and fire prevention services, emergency medical services, and ambulance services. An individual is treated as a bona fide volunteer for this purpose if the only compensation received by the individual for performing qualified services is in the form of (1) reimbursement or a reasonable allowance for reasonable expenses incurred in the performance of such services, or (2) reasonable benefits (including length of service awards) and nominal fees for the services, customarily paid in connection with the performance of such services by volunteers. The exception applies only if the aggregate amount of length of service awards accruing for a bona fide volunteer with respect to any year of service does not exceed \$3,000.

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<sup>849</sup> Treas. Reg. sec. 1.408A-5, Q&A-9.

<sup>850</sup> The provision does not preclude an individual from making a contribution to a traditional IRA and converting the traditional IRA to a Roth IRA. Rather, the provision would preclude the individual from later unwinding the conversion through a recharacterization.

<sup>851</sup> Sec. 457.

### **Reasons for Change**

Many communities rely on volunteer firefighters, emergency medical technicians, and ambulance drivers to support and supplement the services of public safety employees. In return, some communities award benefits to these volunteers based on a volunteer's years of service. However, under present law, the amount awarded cannot exceed \$3,000 per year of service. The Committee wishes to facilitate the recruitment and retention of such volunteers by increasing that limit.

### **Explanation of Provision**

The provision increases the aggregate amount of length of service awards that may accrue for a bona fide volunteer with respect to any year of service to \$6,000 and adjusts that amount in \$500 increments to reflect changes in cost-of-living for years after the first year the provision is effective. In addition, under the provision, if the plan is a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service. Actuarial present value is to be calculated using reasonable actuarial assumptions and methods, assuming payment will be made under the most valuable form of payment under the plan with payment commencing at the later of the earliest age at which unreduced benefits are payable under the plan or the participant's age at the time of the calculation.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **8. Extended rollover period for plan loan offset amounts (sec. 13614 of the bill and sec. 402(c) of the Code)**

### **Present Law**

#### **Taxation of retirement plan distributions**

A distribution from a tax-favored employer-sponsored retirement plan (that is, a qualified retirement plan, section 403(b) plan, or a governmental section 457(b) plan) is generally includible in gross income, except in the case of a qualified distribution from a designated Roth account or to the extent the distribution is a recovery of basis under the plan or the distribution is contributed to another such plan or an IRA (referred to as eligible retirement plans) in a tax-free rollover.<sup>852</sup> In the case of a distribution from a retirement plan to an employee under age 59½ (other than a distribution from a governmental section 457(b) plan), the distribution is also subject to a 10-percent early withdrawal tax unless an exception applies.<sup>853</sup>

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<sup>852</sup> Secs. 402(a) and (c), 402A(d), 403(a) and (b), 457(a) and (e)(16).

<sup>853</sup> Sec. 72(t).

A distribution from a tax-favored employer-sponsored retirement plan that is an eligible rollover distribution may be rolled over to an eligible retirement plan (referred to as a rollover contribution).<sup>854</sup> The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution (“60-day rollover”).

Employer-sponsored retirement plans are required to offer an employee a direct rollover with respect to any eligible rollover distribution before paying the amount to the employee. If an eligible rollover distribution is not directly rolled over to an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20-percent income tax withholding.<sup>855</sup> Employees who do not elect a direct rollover but who roll over eligible distributions within 60 days of receipt also defer tax on the rollover amounts; however, the 20 percent income tax withheld will remain taxable unless the employee substitutes funds within the 60-day period.

### **Plan loans**

Employer-sponsored retirement plans may provide loans to employees. However, the amount of a loan is a deemed distribution from the retirement plan unless the loan satisfies certain requirements in both form and operation, including that the terms of the loan (other than a loan specifically to purchase a home) provide for a repayment period of not more than five years and for level amortization of loan payments with payments not less frequently than quarterly.<sup>856</sup> Thus, if an employee stops making payments on a loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs. A deemed distribution of an unpaid loan balance is generally taxed as though an actual distribution occurred, including being subject to the 10-percent early withdrawal tax, if applicable. A deemed distribution is not eligible for rollover to another eligible retirement plan.

A plan may also provide that, in certain circumstances (for example, if an employee terminates employment), an employee’s obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the amount in employee’s account balance is offset by the amount of the unpaid loan balance, referred to as a loan offset. A loan offset is treated as an actual distribution from the plan equal to the unpaid loan balance (rather than a deemed distribution), and (unlike a deemed distribution) the amount of the distribution is eligible for tax-free rollover to another eligible retirement plan within 60 days. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution, and the plan loan offset amount is generally not subject to 20-percent income tax withholding.

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<sup>854</sup> Certain distributions are not eligible rollover distributions, such as annuity payments, required minimum distributions, hardship distributions, and loans that are treated as deemed distributions under section 72(p).

<sup>855</sup> Treas. Reg. sec. 1.402(c)-2, Q&A-1(b)(3).

<sup>856</sup> Sec. 72(p).



### **Reasons for Change**

A plan loan offset does not involve the current payment of funds to a participant. Thus, in order to roll over a plan offset amount, a participant must have other funds in that amount available. If a loan offset occurs at the time of a participant's termination of employment, the participant might not have funds immediately available for the rollover, particularly in the case of an involuntary termination. In addition, the participant may not know the precise date when the 60-day rollover period begins. The Committee believes that providing a longer rollover period with respect to plan loan offsets may result in more rollovers, thus preserving retirement savings.

### **Explanation of Provision**

Under the provision, the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution is extended from 60 days after the date of the offset to the due date (including extensions) for filing the Federal income tax return for the taxable year in which the plan loan offset occurs, that is, the taxable year in which the amount is treated as distributed from the plan. Under the provision, a qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, a section 403(b) plan or a governmental section 457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's severance from employment. As under present law, a loan offset amount under the provision is the amount by which an employee's account balance under the plan is reduced to repay a loan from the plan.

### **Effective Date**

The provision applies to plan loan offset amounts treated as distributed in taxable years beginning after December 31, 2017.

## PART VIII – EXEMPT ORGANIZATIONS

### 1. Excise tax based on investment income of private colleges and universities (sec. 13701 of the bill and new sec. 4968 of the Code)

#### Present Law

#### Public charities and private foundations

An organization qualifying for tax-exempt status under section 501(c)(3) is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.<sup>857</sup> Certain organizations are classified as public charities *per se*, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations, certain organizations providing assistance to colleges and universities, and governmental units.<sup>858</sup> Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.<sup>859</sup> Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public plus revenue arising from activities related to its exempt purposes (e.g., fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.<sup>860</sup> A supporting organization, *i.e.*, an organization that provides support to another section 501(c)(3) entity that is not a private foundation and meets the requirements of the Code, also is classified as a public charity.<sup>861</sup>

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<sup>857</sup> The Code does not expressly define the term “public charity,” but rather provides exceptions to those entities that are treated as private foundations.

<sup>858</sup> Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

<sup>859</sup> Treas. Reg. sec. 1.170A-9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a “facts and circumstances” test. Treas. Reg. sec. 1.170A-9(f)(3).

<sup>860</sup> To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization’s exempt purposes. Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

<sup>861</sup> Sec. 509(a)(3). Supporting organizations are further classified as Type I, II, or III depending on the relationship they have with the organizations they support. Supporting organizations must support public charities listed in one of the other categories (*i.e.*, *per se* public charities, broadly supported public charities, or revenue generating public charities), and they are not permitted to support other supporting organizations or testing for public safety organizations.

A section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (*e.g.*, an individual, a family, or a corporation).

The deduction for charitable contributions to private foundations is in some instances less generous than the deduction for charitable contributions to public charities. In addition, private foundations are subject to a number of operational rules and restrictions that do not apply to public charities.<sup>862</sup>

### **Excise tax on investment income of private foundations**

Under section 4940(a), private foundations that are recognized as exempt from Federal income tax under section 501(a) (other than exempt operating foundations)<sup>863</sup> are subject to a two-percent excise tax on their net investment income. Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)<sup>864</sup> equal or exceed the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.<sup>865</sup> In addition, the foundation cannot have been

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Organizations organized and operated exclusively for testing for public safety also are classified as public charities. Sec. 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under section 170.

<sup>862</sup> Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases). Sec. 4940. Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are prohibited from engaging in self-dealing transactions (sec. 4941), are required to make a minimum amount of charitable distributions each year, (sec. 4942), are limited in the extent to which they may control a business (sec. 4943), may not make speculative investments (sec. 4944), and may not make certain expenditures (sec. 4945). Violations of these rules result in excise taxes on the foundation and, in some cases, may result in excise taxes on the managers of the foundation.

<sup>863</sup> Exempt operating foundations are exempt from the section 4940 tax. Sec. 4940(d)(1). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation (as defined in section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons. Sec. 4940(d)(2).

<sup>864</sup> Sec. 4942(g).

<sup>865</sup> Sec. 4940(e).

subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements in section 4942.

Private foundations that are not exempt from tax under section 501(a), such as certain charitable trusts, are subject to an excise tax under section 4940(b). The tax is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the tax on unrelated business income that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

Private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.<sup>866</sup>

### **Private colleges and universities**

Private colleges and universities generally are treated as public charities rather than private foundations<sup>867</sup> and thus are not subject to the private foundation excise tax on net investment income.

### **Reasons for Change**

In recent years, the endowment balances at many private colleges and universities have increased dramatically. At the same time, college tuition has risen at rates in excess of the rate of inflation. Where the endowment of a private college or university has grown so large that it is not commensurate with the scope of the institution's activities in educating students, and where the significant portion of the student population does not receive scholarships, the Committee believes it is appropriate to impose a modest excise tax on the investment income derived from the endowment.

### **Explanation of Provision**

The provision imposes an excise tax on an applicable educational institution for each taxable year equal to 1.4 percent of the net investment income of the institution for the taxable year. Net investment income is determined using rules similar to the rules of section 4940(c) (relating to the net investment income of a private foundation).

For purposes of the provision, an applicable educational institution is an institution: (1) that has at least 500 tuition-paying students during the preceding taxable year; (2) that is an

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<sup>866</sup> Sec. 4942(d)(2).

<sup>867</sup> Secs. 509(a)(1) and 170(b)(1)(A)(ii).

eligible educational institution as described in section 25A of the Code<sup>868</sup>; (3) that is not described in the first section of section 511(a)(2)(B) of the Code (generally describing State colleges and universities); and (4) the aggregate fair market value of the assets of which at the end of the preceding taxable year (other than those assets which are used directly in carrying out the institution's exempt purpose<sup>869</sup>) is at least \$250,000 per student. For these purposes, the number of students of an institution is based on the daily average number of full-time students attending the institution, with part-time students being taken into account on a full-time student equivalent basis.

For purposes of determining whether an educational institution meets the asset-per-student threshold and for purposes of determining net investment income, assets and net investment income of a related organization are treated as assets and net investment income, respectively, of the educational institution, except that:

1. No such amount is taken into account with respect to more than one educational institution; and
2. Unless the related organization is controlled by the educational institution or is a supporting organization (described in section 509(a)(3)) with respect to the institution for the taxable year, assets and investment income that are not intended or available for the use or benefit of the educational institution are not taken into account. For example, assets of a related organization that are earmarked or restricted for (or fairly attributable to) the educational institution would be treated as assets of the educational institution, whereas assets of a related organization that are held for unrelated purposes (and are not fairly attributable to the educational institution) would be disregarded.

The term "related organization" means, with respect to any educational institution, any organization that: (1) controls, or is controlled by, the institution; (2) is controlled by one or more persons that also control the institution; or (3) is a supported organization<sup>870</sup> or a supporting organization<sup>871</sup> during the taxable year with respect to the institution.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

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<sup>868</sup> Section 25A defines an eligible educational institution as an institution (1) which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. sec. 1088), as in effect on August 5, 1977, and (2) which is eligible to participate in a program under title IV of such Act.

<sup>869</sup> Assets used directly in carrying out the institution's exempt purpose include, for example, classroom buildings and physical facilities used for educational activities and office equipment or other administrative assets used by employees of the institution in carrying out exempt activities, among other assets.

<sup>870</sup> Secs. 509(f)(3).

<sup>871</sup> Secs. 509(a)(3).

## **2. Name and logo royalties treated as unrelated business taxable income (sec. 13702 of the bill and secs. 512(b) and 513 of the Code)**

### **Present Law**

#### **Tax exemption for certain organizations**

Section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in section 401(a).

#### **Unrelated business income tax, in general**

An exempt organization generally may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (*e.g.*, program service revenue); investment income; and trade or business income that is not related to exempt activities. The Federal income tax exemption generally extends to the first three categories, and does not extend to an organization's unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.<sup>872</sup>

The unrelated business income tax ("UBIT") generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.<sup>873</sup> An organization that is subject to UBIT and that has \$1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing exempt status. A section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities.<sup>874</sup> Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

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<sup>872</sup> This is the case for social clubs (sec. 501(c)(7)), voluntary employees' beneficiary associations (sec. 501(c)(9)), and organizations and trusts described in sections 501(c)(17) and 501(c)(20). Sec. 512(a)(3).

<sup>873</sup> Secs. 511-514.

<sup>874</sup> Treas. Reg. sec. 1.501(c)(3)-1(e).

## **Organizations subject to tax on unrelated business income**

Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to the unrelated business income tax generally include: (1) organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts);<sup>875</sup> (2) qualified pension, profit-sharing, and stock bonus plans described in section 401(a);<sup>876</sup> and (3) certain State colleges and universities.<sup>877</sup>

## **Exclusions from Unrelated Business Taxable Income**

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents,<sup>878</sup> unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.<sup>879</sup> Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and State fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

### **Reasons for Change**

The Committee has learned that tax-exempt organizations are engaging in more commercial activity than ever and are using more complex organization structures to do so. Many organizations, for example, are now earning significant income by licensing their own names and logos to for-profit businesses to avoid directly engaging in a taxable business in a manner that would cause UBIT liability. The Committee believes that such income should not be excluded from UBIT.

### **Explanation of Provision**

The provision modifies the UBIT treatment of the licensing of an organization's name or logo generally to subject royalty income derived from such a license to UBIT. Specifically, the provision amends section 513 (regarding unrelated trades or businesses) to provide that any sale

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<sup>875</sup> Sec. 511(a)(2)(A).

<sup>876</sup> Sec. 511(a)(2)(A).

<sup>877</sup> Sec. 511(a)(2)(B).

<sup>878</sup> Secs. 511-514.

<sup>879</sup> Sec. 512(b)(13).

or licensing by an organization of any name or logo of the organization (including any trademark or copyright related to a name or logo) is treated as an unrelated trade or business that is regularly carried on by the organization. In addition, the provision amends section 512 (regarding unrelated business taxable income) to provide that income derived from any such licensing of a name or logo of the organization is included in the organization's gross unrelated business taxable income, notwithstanding the provisions of section 512 that otherwise exclude certain types of passive income (including royalties) from unrelated business taxable income.<sup>880</sup>

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

### **3. Unrelated business taxable income separately computed for each trade or business activity (sec. 13703 of the bill and sec. 512(a) of the Code)**

#### **Present Law**

#### **Tax exemption for certain organizations**

Section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in section 401(a).

#### **Unrelated business income tax, in general**

An exempt organization generally may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (*e.g.*, program service revenue); investment income; and trade or business income that is not related to exempt activities. The Federal income tax exemption generally extends to the first three categories, and does not extend to an organization's unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.<sup>881</sup>

The unrelated business income tax ("UBIT") generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.<sup>882</sup> An organization that is subject to

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<sup>880</sup> Specifically, the proposal references sections 512(b)(1), (2), (3) and (5).

<sup>881</sup> This is the case for social clubs (sec. 501(c)(7)), voluntary employees' beneficiary associations (sec. 501(c)(9)), and organizations and trusts described in sections 501(c)(17) and 501(c)(20). Sec. 512(a)(3).

<sup>882</sup> Secs. 511-514.



UBIT and that has \$1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing exempt status. A section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities.<sup>883</sup> Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

### **Organizations subject to tax on unrelated business income**

Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to the unrelated business income tax generally include: (1) organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts)<sup>884</sup> (2) qualified pension, profit-sharing, and stock bonus plans described in section 401(a),<sup>885</sup> and (3) certain State colleges and universities.<sup>886</sup>

### **Exclusions from Unrelated Business Taxable Income**

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents,<sup>887</sup> unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.<sup>888</sup> Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and State fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

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<sup>883</sup> Treas. Reg. sec. 1.501(c)(3)-1(e).

<sup>884</sup> Sec. 511(a)(2)(A).

<sup>885</sup> Sec. 511(a)(2)(A).

<sup>886</sup> Sec. 511(a)(2)(B).

<sup>887</sup> Secs. 511-514.

<sup>888</sup> Sec. 512(b)(13).

### **Specific deduction against unrelated business taxable income**

In computing unrelated business taxable income, an exempt organization may take a specific deduction of \$1,000. This specific deduction may not be used to create a net operating loss that will be carried back or forward to another year.<sup>889</sup>

In the case of a diocese, province or religious order, or a convention or association of churches, a specific deduction is allowed with respect to each parish, individual church, district, or other local unit. The specific deduction is equal to the lower of \$1,000 or the gross income derived from any unrelated trade or business regularly carried on by the local unit.<sup>890</sup>

### **Operation of multiple unrelated trades or businesses**

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated trade or business.<sup>891</sup> Under regulations, in determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions.<sup>892</sup> As a result, an organization may use a deduction from one unrelated trade or business to offset income from another, thereby reducing total unrelated business taxable income.

### **Reasons for Change**

The Committee has learned that tax-exempt organizations are engaging in more commercial activity than ever and are using more complex organization structures to do so. In a recent study of colleges and universities, for example, the IRS issued a report detailing how some institutions improperly claim losses from non-exempt activities that lack a profit motive and thus are not truly trades or businesses. These losses are used to offset UBIT income from profitable business activities in the current year or future years. The Committee believes this behavior should be prohibited.

### **Explanation of Provision**

For an organization with more than one unrelated trade or business, the provision requires that unrelated business taxable income first be computed separately with respect to each trade or business and without regard to the specific deduction generally allowed under section 512(b)(12). The organization's unrelated business taxable income for a taxable year is the sum of the amounts (not less than zero) computed for each separate unrelated trade or business, less

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<sup>889</sup> Sec. 512(b)(12).

<sup>890</sup> *Ibid.*

<sup>891</sup> Sec. 512(a).

<sup>892</sup> Treas. Reg. sec. 1.512(a)-1(a).

the specific deduction allowed under section 512(b)(12). A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose.

The result of the provision is that a deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year. The provision generally does not, however, prevent an organization from using a deduction from one taxable year to offset income from the same unrelated trade or business activity in another taxable year, where appropriate.

#### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017. Under a special transition rule, net operating losses arising in a taxable year beginning before January 1, 2018, that are carried forward to a taxable year beginning on or after such date are not subject to the rule of the provision.

#### **4. Repeal of tax-exempt status for professional sports leagues (sec. 13704 of the bill and sec. 501(c)(6) of the Code)**

#### **Present Law**

#### **Tax exemption for section 501(c)(6) organizations**

Section 501(c)(6) provides tax exempt status for business leagues and certain other organizations not organized for profit, no part of the net earnings of which inures to the benefit of any private shareholder or individual. A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit.<sup>893</sup> Such an organization may not have as its primary activity performing “particular services” for members.<sup>894</sup> Contributions to these types of organizations are not deductible as charitable contributions; however, they may be deductible as trade or business expenses if ordinary and necessary in the conduct of the taxpayer’s business. Many organizations known as “trade associations” may qualify for exempt status under this provision.

#### **Professional sports leagues**

Since 1966, section 501(c)(6) has included language exempting from tax “professional football leagues (whether or not administering a pension fund for football players).” The Internal Revenue Service has interpreted this language as applying not only to professional football leagues, but to all professional sports leagues.<sup>895</sup>

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<sup>893</sup> Treas. Reg. sec. 1.501(c)(6)-1.

<sup>894</sup> Treas. Reg. sec. 1.501(c)(6)-1.

<sup>895</sup> See General Counsel Memorandum 38179, November 29, 1979 (“We continue to believe that professional sports leagues, including football leagues, do not qualify for exemption if the ordinary standards of

## Reasons for Change

Professional sports leagues are highly profitable businesses that promote the specific brand of a sports league, rather than an industry or a profession as a whole. The Committee does not believe that it is appropriate for the taxpayers to subsidize this activity through tax-exempt status.

## Explanation of Provision

The provision strikes from section 501(c)(6) the phrase “professional football leagues (whether or not administering a pension fund for football players).” In addition, the provision amends section 501(c)(6) to provide that section 501(c)(6) “shall not apply to any professional sports league (whether or not administering a pension fund for players).”

## Effective Date

The provision is effective for taxable years beginning after December 31, 2017.

## **5. Modification of taxes on excess benefit transactions (intermediate sanctions) (sec. 13705 of the bill and sec. 4958 of the Code)**

### Present Law

#### Excess benefit transactions

The Code imposes excise taxes on excess benefit transactions between disqualified persons and charitable organizations (other than private foundations) or social welfare organizations (as described in section 501(c)(4)).<sup>896</sup> The excess benefit transaction tax commonly is referred to as “intermediate sanctions.”<sup>897</sup> An excess benefit transaction generally is a transaction in which an economic benefit is provided, directly or indirectly, by a charitable or

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section 501(c)(6) are applied. However, while the answer is far from clear, we have concluded upon reflection that the specific exemption of football leagues in 1966 can be viewed as providing support for recognition of exemption of all professional sports leagues as a unique category of organizations under section 501(c)(6). Since other professional sports leagues are indistinguishable in any meaningful way from football leagues, we think it is fair to conclude that by formally blessing the exemption it knew football leagues had historically enjoyed, Congress implicitly recognized a unique historical category of exemption under section 501(c)(6). The specific enumeration of football leagues can be viewed as merely exemplary of the category thus recognized, and as necessitated only by the problem of insuring that football’s pension and merger arrangement would not endanger its exemption”).

<sup>896</sup> Sec. 4958.

<sup>897</sup> The excess benefit transaction rules were enacted in 1996 to provide a sanction short of revocation of tax exemption, an “intermediate” sanction, for abusive self-dealing transactions (*i.e.*, private inurement) between an organization insider and the organization. Prior to enactment of the excess benefit transaction rules, there was no sanction in the Code on organization insiders or disqualified persons for engaging in self-dealing transactions with respect to a public charity.

social welfare organization to or for the use of a disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. The excise tax is imposed on any such excess.

### **Disqualified persons**

Disqualified persons generally include: (1) persons who were, at any time during the five-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the organization (including officers and directors); (2) a member of the family of such a person; and (3) certain 35-percent or more controlled entities.<sup>898</sup>

Special rules apply with respect to charities that are sponsoring organizations of donor advised funds. For such organizations, the term “disqualified person” also includes: (1) donors and certain other persons appointed by a donor to provide advice with respect to the fund (donor advisors); (2) investment advisors; and (3) members of the family and certain 35-percent or more controlled entities of a person described in (1) or (2).<sup>899</sup> An investment advisor is a person (other than an employee of the sponsoring organization) compensated by the organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the organization.<sup>900</sup>

### **Rebuttable presumption of reasonableness**

Under the intermediate sanctions regulations, in certain cases an exempt organization may avail itself of a rebuttable presumption with respect to compensation arrangements and property transfers. Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if: (1) the arrangement or terms of transfer are approved in advance by an authorized body of the organization (as defined below) composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transfer; (2) the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and (3) the authorized body adequately documented the basis for its determination concurrently with making that determination.<sup>901</sup> If these requirements are satisfied, the IRS may overcome the presumption of reasonableness if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body.<sup>902</sup>

An authorized body is defined as: (1) the governing body of the organization; (2) a committee of the governing body, which may be composed of any individuals permitted under

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<sup>898</sup> Sec. 4958(f)(1).

<sup>899</sup> Secs. 4958(f)(1)(E) and (F).

<sup>900</sup> Sec. 4958(f)(8).

<sup>901</sup> Treas. Reg. sec. 53.4958-6(a). See also H. Rep. No. 506, 104<sup>th</sup> Congress, 2d Sess. 1996, pp. 53, 56-7.

<sup>902</sup> Treas. Reg. sec. 53.4958-6(b).

State law to serve on such a committee, to the extent that the committee is permitted by State law to act on behalf of the governing body; or (3) to the extent permitted by State law, other parties authorized by the governing body of the organization to act on its behalf by following procedures specified by the governing body in approving compensation arrangements or property transfers.<sup>903</sup>

In general, an authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether the arrangement is reasonable in its entirety or the transfer is at fair market value.<sup>904</sup> In the case of compensation, relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person. In the case of property, relevant information includes, but is not limited to, current independent appraisals of the value of all property to be transferred, and offers received as part of an open and competitive bidding process. For organizations with annual gross receipts (including contributions) of less than \$1 million, the authorized body is considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. There is no inference with respect to whether circumstances falling outside this safe harbor will meet the requirement with respect to the collection of appropriate data.<sup>905</sup>

In general, for a decision to be documented adequately, the written or electronic records of the authorized body must note: (1) the terms of the transaction that was approved and the date it was approved; (2) the members of the authorized body who were present during debate on the transaction that was approved and those who voted on it; (3) the comparability data obtained and relied upon by the authorized body and how the data was obtained; and (4) any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.<sup>906</sup>

### **Amount of the excise tax**

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization's managers, but is not imposed on the exempt organization.

An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200

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<sup>903</sup> Treas. Reg. sec. 53.4958-6(c)(1)(i).

<sup>904</sup> Treas. Reg. sec. 53.4958-6(c)(2)(i).

<sup>905</sup> Treas. Reg. sec. 53.4958-6(c)(2)(ii).

<sup>906</sup> Treas. Reg. sec. 53.4958-6(c)(3).

percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed \$20,000 with respect to any excess benefit transaction) is imposed on an organization manager who knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.<sup>907</sup> If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.<sup>908</sup>

### **Standard for knowing violations**

A manager participates in a transaction knowingly only if the manager: (1) has actual knowledge of sufficient facts indicating that, based solely upon those facts, such transaction would be an excess benefit transaction; (2) is aware that such a transaction under these circumstances may violate the provisions of Federal tax law governing excess benefit transactions; and (3) negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction.<sup>909</sup> The burden of proof in a Tax Court proceeding as to whether an organization manager (or foundation manager) acted knowingly is on the Secretary.<sup>910</sup>

Knowing does not mean having a reason to know.<sup>911</sup> However, evidence tending to show that an organization manager has reason to know of a particular fact or particular rule is relevant in determining whether the manager had actual knowledge of such a fact or rule. Thus, for example, evidence tending to show that a manager has reason to know of sufficient facts indicating that, based solely upon such facts, a transaction would be an excess benefit transaction is relevant in determining whether the manager has actual knowledge of such facts.<sup>912</sup>

Participation by an organization manager is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. Participation by an organization manager is not willful if the manager does not know that the transaction in which the manager is participating is an excess benefit transaction.<sup>913</sup> An organization manager's participation is due to reasonable

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<sup>907</sup> Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

<sup>908</sup> Sec. 4958(d)(1).

<sup>909</sup> Treas. Reg. sec. 53.4958-1(d)(4)(i).

<sup>910</sup> Sec. 7454(b).

<sup>911</sup> Treas. Reg. sec. 53.4958-1(d)(4)(ii).

<sup>912</sup> *Ibid.*

<sup>913</sup> Treas. Reg. sec. 53.4958-1(d)(5).

cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.<sup>914</sup>

### **Special rules**

An organization manager's reliance on professional advice generally means that the manager has not knowingly participated in an excess benefit transaction. Under Treasury regulations, an organization manager's participation in a transaction ordinarily is not considered knowing, even though the transaction subsequently is held to be an excess benefit transaction, to the extent that, after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned written opinion of that professional with respect to elements of the transaction within the professional's expertise. A written opinion is considered as reasoned even though it reaches a conclusion that is subsequently determined to be incorrect so long as the opinion addresses itself to the facts and the applicable standards. A written opinion is not considered to be reasoned if it does nothing more than recite the facts and express a conclusion. The absence of a written opinion of an appropriate professional with respect to a transaction does not, by itself, give rise to any inference that an organization manager participated in the transaction knowingly.

Appropriate professionals on whose written opinion an organization manager may rely, are: (1) legal counsel, including in-house counsel; (2) certified public accountants or accounting firms with expertise regarding the relevant tax law matters; and (3) independent valuation experts who hold themselves out to the public as appraisers or compensation consultants, perform the relevant valuations on a regular basis, are qualified to make valuations of the type of property or services involved, and include in the written opinion a certification that the three preceding requirements are met.<sup>915</sup>

An organization manager's participation in a transaction ordinarily is not considered knowing even though the transaction subsequently is held to be an excess benefit transaction, if an appropriate authorized body that approved the transaction meets the requirements of the rebuttable presumption of reasonableness with respect to the transaction.<sup>916</sup>

### **Reasons for Change**

The intermediate sanctions regime was enacted in 1996 to provide a sanction short of revocation of tax exemption in cases where the assets of a public charity or social welfare organization are used to benefit insiders. Since the enactment of intermediate sanctions, however, there continue to be reports of abuses by insiders and managers of such organizations. Compensation packages, loans, sales of property to insiders, joint ventures, and other transactions increasingly raise questions about the extent to which excess benefits are being

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<sup>914</sup> Treas. Reg. sec. 53.4958-1(d)(6).

<sup>915</sup> Treas. Reg. sec. 53.4958-1(d)(4)(iii).

<sup>916</sup> Treas. Reg. sec. 53.4958-1(d)(4)(iv).



provided to insiders of exempt organizations. Transactions with insiders create widespread opportunities for abuse, especially when the determination of whether a transaction passes muster depends upon a subjective determination of fair market value or reasonableness of compensation. Given the practical difficulties of addressing valuation questions, the continued report of abuses, and the critical importance of ensuring that charitable assets are not used for private purposes, the Committee believes it is necessary to address specific aspects of the intermediate sanctions regime that impede enforcement.

### **Explanation of Provision**

#### **Entity-level tax in the event of an excess benefit transaction**

Under the provision, if an initial tax is imposed on a disqualified person under the intermediate sanctions rules,<sup>917</sup> the organization is subject to an excise tax equal to 10 percent of the excess benefit, unless the participation of the organization in the transaction is not willful and is due to reasonable cause. No tax on the organization is imposed if the organization: (1) establishes that the minimum standards of due diligence (described below) were met with respect to the transaction; or (2) establishes to the satisfaction of the Secretary that other reasonable procedures were used to ensure that no excess benefit was provided.

#### **Eliminate rebuttable presumption and establish due diligence procedures**

The provision eliminates the rebuttable presumption of reasonableness contained in the intermediate sanctions regulations. Under the provision, the procedures that presently provide an organization with a presumption of reasonableness (*i.e.*, advance approval by an authorized body, reliance upon data as to comparability, and adequate and concurrent documentation) generally will establish instead that an organization has performed the minimum standards of due diligence with respect to an arrangement or transfer involving a disqualified person. Satisfaction of these minimum standards will not result in a presumption of reasonableness with respect to the transaction.

#### **Eliminate certain special rules for knowing behavior by organization managers**

The provision eliminates the special rule that provides that an organization manager's participation ordinarily is not "knowing" for purposes of the intermediate sanctions excise taxes if the manager relied on professional advice. Although the provision eliminates the special rule, whether an organization manager relies on professional advice is a relevant consideration in determining the manager knowingly participated in an excess benefit transaction.

The provision also eliminates the special regulatory rule that provides that an organization manager ordinarily does not act knowingly for purposes of the excess benefit transaction excise tax if the organization has met the requirements of the rebuttable presumption procedure.

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<sup>917</sup> Sec. 4958(a)(1).

## **Treat investment advisors and certain athletic coaches as disqualified persons**

The provision modifies the definition of a disqualified person for purposes of the intermediate sanctions rules. First, a person who performs services as an athletic coach for an organization that is an eligible educational institution (within the meaning of section 25A of the Code<sup>918</sup>) and is subject to the intermediate sanctions rules is treated as a disqualified person with respect to the organization. Second, the provision (1) expands to all organizations that are subject to the intermediate sanctions rules the present-law rule that treats investment advisors to donor advised funds as disqualified persons, and (2) modifies the definition of investment advisor for this purpose. For all applicable tax-exempt organizations (including sponsoring organizations of donor advised funds), the term investment advisor means, with respect to an organization, any person compensated by the organization, and who is primarily responsible, for managing the investment of, or providing investment advice with respect to, assets of the organization.<sup>919</sup> For a sponsoring organization of a donor advised fund, the term investment advisor also includes any person who is an investment advisor with respect to a sponsoring organization under present law, *i.e.*, a person (other than an employee of the organization) compensated by such organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the sponsoring organization.

## **Application of intermediate sanctions rules to section 501(c)(5) and section 501(c)(6) organizations**

The provision extends application of the section 4958 intermediate sanctions rules to tax-exempt organizations described in sections 501(c)(5) (labor and certain other organizations) and 501(c)(6) (business leagues and certain other organizations).

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

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<sup>918</sup> Section 25A defines an eligible educational institution as an institution (1) which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. sec. 1088), as in effect on August 5, 1977, and (2) which is eligible to participate in a program under title IV of such Act.

<sup>919</sup> Under the provision, the existing rules that treat as disqualified persons certain family members and 35-percent controlled entities of investment advisors to sponsoring organizations of donor advised funds will apply more broadly to investment advisors that are disqualified persons with respect to any organization subject to the intermediate sanctions rules.

## **6. Exception from private foundation excess business holding tax for independently-operated philanthropic business holdings (sec. 13706 of the bill and sec. 4943 of the Code)**

### **Present Law**

#### **Public charities and private foundations**

An organization qualifying for tax-exempt status under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”) is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.<sup>920</sup> Certain organizations are classified as public charities *per se*, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations (including medical research organizations), certain organizations providing assistance to colleges and universities, and governmental units.<sup>921</sup> Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.<sup>922</sup> Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public plus revenue arising from activities related to its exempt purposes (e.g., fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.<sup>923</sup> A supporting organization, *i.e.*, an organization that provides support to another section 501(c)(3) entity that is not a private foundation and meets certain other requirements of the Code, also is classified as a public charity.<sup>924</sup>

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<sup>920</sup> The Code does not expressly define the term “public charity,” but rather provides exceptions to those entities that are treated as private foundations.

<sup>921</sup> Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

<sup>922</sup> Treas. Reg. sec. 1.170A-9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a “facts and circumstances” test. Treas. Reg. sec. 1.170A-9(f)(3).

<sup>923</sup> To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization’s exempt purposes. Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

<sup>924</sup> Sec. 509(a)(3). Organizations organized and operated exclusively for testing for public safety also are classified as public charities. Sec. 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under section 170.

A section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (*e.g.*, an individual, a family, or a corporation).

The deduction for charitable contributions to private foundations is in some instances less generous than the deduction for charitable contributions to public charities. In addition, private foundations are subject to a number of operational rules and restrictions that do not apply to public charities, as well as a tax on their net investment income.<sup>925</sup>

### **Excess business holdings of private foundations**

Private foundations are subject to tax on excess business holdings.<sup>926</sup> In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership (substituting “profits interest” for “voting stock” and “capital interest” for “nonvoting stock”) and to other unincorporated enterprises (by substituting “beneficial interest” for “voting stock”). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.<sup>927</sup> This five-year period may be extended an additional five years in limited circumstances.<sup>928</sup> The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.<sup>929</sup>

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation’s applicable taxable year. An additional tax is imposed if an initial tax is

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<sup>925</sup> Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases). Sec. 4940. Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are prohibited from engaging in self-dealing transactions (sec. 4941), are required to make a minimum amount of charitable distributions each year (sec. 4942), are limited in the extent to which they may control a business (sec. 4943), may not make speculative investments (sec. 4944), and may not make certain expenditures (sec. 4945). Violations of these rules result in excise taxes on the foundation and, in some cases, may result in excise taxes on the managers of the foundation.

<sup>926</sup> Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

<sup>927</sup> Sec. 4943(c)(6).

<sup>928</sup> Sec. 4943(c)(7).

<sup>929</sup> Sec. 4943(d)(3).

imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

### **Reasons for Change**

In recent years, a new type of philanthropy has combined private sector entrepreneurship with charitable giving, such as through the donation of a private company's after-tax profits to charity. The Committee believes it is appropriate to encourage this form of philanthropy by eliminating certain legal impediments to its use, while also ensuring that private individuals cannot improperly benefit from amounts intended for a charitable purpose or inappropriately manage a taxable business. The Committee therefore believes it is appropriate to create an exception to the present-law private foundation excess business holdings rules for certain philanthropic business holdings. By so doing, the law will permit private philanthropists to bequeath an entire business to a private foundation, provided that the after-tax profits of the business will be paid to the foundation and certain other requirements are satisfied, while also ensuring that the donor's heirs cannot improperly benefit from the arrangement.

### **Explanation of Provision**

The provision creates an exception to the excess business holdings rules for certain philanthropic business holdings. Specifically, the tax on excess business holdings does not apply with respect to the holdings of a private foundation in any business enterprise that, for the taxable year, satisfies the following requirements: (1) the ownership requirements; (2) the "all profits to charity" distribution requirement; and (3) the independent operation requirements.

The ownership requirements are satisfied if: (1) all ownership interests in the business enterprise are held by the private foundation at all times during the taxable year; and (2) all the private foundation's ownership interests in the business enterprise were acquired not by purchase.

The "all profits to charity" distribution requirement is satisfied if the business enterprise, not later than 120 days after the close of the taxable year, distributes an amount equal to its net operating income for such taxable year to the private foundation. For this purpose, the net operating income of any business enterprise for any taxable year is an amount equal to the gross income of the business enterprise for the taxable year, reduced by the sum of: (1) the deductions allowed by chapter 1 of the Code for the taxable year that are directly connected with the production of the income; (2) the tax imposed by chapter 1 on the business enterprise for the taxable year; and (3) an amount for a reasonable reserve for working capital and other business needs of the business enterprise.

The independent operation requirements are met if, at all times during the taxable year, the following three requirements are satisfied. First, no substantial contributor to the private foundation, or family member of such a contributor, is a director, officer, trustee, manager, employee, or contractor of the business enterprise (or an individual having powers or responsibilities similar to any of the foregoing). Second, at least a majority of the board of directors of the private foundation are not also directors or officers of the business enterprise or members of the family of a substantial contributor to the private foundation. Third, there is no

loan outstanding from the business enterprise to a substantial contributor to the private foundation or a family member of such contributor. For purposes of the independent operation requirements, “substantial contributor” has the meaning given to the term under section 4958(c)(3)(C), and family members are determined under section 4958(f)(4).

The provision does not apply to the following organizations: (1) donor advised funds or supporting organizations that are subject to the excess business holdings rules by reason of section 4943(e) or (f); (2) any trust described in section 4947(a)(1) (relating to charitable trusts); or (3) any trust described in section 4947(a)(2) (relating to split-interest trusts).

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **7. Repeal of deduction for amounts paid in exchange for college athletic seating rights (sec. 13707 of the bill and sec. 170(l) of the Code)**

### **Present Law**

#### **In general**

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

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.*, an organization or entity described in section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor’s entire interest in the contributed property (*i.e.*, not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.<sup>930</sup> Fourth, the transfer must be of money or property—contributions of services are not deductible.<sup>931</sup> Finally, the transfer must be substantiated and in the proper form.

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

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<sup>930</sup> Sec. 170(a)(1).

<sup>931</sup> For example, the value of time spent volunteering for a charitable organization is not deductible. Incidental expenses such as mileage, supplies, or other expenses incurred while volunteering for a charitable organization, however, may be deductible.

## **College athletic seating rights**

In general, where a taxpayer receives or expects to receive a substantial return benefit for a payment to charity, the payment is not deductible as a charitable contribution. However, special rules apply to certain payments to institutions of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event. Specifically, the payor may treat 80 percent of a payment as a charitable contribution where: (1) the amount is paid to or for the benefit of an institution of higher education (as defined in section 3304(f)) described in section (b)(1)(A)(ii) (generally, a school with a regular faculty and curriculum and meeting certain other requirements), and (2) such amount would be allowable as a charitable deduction but for the fact that the taxpayer receives (directly or indirectly) as a result of the payment the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution.<sup>932</sup>

### **Reasons for Change**

The Committee believes that a robust charitable sector is vital to our economy, and that charitable giving is critical to ensuring that the sector thrives. For this reason, the Committee believes that it is desirable to provide additional incentives for taxpayers to provide monetary and volunteer support to charities. At the same time, the Committee believes that taxpayers should only be permitted a charitable deduction commensurate with the value of assets given to charity. For this reason, the provision eliminates the special rule under present law that allows taxpayers to take a charitable deduction for 80 percent of an amount contributed to a college or university in exchange for the right to purchase stadium seating and denies a deduction for such contribution.

### **Explanation of Provision**

The provision amends section 170(l) to provide that no charitable deduction shall be allowed for any amount described in paragraph 170(l)(2), generally, a payment to an institution of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event, as described in greater detail above.

### **Effective Date**

The provision is effective for contributions made in taxable years beginning after December 31, 2017.

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<sup>932</sup> Sec. 170(l).

## **8. Repeal charitable contribution substantiation exception for contributions reported by donee organization (sec. 13708 of the bill and sec. 170(f)(8) of the Code)**

### **Present Law**

#### **Charitable contributions**

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

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.*, an organization or entity described in section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.*, not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.<sup>933</sup> Fourth, the transfer must be of money or property—contributions of services are not deductible.<sup>934</sup> Finally, the transfer must be substantiated and in the proper form.

#### **Substantiation and other formal requirements**

##### **In general**

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution.<sup>935</sup> In the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. In such cases, the recordkeeping requirements may not be satisfied by maintaining other written records.

No charitable contribution deduction is allowed for a separate contribution of \$250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution

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<sup>933</sup> Sec. 170(a)(1).

<sup>934</sup> For example, the value of time spent volunteering for a charitable organization is not deductible. Incidental expenses such as mileage, supplies, or other expenses incurred while volunteering for a charitable organization, however, may be deductible.

<sup>935</sup> Sec. 170(f)(17).



from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.<sup>936</sup>

In addition, any charity receiving a contribution exceeding \$75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a “quid pro quo” contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.<sup>937</sup>

If the total charitable deduction claimed for noncash property is more than \$500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer’s return or the deduction is not allowed.<sup>938</sup> In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than \$5,000, and to attach an appraisal summary to the tax return.

#### Exception for certain contributions reported by the donee organization

Subsection 170(f)(8)(D) provides an exception to the contemporaneous written acknowledgment requirement described above. Under the exception, a contemporaneous written acknowledgment is not required if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, that includes the same content. “[T]he section 170(f)(8)(D) exception is not available unless and until the Treasury Department and the IRS issue final regulations prescribing the method by which donee reporting may be accomplished.”<sup>939</sup> No such final regulations have been issued.<sup>940</sup>

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<sup>936</sup> Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services. Sec. 170(f)(8).

<sup>937</sup> Sec. 6115.

<sup>938</sup> Sec. 170(f)(11).

<sup>939</sup> See IRS, Notice of Proposed Rulemaking, Substantiation Requirement for Certain Contributions, REG-138344-13 (October 13, 2015), I.R.B. 2015-41 (preamble).

<sup>940</sup> In October 2015, the IRS issued proposed regulations that, if finalized, would have implemented the section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement. The proposed regulations provided that a return filed by a donee organization under section 170(f)(8)(D) must include, in addition to the information generally required on a contemporaneous written acknowledgment: (1) the name and address of the donee organization; (2) the name and address of the donor; and (3) the taxpayer identification number of the donor. In addition, the return must be filed with the IRS (with a copy provided to the donor) on or before February 28 of the year following the calendar year in which the contribution was made. Under the proposed regulations, donee reporting would have been optional and would have been available solely at the discretion of the donee organization. The proposed regulations were withdrawn in January 2016. See Prop. Treas. Reg. sec 1.170A-13(f)(18).

### **Reasons for Change**

The alternative substantiation regime under section 170(f)(8)(D), if implemented by regulation, likely would require donee charities to collect and maintain sensitive taxpayer identifying information relating to their donors, such as Social Security numbers, thereby increasing the risk of identity theft. The Committee believes section 170(f)(8)(D) should be repealed to prevent this undesirable result.

### **Explanation of Provision**

The provision repeals the section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement.

### **Effective Date**

The provision is effective for contributions made in taxable years beginning after December 31, 2016.

## PART IX – OTHER PROVISIONS

### 1. Production period for beer, wine, and distilled spirits (sec. 13802 of the bill 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>941</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>942</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.

In the case of interest expense, the UNICAP rules apply only to interest paid or incurred during the property’s production period<sup>943</sup> and that is allocable to property produced by the taxpayer or acquired for resale which (1) is either real property or property with a class life of at least 20 years, (2) has an estimated production period exceeding two years, or (3) has an estimated production period exceeding one year and a cost exceeding \$1,000,000.<sup>944</sup> The production period with respect to any property is the period beginning on the date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or held for sale.<sup>945</sup> In the case of property that is customarily aged (e.g., tobacco, wine, and whiskey) before it is sold, the production period includes the aging period.<sup>946</sup>

##### 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

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<sup>941</sup> Sec. 803(a) of Pub. L. No. 99-514 (1986).

<sup>942</sup> Sec. 263A.

<sup>943</sup> See Treas. Reg. sec. 1.263A-12.

<sup>944</sup> Sec. 263A(f).

<sup>945</sup> Sec. 263A(f)(4)(B).

<sup>946</sup> See Treas. Reg. sec. 1.263A-12(d)(1). See also TAM 9327007 (Mar. 31, 1993) (holding that producers of wine must include the time that wine ages in bottles as part of the production period, which concludes when the wine vintage is officially released to the distribution chain).

\$10 million or less of average annual gross receipts for the preceding three-taxable year period;<sup>947</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>948</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 any animal or plant having a reproductive period of two years or less, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under section 447 or 448(a)(3)).<sup>949</sup>

Freelance authors, photographers, and artists also are exempt from section 263A for any qualified creative expenses.<sup>950</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.

### **Reasons for Change**

The Committee believes that the present law interest capitalization rules impose overly complex recordkeeping requirements that increase compliance costs for the alcoholic beverage industry. The Committee also believes that any potential distortion to income caused by not applying such rules is not material enough to warrant the application of unduly burdensome rules to such industry. Accordingly, the Committee believes that providing an exception to such rules for the alcoholic beverage industry will simplify tax administration and taxpayer compliance.<sup>951</sup>

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<sup>947</sup> Sec. 263A(b)(2)(B). No statutory exception is available for small taxpayers who produce property subject to section 263A. However, a *de minimis* rule under Treasury regulations treats producers that use the simplified production method and incur total indirect costs of \$200,000 or less in a taxable year as having no additional indirect costs beyond those normally capitalized for financial accounting purposes. Treas. Reg. sec. 1.263A-2(b)(3)(iv). However, the Chairman's Mark of the "Tax Cuts and Jobs Act" proposes to expand the exception for small taxpayers from the uniform capitalization rules. Under the provision, any producer or reseller that meets the \$15 million gross receipts test is exempted from the application of section 263A. See section III.B.4 of *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), November 9, 2017.

<sup>948</sup> Sec. 263A(c)(5).

<sup>949</sup> Sec. 263A(d). See also section III.B.3 of *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), November 9, 2017, which expands the universe of farming C corporations that may use the cash method to include any farming C corporation that meets the \$15 million gross receipts test.

<sup>950</sup> Sec. 263A(h).

<sup>951</sup> For taxpayers in the craft beverage industry that meet the \$15 million gross receipts test, such taxpayers are exempt from all uniform capitalization rules under section 263A, including the interest capitalization rules. See section 13104 of the bill (Modification of rules for uniform capitalization of certain expenses).

### **Explanation of Provision**

The provision would exclude the aging periods for beer, wine, and distilled spirits from the production period for purposes of the UNICAP interest capitalization rules. Thus, under the provision, producers of beer, wine and distilled spirits are able to deduct interest expenses (subject to any other applicable limitation) attributable to a shorter production period.

The provision expires for taxable years beginning after December 31, 2019.

### **Effective Date**

The provision is effective for interest costs paid or incurred after December 31, 2017.

## **2. Reduced rate of excise tax on beer (sec. 13803 of the bill and sec. 5051 of the Code)**

### **Present Law**

Federal excise taxes are imposed at different rates on distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are administered and enforced by the TTB, except the taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau (the “CBP”) of the Department of Homeland Security (under delegation by the Secretary of the Treasury).

Liability for the excise tax on beer also come into existence when the alcohol is produced but is not payable until the beer is removed from the brewery for consumption or sale. Generally, beer may be transferred between commonly owned breweries without payment of tax; however, tax liability follows these products. Imported bulk beer may be released from customs custody without payment of tax and transferred in bond to a brewery. Beer may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

The rate of tax on beer is \$18 per barrel (31 gallons).<sup>952</sup> Small brewers are subject to a reduced tax rate of \$7 per barrel on the first 60,000 barrels of beer domestically produced and removed each year.<sup>953</sup> Small brewers are defined as brewers producing fewer than two million barrels of beer during a calendar year. The credit reduces the effective per-gallon tax rate from approximately 58 cents per gallon to approximately 22.6 cents per gallon for this beer.

In the case of a controlled group, the two million barrel limitation for small brewers is applied to the controlled group, and the 60,000 barrels eligible for the reduced rate of tax, are apportioned among the brewers who are component members of such group. The term “controlled group” has the meaning assigned to it by sec. 1563(a), except that the phrase “more

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<sup>952</sup> Sec. 5051.

<sup>953</sup> Sec. 5051(a)(2).

than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in sec. 1563(a).

Individuals may produce limited quantities of beer for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

### **Reasons for Change**

The Committee believes that reducing the excise tax rates on producers of beer will provide the industry with needed tax relief, create jobs, and contribute to tax reform’s goal of economic growth. While all producers will benefit from the reduced rates, small producers will experience the greatest reduction in their excise tax burden. Further, the Committee seeks to provide equitable tax treatment across all producers by allowing importers to qualify for the reduced rates.

### **Explanation of Provision**

The provision lowers the rate of tax on beer to \$16 per barrel on the first six million barrels brewed by the brewer or imported by the importer. In general, in the case of a controlled group of brewers, the six million barrel limitation is applied and apportioned at the level of the controlled group. Beer brewed or imported in excess of the six million barrel limit would continue to be taxed at \$18 per barrel. In the case of small brewers, such brewers would be taxed at a rate of \$3.50 per barrel on the first 60,000 barrels domestically produced, and \$16 per barrel on any further barrels produced. The same rules applicable to controlled groups under present law apply with respect to this limitation.

For barrels of beer that have been brewed or produced outside of the United States and imported into the United States, the reduced tax rate may be assigned by the brewer to any importer of such barrels pursuant to requirements set forth by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services and the Secretary of the Department of Homeland Security. These requirements are to include: (1) a limitation to ensure that the number of barrels of beer for which the reduced tax rate has been assigned by a brewer to any importer does not exceed the number of barrels of beer brewed or produced by such brewer during the calendar year which were imported into the United States by such importer; (2) procedures that allow a brewer and an importer to elect whether to receive the reduced tax rate; (3) requirements that the brewer provide any information as the Secretary of the Treasury determines necessary and appropriate for purposes of assignment of the reduced tax rate; and (4) procedures that allow for revocation of eligibility of the brewer and the importer for the reduced tax rate in the case of erroneous or fraudulent information provided in (3) which the Secretary of the Treasury deems to be material for qualifying for the reduced tax rate.

Any importer making an election to receive the reduced tax rate shall be deemed to be a member of the controlled group of the brewer, within the meaning of sec. 1563(a), except that

the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in sec 1563(a).<sup>954</sup>

Under rules issued by the Secretary of the Treasury, two or more entities (whether or not under common control) that produce beer marketed under a similar brand, license, franchise, or other arrangement shall be treated as a single taxpayer for purposes of the excise tax on beer.

The provision expires for taxable years beginning after December 31, 2019.

#### **Effective Date**

The provision is effective for beer removed after December 31, 2017.

### **3. Simplification of rules regarding records, statements, and returns (sec. 13804 of the bill and secs. 5141 and 5555 of the Code)**

#### **Present Law**

Brewers are required to maintain records and file reports of operations as required by the regulations<sup>955</sup> and are subject to inspection of their premises and records.<sup>956</sup> Special occupational taxes had been imposed on alcohol industry members, including wholesale and retail dealers, but were effectively repealed for taxes due on or after July 1, 2005. However, these persons remain subject to registration and recordkeeping requirements that supplement the operational reporting rules. Brewers file monthly, quarterly, or annual reports of operations (the frequency depends upon the type of operation and its size), which do not include reports of inventory, although inventory records must be kept. Wholesalers and some retailers must keep records, including inventory, but need only register and need not file reports. Civil and criminal penalties, in addition to forfeiture provisions, may apply in the event of non-compliance with the laws and regulations.<sup>957</sup>

#### **Reasons for Change**

The Committee believes that brewers should be permitted to employ a unified record keeping system for purposes of compliance with the Internal Revenue Code.

#### **Explanation of Provision**

Under the provision, the Secretary shall permit a person to employ a unified system for any records, statements, and returns required to be kept, rendered or made under section 5555.

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<sup>954</sup> Members of the controlled group may include foreign corporations.

<sup>955</sup> Secs. 5414 and 5555.

<sup>956</sup> Sec. 5553.

<sup>957</sup> Secs. 5601-91.

The provision expires for taxable years beginning after December 31, 2019.

#### **Effective Date**

The provision applies to any calendar quarters beginning after December 31, 2017.

#### **4. Transfer of beer between bonded facilities (sec. 13805 of the bill and sec. 5414 of the Code)**

##### **Present Law**

Federal excise taxes are imposed at different rates on distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are administered and enforced by the TTB, except the taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau (the “CBP”) of the Department of Homeland Security (under delegation by the Secretary of the Treasury). The rate of tax on beer is \$18 per barrel (31 gallons).<sup>958</sup>

Liability for the excise tax on beer also come into existence when the alcohol is produced but is not payable until the beer is removed from the brewery for consumption or sale. Generally, beer may be transferred between commonly owned breweries without payment of tax; however, tax liability follows these products. Imported bulk beer may be released from customs custody without payment of tax and transferred in bond to a brewery. Beer may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Small domestic brewers are subject to a reduced tax rate of \$7 per barrel on the first 60,000 barrels of beer removed each year.<sup>959</sup> Small brewers are defined as brewers producing fewer than two million barrels of beer during a calendar year. The credit reduces the effective per-gallon tax rate from approximately 58 cents per gallon to approximately 22.6 cents per gallon for this beer.

Individuals may produce limited quantities of beer for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

##### **Transfer rules and removals without tax**

Certain removals or transfers of beer are exempt from tax. Beer may be transferred without payment of the tax between bonded premises under certain conditions specified in the regulations.<sup>960</sup> The tax liability accompanies the beer that is transferred in bond. However, beer

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<sup>958</sup> Sec. 5051.

<sup>959</sup> Sec. 5051(a)(2).

<sup>960</sup> Sec. 5414.



may only be transferred free of tax between breweries if both breweries are owned by the same brewer.

### **Reasons for Change**

The Committee believes that the rules relating to the transfer of beer in bond should be liberalized, so as to provide more flexibility to brewers in transporting beer between owners and facilities.

### **Explanation of Provision**

The provision relaxes the shared ownership requirement of section 5414. Thus, under the provision, a brewer may transfer beer from one brewery to another without incurring tax, provided that: (i) the breweries are owned by the same person; (ii) one brewery owns a controlling interest in the other; (iii) the same person or persons have a controlling interest in both breweries; or (iv) the proprietors of the transferring and receiving premises are independent of each other, and the transferor has divested itself of all interest in the beer so transferred, and the transferee has accepted responsibility for payment of the tax.

For purposes of transferring the tax liability pursuant to (iv) above, such relief from liability shall be effective from the time of removal from the transferor's bonded premises, or from the time of divestment, whichever is later.

The provision expires for taxable years beginning after December 31, 2019.

### **Effective Date**

The provision applies to any calendar quarters beginning after December 31, 2017.

## **5. Reduced rate of excise tax on certain wine (sec. 13806 of the bill and sec. 5041 of the Code)**

### **Present Law**

#### **In general**

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (sec. 5041)	
“Still wines” <sup>961</sup> not more than 14 percent alcohol	\$1.07 per wine gallon <sup>962</sup>
“Still wines” more than 14 percent, but not more than 21 percent, alcohol	\$1.57 per wine gallon
“Still wines” more than 21 percent, but not more than 24 percent, alcohol	\$3.15 per wine gallon
“Still wines” more than 24 percent alcohol	\$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	\$3.40 per wine gallon
Artificially carbonated wines	\$3.30 per wine gallon

Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

### **Reduced rates and exemptions for certain wine producers**

Wineries having aggregate annual production not exceeding 250,000 gallons (“small domestic producers”) receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.<sup>963</sup> The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term “controlled group” has the meaning assigned to it by sec. 1563(a), except that the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in sec 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

<sup>961</sup> A “still wine” is a non-sparkling wine. Most common table wines are still wines.

<sup>962</sup> A wine gallon is a U.S. liquid gallon.

<sup>963</sup> Sec. 5041(c).

## **Reasons for Change**

The Committee believes that reducing the net excise taxes on wine through expansion of the available credits for wine production will provide the industry with needed tax relief, create jobs, and contribute to tax reform's goal of economic growth. While all producers will benefit from the reduced rates, small producers will experience the greatest reduction in their excise tax burden. Further, the Committee seeks to provide equitable tax treatment across all producers by allowing importers to qualify for the expanded credits.

## **Explanation of Provision**

The provision modifies the credit against the wine excise tax for small domestic producers, by removing the 250,000 wine gallon domestic production limitation (and thus making the credit available for all wine producers and importers). Additionally, under the provision, sparkling wine producers and importers are now eligible for the credit. With respect to wine produced in, or imported into, the United States during a calendar year, the credit amount is (1) \$1.00 per wine gallon for the first 30,000 wine gallons of wine, plus; (2) 90 cents per wine gallon on the next 100,000 wine gallons of wine, plus; (3) 53.5 cents per wine gallon on the next 620,000 wine gallons of wine.<sup>964</sup> There is no phaseout of the credit.

In the case of any wine gallons of wine that have been produced outside of the United States and imported into the United States, the tax credit allowable may be assigned by the person who produced such wine (the "foreign producer") to any electing importer of such wine gallons pursuant to requirements established by the Secretary of the Treasury, in consultation with the Secretary of Health and Human Services and the Secretary of the Department of Homeland Security. These requirements are to include: (1) a limitation to ensure that the number of wine gallons of wine for which the tax credit has been assigned by a foreign producer to any importer does not exceed the number of wine gallons of wine produced by such foreign producer, during the calendar year, which were imported into the United States by such importer; (2) procedures that allow the election of a foreign producer to assign, and an importer to receive, the tax credit; (3) requirements that the foreign producer provide any information that the Secretary of the Treasury determines to be necessary and appropriate for purposes of assigning the tax credit; and (4) procedures that allow for revocation of eligibility of the foreign producer and the importer for the tax credit in the case of erroneous or fraudulent information provided in (3) which the Secretary of the Treasury deems to be material for qualifying for the reduced tax rate.

Any importer making an election to receive the reduced tax rate shall be deemed to be a member of the controlled group of the brewer, within the meaning of sec. 1563(a), except that the phrase "more than 50 percent" is substitute for the phrase "at least 80 percent" in each place it appears in sec 1563(a).<sup>965</sup>

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<sup>964</sup> The credit rate for hard cider is tiered at the same level of production or importation, but is equal to 6.2 cents, 5.6 cents and 3.3 cents, respectively.

<sup>965</sup> Members of the controlled group may include foreign corporations.

The provision expires for taxable years beginning after December 31, 2019.

**Effective Date**

The provision applies to wine removed after December 31, 2017.

**6. Adjustment of alcohol content level for application of excise tax rates (sec. 13807 of the bill and sec. 5041 of the Code)**

**Present Law**

**In general**

Under present law, excise taxes are imposed at different rates on wine, depending on the wine’s alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

<b>Tax (and Code Section)</b>	<b>Tax Rates</b>
Wines (sec. 5041)	
“Still wines” <sup>966</sup> not more than 14 percent alcohol	\$1.07 per wine gallon <sup>967</sup>
“Still wines” more than 14 percent, but not more than 21 percent, alcohol	\$1.57 per wine gallon
“Still wines” more than 21 percent, but not more than 24 percent, alcohol	\$3.15 per wine gallon
“Still wines” more than 24 percent alcohol	\$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	\$3.40 per wine gallon
Artificially carbonated wines	\$3.30 per wine gallon

Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

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<sup>966</sup> A “still wine” is a non-sparkling wine. Most common table wines are still wines.

<sup>967</sup> A wine gallon is a U.S. liquid gallon.

### **Reduced rates and exemptions for certain wine producers**

Wineries having aggregate annual production not exceeding 250,000 gallons (“small domestic producers”) receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.<sup>968</sup> The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term “controlled group” has the meaning assigned to it by sec. 1563(a), except that the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in sec. 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

#### **Reasons for Change**

The Committee believes that it is appropriate to adjust the tiers of alcohol-by-volume levels which apply to wine to simplify the excise tax treatment for the majority of table wine.

#### **Explanation of Provision**

The provision modifies alcohol-by-volume levels of the first two tiers of the excise tax on wine, by changing 14 percent to 16 percent. Thus, under the provision, a wine producer or importer may produce or import “still wine” that has an alcohol-by-volume level of up to 16 percent, and remain subject to the lowest rate of \$1.07 per wine gallon.

The provision expires for taxable years beginning after December 31, 2019.

#### **Effective Date**

The provision applies to wine removed after December 31, 2017.

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<sup>968</sup> Sec. 5041(c).

**7. Definition of mead and low alcohol by volume wine (sec. 13808 of the bill and sec. 5041 of the Code)**

**Present Law**

**In general**

Under present law, excise taxes are imposed at different rates on wine, depending on the wine’s alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (sec. 5041)	
“Still wines” <sup>969</sup> not more than 14 percent alcohol	\$1.07 per wine gallon <sup>970</sup>
“Still wines” more than 14 percent, but not more than 21 percent, alcohol	\$1.57 per wine gallon
“Still wines” more than 21 percent, but not more than 24 percent, alcohol	\$3.15 per wine gallon
“Still wines” more than 24 percent alcohol	\$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	\$3.40 per wine gallon
Artificially carbonated wines	\$3.30 per wine gallon

Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

**Reduced rates and exemptions for certain wine producers**

Wineries having aggregate annual production not exceeding 250,000 gallons (“small domestic producers”) receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.<sup>971</sup> The credit is reduced (but not below zero) by

<sup>969</sup> A “still wine” is a non-sparkling wine. Most common table wines are still wines.

<sup>970</sup> A wine gallon is a U.S. liquid gallon.

<sup>971</sup> Sec. 5041(c).

one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term “controlled group” has the meaning assigned to it by sec. 1563(a), except that the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in sec 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

### **Reasons for Change**

The Committee believes that reducing the excise tax rate on mead and certain carbonated wines will provide the industry with needed tax relief, create jobs, expand beverage choices for consumers, and contribute to tax reform’s goal of economic growth.

### **Explanation of Provision**

The provision designates mead and certain sparkling wines to be taxed at the lowest rate applicable to “still wine,” of \$1.07 per wine gallon of wine. Mead is defined as a wine that contains not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,<sup>972</sup> which is derived solely from honey and water, contains no fruit product or fruit flavoring, and contains less than 8.5 percent alcohol-by-volume. The sparkling wines eligible to be taxed at the lowest rate are those wines that contain not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,<sup>973</sup> which are derived primarily from grapes or grape juice concentrate and water, which contain no fruit flavoring other than grape, and which contain less than 8.5 percent alcohol by volume.

The provision expires for taxable years beginning after December 31, 2019.

### **Effective Date**

The provision applies to wine removed after December 31, 2017.

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<sup>972</sup> The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.

<sup>973</sup> The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.

## **8. Reduced rate of excise tax on certain distilled spirits (sec. 13809 of the bill and sec. 5001 of the Code)**

### **Present Law**

An excise tax is imposed on all distilled spirits produced in, or imported into, the United States.<sup>974</sup> The tax liability legally comes into existence the moment the alcohol is produced or imported but payment of the tax is not required until a subsequent withdrawal or removal from the distillery, or, in the case of an imported product, from customs custody or bond.<sup>975</sup>

Distilled spirits are taxed at a rate of \$13.50 per proof gallon.<sup>976</sup> Liability for the excise tax on distilled spirits comes into existence when the alcohol is produced but is not determined and payable until bottled distilled spirits are removed from the bonded premises of the distilled spirits plant where they are produced. Generally, bulk distilled spirits may be transferred in bond between bonded premises; however, tax liability follows these products. Imported bulk distilled spirits may be released from customs custody without payment of tax and transferred in bond to a distillery. Distilled spirits be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

A portion of the revenues from the distilled spirits excise tax imposed on rum imported or brought into<sup>977</sup> the United States (less certain administrative costs) is transferred (“covered over”) to Puerto Rico and the U.S. Virgin Islands.<sup>978</sup> The amount covered over is \$10.50 per proof gallon (\$13.25 per proof gallon during the period from July 1, 1999, through December 31, 2016).

Eligible distilled spirits wholesale distributors and distillers receive an income tax credit for the average cost of carrying previously imposed excise tax on beverages stored in their warehouses.<sup>979</sup>

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<sup>974</sup> Secs. 5001.

<sup>975</sup> Secs. 5006, 5043, and 5054. In general, proprietors of distilled spirit plants, proprietors of bonded wine cellars, brewers, and importers are liable for the tax.

<sup>976</sup> A “proof gallon” is a U.S. liquid gallon of proof spirits, or the alcoholic equivalent thereof. Generally a proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol. On lesser quantities, the tax is paid proportionately. Credits are allowed for wine content and flavors content of distilled spirits. Sec. 5010.

<sup>977</sup> Because Puerto Rico is inside U.S. customs territory, articles entering the United States from that commonwealth are “brought into” rather than “imported into” the U.S.

<sup>978</sup> Sec. 7652.

<sup>979</sup> Sec. 5011. Section 5011 is administered and enforced by the IRS.



### **Reasons for Change**

The Committee believes that reducing the excise tax rate on distilled spirits will provide the industry with needed tax relief, create jobs, and contribute to tax reform's goal of economic growth. While all producers will benefit from the reduced rates, small producers will experience the greatest reduction in their excise tax burden. Further, the Committee seeks to provide equitable tax treatment across all producers by allowing importers to qualify for the reduced rates.

### **Explanation of Provision**

The provision institutes a tiered rate for distilled spirits. The rate of tax is lowered to \$2.70 per proof gallon on the first 100,000 proof gallons of distilled spirits, \$13.34 for all proof gallons in excess of that amount but below 22,130,000 proof gallons, and \$13.50 for amounts thereafter. The provision contains rules so as to prevent members of the same controlled group from receiving the lower rate on more than 100,000 proof gallons of distilled spirits. Importers of distilled spirits are eligible for the lower rates.

The provision expires for taxable years beginning after December 31, 2019.

### **Effective Date**

The provision applies to distilled spirits removed after December 31, 2017.

## **9. Bulk distilled spirits (sec. 13810 of the bill and sec. 5212 of the Code)**

### **Present Law**

An excise tax is imposed on all distilled spirits produced in, or imported into, the United States.<sup>980</sup> The tax liability legally comes into existence the moment the alcohol is produced or imported but payment of the tax is not required until a subsequent withdrawal or removal from the distillery, or, in the case of an imported product, from customs custody or bond.<sup>981</sup>

Distilled spirits are taxed at a rate of \$13.50 per proof gallon.<sup>982</sup> Liability for the excise tax on distilled spirits comes into existence when the alcohol is produced but is not determined and payable until bottled distilled spirits are removed from the bonded premises of the distilled spirits plant where they are produced. Generally, bulk distilled spirits may be transferred in bond between bonded premises; however, tax liability follows these products. Additionally, in order to

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<sup>980</sup> Secs. 5001.

<sup>981</sup> Secs. 5006, 5043, and 5054. In general, proprietors of distilled spirit plants, proprietors of bonded wine cellars, brewers, and importers are liable for the tax.

<sup>982</sup> A "proof gallon" is a U.S. liquid gallon of proof spirits, or the alcoholic equivalent thereof. Generally a proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol. On lesser quantities, the tax is paid proportionately. Credits are allowed for wine content and flavors content of distilled spirits. Sec. 5010.

transfer such spirits in bond without payment of tax, such spirits may not be transferred in containers smaller than one gallon.<sup>983</sup> Imported bulk distilled spirits may be released from customs custody without payment of tax and transferred in bond to a distillery. Distilled spirits be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

A portion of the revenues from the distilled spirits excise tax imposed on rum imported or brought into<sup>984</sup> the United States (less certain administrative costs) is transferred (“covered over”) to Puerto Rico and the U.S. Virgin Islands.<sup>985</sup> The amount covered over is \$10.50 per proof gallon (\$13.25 per proof gallon during the period from July 1, 1999, through December 31, 2016).

Eligible distilled spirits wholesale distributors and distillers receive an income tax credit for the average cost of carrying previously imposed excise tax on beverages stored in their warehouses.<sup>986</sup>

### **Reasons for Change**

The Committee believes that the rules relating to the transfer of distilled spirits in bond should be liberalized, so as to provide more flexibility to distillers in transporting spirits between facilities.

### **Explanation of Provision**

The provision allows distillers to transfer spirits in approved containers other than bulk containers in bond without payment of tax.

The provision expires for taxable years beginning after December 31, 2019.

### **Effective Date**

The provision applies to distilled spirits transferred in bond after December 31, 2017.

## **10. Modification of tax treatment of Alaska Native Corporations and Settlement Trusts (sec. 13821 of the bill and sec. 6039H and new secs. 139G and 247 of the Code)**

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<sup>983</sup> Sec. 5212.

<sup>984</sup> Because Puerto Rico is inside U.S. customs territory, articles entering the United States from that commonwealth are “brought into” rather than “imported into” the U.S.

<sup>985</sup> Sec. 7652.

<sup>986</sup> Sec. 5011. Section 5011 is administered and enforced by the IRS.

## Present Law

The Alaska Native Claims Settlement Act (“ANCSA”)<sup>987</sup> established Native Corporations<sup>988</sup> to hold property for Alaska Natives. Alaska Natives are generally the only permitted common shareholders of those corporations under section 7(h) of ANCSA, unless a Native Corporation specifically allows other shareholders under specified procedures.

ANCSA permits a Native Corporation to transfer money or other property to an Alaska Native Settlement Trust (“Settlement Trust”) for the benefit of beneficiaries who constitute all or a class of the shareholders of the Native Corporation, to promote the health, education and welfare of beneficiaries and to preserve the heritage and culture of Alaska Natives.<sup>989</sup>

Native Corporations and Settlement Trusts, as well as their shareholders and beneficiaries, are generally subject to tax under the same rules and in the same manner as other taxpayers that are corporations, trusts, shareholders, or beneficiaries.

Special tax rules enacted in 2001 allow an election to use a more favorable tax regime for transfers of property by a Native Corporation to a Settlement Trust and for income taxation of the Settlement Trust. There is also simplified reporting to beneficiaries.

Under the special tax rules, a Settlement Trust may make an irrevocable election to pay tax on taxable income at the lowest rate specified for individuals, (rather than the highest rate that is generally applicable to trusts) and to pay tax on capital gains at a rate consistent with being subject to such lowest rate of tax. As described further below, beneficiaries may generally thereafter exclude from gross income distributions from a trust that has made this election. Also, contributions from a Native Corporation to an electing Settlement Trust generally will not result in the recognition of gross income by beneficiaries on account of the contribution. An electing Settlement Trust remains subject to generally applicable requirements for classification and taxation as a trust.

A Settlement Trust distribution is excludable from the gross income of beneficiaries to the extent of the taxable income of the Settlement Trust for the taxable year and all prior taxable years for which an election was in effect, decreased by income tax paid by the Trust, plus tax-exempt interest from State and local bonds for the same period. Amounts distributed in excess of the amount excludable is taxed to the beneficiaries as if distributed by the sponsoring Native Corporation in the year of distribution by the Trust, which means that the beneficiaries must include in gross income as dividends the amount of the distribution, up to the current and accumulated earnings and profits of the Native Corporation. Amounts distributed in excess of

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<sup>987</sup> 43 U.S.C. 1601 *et. seq.*

<sup>988</sup> Defined at 43 U.S.C. 1602(m).

<sup>989</sup> With certain exceptions, once an Alaska Native Corporation has made a conveyance to a Settlement Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Settlement Trust.

the current and accumulated earnings and profits are not included in gross income by the beneficiaries.

A special loss disallowance rule reduces (but not below zero) any loss that would otherwise be recognized upon disposition of stock of a sponsoring Native Corporation by a proportion, determined on a per share basis, of all contributions to all electing Settlement Trusts by the sponsoring Native Corporation. This rule prevents a stockholder from being able to take advantage of a decrease in value of a Native Corporation that is caused by a transfer of assets from the Native Corporation to a Settlement Trust.

The fiduciary of an electing Settlement Trust is obligated to provide certain information relating to distributions from the trust in lieu of reporting requirements under Section 6034A.

The election to pay tax at the lowest rate is not available in certain disqualifying cases where transfer restrictions have been modified to allow a transfer of either: (a) a beneficial interest that would not be permitted by section 7(h) of the Alaska Native Claims Settlement Act if the interest were Settlement common stock, or (b) any stock in an Alaska Native Corporation that would not be permitted by section 7(h) if it were Settlement common stock and the Native Corporation thereafter makes a transfer to the Trust. Where an election is already in effect at the time of such disqualifying transfers, the special rules applicable to an electing trust cease to apply and rules generally applicable to trusts apply. In addition, the distributable net income of the trust is increased by undistributed current and accumulated earnings and profits of the trust, limited by the fair market value of trust assets at the date the trust becomes so disposable. The effect is to cause the trust to be taxed at regular trust rates on the amount of recomputed distributable net income not distributed to beneficiaries, and to cause the beneficiaries to be taxed on the amount of any distributions received consistent with the applicable tax rate bracket.

### **Reasons for Change**

The Committee believes that restrictions on the activities and assets of Settlement Trusts may discourage contributions by Native Corporations. The Committee further believes that Settlement Trusts are effective tools for reducing dependence on state and federal welfare programs in Alaska Native communities. More generally, the Committee believes that it is desirable to promote the funding of Settlement Trusts as a means to improve the health, education, and welfare of the Settlement Trusts' beneficiaries.

### **Explanation of Provision**

The provision comprises three separate but related sections. The first section allows a Native Corporation to assign certain payments described in ANCSA to a Settlement Trust without having to recognize gross income from those payments, provided the assignment is in writing and the Native Corporation has not received the payment prior to assignment. The Settlement Trust is required to include the assigned payment in gross income when received.

The second section allows a Native Corporation to elect annually to deduct contributions made to a Settlement Trust. If the contribution is in cash, the deduction is in the amount of cash contributed. If the contribution is property other than cash, the deduction is the amount of the Native Corporation's basis in the contributed property (or the fair market value of such property,

if less than the Native Corporation's basis), and no gain or loss can be recognized on the contribution. The Native Corporation's deduction is limited to the amount of its taxable income for that year, and any unused deduction may be carried forward 15 additional years. The Native Corporation's earnings and profits for the taxable year are reduced by the amount of any deduction claimed for that year.

Generally, the Settlement Trust must include income equal to the deduction by the Native Corporation. For contributions of property other than cash, the Settlement Trust takes a basis in the property equal to its basis in the hands of the Native Corporation immediately before the contribution (or the fair market value of such property, if less than the Native Corporation's basis), and may elect to defer recognition of income associated with such property until the Settlement Trust sells or disposes of the property. In that case, any income that is deferred (i.e., the amount of income that would have been included upon contribution absent the election to defer) is treated as ordinary income, while any gain in excess of the amount that is deferred takes the same character as if the election had not been made. If property subject to this election is disposed of within the first taxable year subsequent to the taxable year in which the property was contributed to the Settlement Trust, the election is voided with respect to the property, and the Settlement Trust is required to pay any tax applicable to the disposition of the property, including interest, as well as a penalty of 10 percent of the amount of the tax. The provision provides for a four year assessment period in which to assess the tax, interest, and penalty amounts. The provision permits the amendment of the terms of any Settlement Trust agreement to allow this election within one year of the enactment of the provision, with certain restrictions.

The third section of the provision requires any Native Corporation which has made an election to deduct contributions to a Settlement Trust as described above to furnish a statement to the Settlement Trust containing: (1) the total amount of contributions; (2) whether such contribution was in cash; (3) for non-cash contributions, the date that such property was acquired by the Native Corporation and the adjusted basis of such property on the contribution date; (4) the date on which each contribution was made to the Settlement Trust; and (5) such information as the Secretary determines is necessary for the accurate reporting of income relating to such contributions.

#### **Effective Date**

The provision relating to the exclusion for ANCSA payments assigned to Settlement Trusts is effective to taxable years beginning after December 31, 2016.

The provision relating to the deduction of contributions is effective for taxable years for which the Native Corporation's refund statute of limitations period has not expired, and the provision provides a one-year waiver of the refund statute of limitations period in the event that the limitation period expires before the end of the one-year period beginning on the date of enactment.

The provision relating to the reporting requirement applies to taxable years beginning after December 31, 2016.

## **11. Amounts paid for aircraft management services (sec. 13822 of the bill and sec. 4261 of the Code)**

### **Present Law**

#### **Excise tax on taxable transportation by air**

For domestic passenger transportation, section 4261 imposes an excise tax on amounts paid for taxable transportation. In general, for domestic flights, the tax consists of two parts: a 7.5 percent *ad valorem* tax applied to the amount paid and a flat dollar amount for each flight segment (consisting of one takeoff and one landing). “Taxable transportation” generally means transportation by air which begins and ends in the United States. The tax is paid by the person making the payment subject to tax and the tax is collected by the person receiving the payment. For commercial freight aviation, the *ad valorem* tax is 6.25 percent of the amount paid for transportation

In determining whether a flight constitutes taxable transportation and whether the amounts paid for such transportation are subject to tax, the Internal Revenue Service (“IRS”) has looked at who has “possession, command, and control” of the aircraft based on the relevant facts and circumstances.<sup>990</sup>

#### **Applicability to aircraft management services**

Generally, an aircraft management services company (“management company”) has as its business purpose the management of aircraft owned by other corporations or individuals (“aircraft owners”). In this function, management companies provide aircraft owners, among other things, with administrative and support services (such as scheduling, flight planning, and weather forecasting), aircraft maintenance services, the provision of pilots and crew, and compliance with regulatory standards. Although the arrangement between management companies and aircraft owners may vary, it is our understanding that aircraft owners generally pay management companies a monthly fee to cover the fixed expenses of maintaining the aircraft (such as insurance, maintenance, and recordkeeping) and a variable fee to cover the cost of using the aircraft (such as the provision of pilots, crew, and fuel).

In March 2012, the IRS issued a Chief Counsel Advice determining that a management company provided all of the essential elements necessary for providing transportation by air and the owner relinquished possession, command and control to the management company.<sup>991</sup> Thus, the management company was determined to be providing taxable transportation to the owner

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<sup>990</sup> See, e.g., Rev. Rul. 60-311, 1960-2 C.B. 341, which held that, since the company in question retains the elements of possession, command, and control of the aircraft and performs all services in connection with the operation of the aircraft, the company is, in fact, furnishing taxable transportation to the lessee; and the tax on the transportation of persons applies to the portion of the total payment which is allocable to the transportation of persons, provided such allocation is made on a fair and reasonable basis. If no allocation is made, the tax applies to the total payment for the lease of the aircraft.

<sup>991</sup> CCA 2012-10026 (March, 2012).

and was required to collect the appropriate federal excise tax from the aircraft owner and remit it to the IRS. The Chief Counsel Advice resulted in increased audit activity by the IRS on aircraft management companies.

In May 2013, the IRS suspended assessment of the federal excise tax with respect to aircraft management services while it developed guidance on the tax treatment of aircraft management issues. In a 2015 opinion,<sup>992</sup> an Ohio district court held that the existing revenue rulings (in effect for the tax period April 1, 2005, through June 30, 2009, the period that was the subject of the litigation) regarding the possession, command and control test, failed to provide precise and not speculative notice of a collection obligation as it related to whole-aircraft management contracts.<sup>993</sup> As a result, the court ruled as a matter of law that because precise and not speculative notice was not received, the aircraft management company plaintiff did not have a collection obligation with respect to the Federal excise tax on payments received for whole-aircraft management services.

In 2017, the IRS decided not to pursue examination of the issue of whether amounts paid to aircraft companies by the owners or lessors of the aircraft are taxable until further guidance is made available. According to the IRS, for any exam in suspense the aircraft management fee issue was conceded and the taxpayers were notified accordingly.<sup>994</sup> The IRS has not issued further guidance on this issue.

### **Reasons for Change**

The Committee believes that the ticket tax should not be levied on amounts paid for aircraft management services when the management company is providing such services with respect to an aircraft owner's own aircraft.

### **Explanation of Provision**

The provision exempts certain payments related to the management of private aircraft from the excise taxes imposed on taxable transportation by air. Exempt payments are those amounts paid by an aircraft owner for management services related to maintenance and support of the owner's aircraft or flights on the owner's aircraft. Applicable services include support activities related to the aircraft itself, such as its storage, maintenance, and fueling, and those related to its operation, such as the hiring and training of pilots and crew, as well as administrative services such as scheduling, flight planning, weather forecasting, obtaining

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<sup>992</sup> *Netjets Large Aircraft Inc. v. United States*, 116 A.F.T.R. 2d. 2015-6776 (S.D. Ohio, 2015).

<sup>993</sup> The district court held that such notice is required to persons having a deputy tax collection obligation under the rationale of the Supreme Court's holding in *Central Illinois Public Service Company v. United States*, 435 U.S. 21 (1978).

<sup>994</sup> See also, Kerry Lynch, *IRS To Shelve Pending Audits on Aircraft Management Fees*, AINonline (July 17, 2017) <http://www.ainonline.com/aviation-news/business-aviation/2017-07-17/irs-shelve-pending-audits-aircraft-management-fees>.

insurance, and establishing and complying with safety standards. Aircraft management services also include such other services as are necessary to support flights operated by an aircraft owner.

Payments for flight services are exempt only to the extent that they are attributable to flights on an aircraft owner's own aircraft.<sup>995</sup> Thus, if an aircraft owner makes a payment to a management company for the provision of a pilot and the pilot provides his services on the aircraft owner's aircraft, such payment is not subject to Federal excise tax. However, if the pilot provides his services to the aircraft owner on an aircraft other than the aircraft owner's (for instance, on an aircraft that is part of a fleet of aircraft available for third-party charter services), then such payment is subject to Federal excise tax.

The provision provides a pro rata allocation rule in the event that a monthly payment made to a management company is allocated in part to exempt services and flights on the aircraft owner's aircraft, and in part to flights on aircraft other than the aircraft owner's. In such a circumstance, Federal excise tax must be collected on that portion of the payment attributable to flights on aircraft not owned by the aircraft owner.

Under the provision, a lessee of an aircraft is considered an aircraft owner provided that the lease is not a "disqualified lease." A disqualified lease is any lease of an aircraft from a management company (or a related party) for a term of 31 days or less.

#### **Effective Date**

The provision is effective for amounts paid after the date of enactment.

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<sup>995</sup> Examples of arrangements that cannot qualify a person as an "aircraft owner" include ownership of stock in a commercial airline and participation in a fractional ownership aircraft program. Ownership of stock in a commercial airline cannot qualify an individual as an "aircraft owner" of a commercial airline's aircraft, and amounts paid for transportation on such flights remain subject to the tax under section 4261. Similarly, participation in a fractional ownership aircraft program does not constitute "aircraft ownership" for purposes of this standard. Amounts paid to a fractional ownership aircraft program for transportation under such a program are exempt from the ticket tax under section 4261(j) if the aircraft is operating under subpart K of part 91 of title 14 of the Code of Federal Regulations ("subpart K"), and flights under such program are subject to both the fuel tax levied on non-commercial aviation an additional fuel surtax under section 4043 of the Code. A business arrangement seeking to circumvent that surtax by operating outside of subpart K, allowing an aircraft owner the right to use any of a fleet of aircraft, be it through an aircraft interchange agreement, through holding nominal shares in a fleet of aircraft, or any other arrangement that does not reflect true tax ownership of the aircraft being flown upon, is not considered ownership for purposes of the provision.



## **12. Opportunity zones (sec. 13823 of the bill and new secs. 1400Z-1 and 1400Z-2 of the Code)**

### **Present Law**

The Code occasionally has provided several incentives aimed at encouraging economic growth and investment in distressed communities by providing Federal tax benefits to businesses located within designated boundaries.<sup>996</sup>

One of these incentives is a federal income tax credit that is allowed in the aggregate amount of 39 percent of a taxpayer investment in a qualified community development entity (CDE).<sup>997</sup> In general, the credit is allowed to a taxpayer who makes a “qualified equity investment” in a CDE which further invests in a “qualified active low-income community business.” CDEs are required to make investments in low income communities (generally communities with 20 percent or greater poverty rate or median family income less than 80 percent of statewide median). The credit is allowed over seven years, five percent in each of the first three years and six percent in each of the next four years. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed. The Department of Treasury’s Community Development Financial Institutions Fund (“CDFI”) allocates the new markets tax credits.

The maximum annual amount of qualified equity investments is \$3.5 billion for calendar years 2010 through 2019. The new markets tax credit is set to expire on December 31, 2019. No amount of unused allocation limitation may be carried to any calendar year after 2024.

### **Reasons for Change**

The Committee believes this provision will help revitalize economically distressed communities which suffer from a lack of investment and business growth, by facilitating new incentives for investment in those areas around the country. The Committee believes that this provision will attract inactive capital that, when reinvested, will be an important new source for catalyzing growth and opportunity. The Committee believes these new dollars will help stem the tide of business closures, a lack of access to capital, and absent entrepreneurship in areas that

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<sup>996</sup> Such designated areas were referred to as empowerment zones, the District of Columbia Enterprise (“DC”) Zone, and the Gulf Opportunity (“GO”) Zone, and each of these designations and attendant tax incentives have expired. The designations and tax incentives for the DC Zone, and the GO Zone generally expired after December 31, 2011. 1400(f), 1400N(h), 1400N(c)(5), 1400N(a)(2)(D), 1400N(a)(7)(C), 1400N(d). The empowerment zones program and attendant tax incentives expired as of December 31, 2016. Secs. 1391(d)(1), There are also areas that were designated as renewal communities under section 1400E which received tax benefits that all expired as of December 31, 2009, except that a zero-percent capital gains rate applies with respect to gain from the sale through December 31, 2014 of a qualified community asset acquired after December 31, 2001, and before January 1, 2010 and held for more than five years. For more information on these programs and attendant tax incentives, see Joint Committee on Taxation, *Incentives for Distressed Communities: Empowerment Zones and Renewal Communities* (JCX-38-09), October 5, 2009.

<sup>997</sup> Sec. 45D.

need it most. The Committee further believes having the Governors designate the qualifying census tracts will help ensure local needs and opportunities are being met as well as encourage concentration of capital in targeted, geographically contiguous zones in each state.

### **Explanation of Provision**

The provision provides for the temporary deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the sale or exchange of an investment in the qualified opportunity fund.

The provision allows for the designation of certain low-income community population census tracts as qualified opportunity zones, where low-income communities are defined in Section 45D(e). The designation of a population census tract as a qualified opportunity zone remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation.

Governors may submit nominations for a limited number of opportunity zones to the Secretary for certification and designation. If the number of low-income communities in a State is less than 100, the Governor may designate up to 25 tracts, otherwise the Governor may designate tracts not exceeding 25 percent of the number of low-income communities in the State. Governors are required to provide particular consideration to areas that: (1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity; (2) have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and (3) have recently experienced significant layoffs due to business closures or relocations. The Secretary must designate zones if a governor fails to submit nominations within a specified period of time.

The provision provides two main tax incentives to encourage investment in qualified opportunity zones. First, it allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property. The provision intends that the certification process for a qualified opportunity fund will be done in a manner similar to the process for allocating the new markets tax credit. The provision provides the Secretary authority to carry out the process.

If a qualified opportunity fund fails to meet the 90 percent requirement and unless the fund establishes reasonable cause, the fund is required to pay a monthly penalty of the excess of the amount equal to 90 percent of its aggregate assets, over the aggregate amount of qualified opportunity zone property held by the fund multiplied by the underpayment rate in the Code. If the fund is a partnership, the penalty is taken into account proportionately as part of each partner's distributive share.

Qualified opportunity zone property includes: any qualified opportunity zone stock, any qualified opportunity zone partnership interest, and any qualified opportunity zone business property.

The maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains. For amounts of the capital gains that exceed the maximum deferral amount, the capital gains must be recognized and included in gross income as under present law.

If the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years, the basis on the original gain is increased by 10 percent of the original gain. If the opportunity zone asset or investment is held by the taxpayer for at least seven years, the basis on the original gain is increased by an additional 5 percent of the original gain. The deferred gain is recognized on the earlier of the date on which the qualified opportunity zone investment is disposed of or December 31, 2026. Only taxpayers who rollover capital gains of non-zone assets before December 31, 2026, will be able to take advantage of the special treatment of capital gains for non-zone and zone realizations under the provision.

The basis of an investment in a qualified opportunity zone fund immediately after its acquisition is zero. If the investment is held by the taxpayer for at least five years, the basis on the investment is increased by 10 percent of the deferred gain. If the investment is held by the taxpayer for at least seven years, the basis on the investment is increased by an additional five percent of the deferred gain. If the investment is held by the taxpayer until at least December 31, 2026, the basis in the investment increases by the remaining 85 percent of the deferred gain.

The second main tax incentive in the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years. Specifically, in the case of the sale or exchange of an investment in a qualified opportunity zone fund held for more than 10 years, at the election of the taxpayer the basis of such investment in the hands of the taxpayer shall be the fair market value of the investment at the date of such sale or exchange. Taxpayers can continue to recognize losses associated with investments in qualified opportunity zone funds as under current law.

The Secretary or the Secretary's delegate is required to report annually to Congress on the opportunity zone incentives beginning 5 years after the date of enactment. The report is to include an assessment of investments held by the qualified opportunity fund nationally and at the State level. To the extent the information is available, the report is to include the number of qualified opportunity funds, the amount of assets held in qualified opportunity funds, the composition of qualified opportunity fund investments by asset class, and the percentage of qualified opportunity zone census tracts designated under the provision that have received qualified opportunity fund investments. The report is also to include an assessment of the impacts and outcomes of the investments in those areas on economic indicators including job creation, poverty reduction and new business starts, and other metrics as determined by the Secretary.

#### **Effective Date**

The provision is effective on the date of enactment.

## D. International Tax Provisions

### PRESENT LAW

The following discussion provides an overview of general principles of taxation of cross-border activity as well as a detailed explanation of provisions in present law that are relevant to the provisions in the bill.

#### A. General Overview of International Principles of Taxation

International law generally recognizes the right of each sovereign nation to prescribe rules to regulate conduct with a sufficient nexus to the sovereign nation. The nexus may be based on nationality of the actor, *i.e.*, a nexus between said conduct and a person (whether natural or juridical) with a connection to the sovereign nation, or it may be territorial, *i.e.*, a nexus between the conduct to be regulated and the territory where the conduct occurs.<sup>998</sup> For example, most legal systems respect limits on the extent to which their measures may be given extraterritorial effect. The broad acceptance of such norms extends to authority to regulate cross-border trade and economic dealings, including taxation.

The exercise of sovereign jurisdiction is usually based on either nationality of the person whose conduct is regulated or the territory in which the conduct or activity occurs. These concepts have been refined and, in varying combinations, adapted to form the principles for determining whether sufficient nexus with a jurisdiction exists to conclude that the jurisdiction may enforce its right to impose a tax. The elements of nexus and the nomenclature of the principles may differ based on the type of tax in question. Taxes are categorized as either direct taxes or indirect taxes. The former category generally refers to those taxes that are imposed directly on a person (“capitation tax”), property, or income from property and that cannot be shifted to another person by the taxpayer. In contrast, indirect taxes are taxes on consumption or production of goods or services, for which a taxpayer may shift responsibility to another person. Such taxes include sales or use taxes, value-added taxes, or customs duties.<sup>999</sup>

Although governments have imposed direct taxes on property and indirect taxes and duties on specific transactions since ancient times, the history of direct taxes in the form of an income tax is relatively recent.<sup>1000</sup> When determining how to allocate the right to tax a particular

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<sup>998</sup> American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States*, secs. 402 and 403, (1987).

<sup>999</sup> Maria S. Cox, Fritz Neumark, et al., “Taxation” *Encyclopedia Britannica*, <https://www.britannica.com/topic/taxation/Classes-of-taxes>, accessed May 16, 2017. Whether a tax is considered a direct tax or indirect tax has varied over time, and no single definition is used. For a review of the significance of these terms in Federal tax history, see Alan O. Dixler, “Direct Taxes Under the Constitution: A Review of the Precedents,” *Tax History Project, Tax Analysts*, available at <http://www.taxhistory.org/thp/readings.nsf/ArtWeb/2B34C7FBDA41D9DA8525730800067017?OpenDocument>, accessed May 17, 2017.

<sup>1000</sup> The earliest western income tax system is traceable to the British Tax Act of 1798, enacted in 1799 to raise funds needed to prosecute the Napoleonic Wars, and rescinded in 1816. See, A.M. Bardopoulos, *eCommerce and the Effects of Technology on Taxation*, Law, Governance and Technology Series 22, DOI 10.1007/978-3-319-

item of income, most jurisdictions consider principles based on either source (territory or situs of the income) or residence (nationality of the taxpayer).<sup>1001</sup> By contrast, when the authority to collect indirect taxes in the form of sales taxes or value added taxes is under consideration, jurisdictions analyze the taxing rights in terms of the origin principle or destination principle.<sup>1002</sup> The balance of this Part I.A describes the principles in more detail and how jurisdictions resolve claims of overlapping jurisdiction.

## 1. Origin and destination principles

Indirect taxes that are imposed based on the place where production of goods or services occur, irrespective of the location of the persons who own the means of production, and where the goods and services go after being produced, are examples of origin-based taxes. If, instead, authority to tax a transaction or service is dependent on the location of use or consumption of the goods or services, the tax system is an example of a destination-based tax. The most common form of a destination-based tax is the destination-based value-added tax (“VAT”). Over 160 countries have adopted a VAT,<sup>1003</sup> which is generally a tax imposed and collected on the “value added” at every stage in the production and distribution of a good or service. Although there are several ways to compute the taxable base for a VAT, the amount of value added can generally be thought of as the difference between the value of sales (outputs) and purchases (inputs) of a business.<sup>1004</sup> The United States does not have a VAT, nor is there a Federal sales or use tax.

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15449-7\_2, (Springer 2015), at Section 2.2. “History of Tax,” pp. 23-24. See also, <http://www.parliament.uk/about/living-heritage/transformingsociety/private-lives/taxation/overview/incometax/>.

<sup>1001</sup> Bret J. Wells and Cym H. Lowell, Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin, 65 Tax L. Rev. 535 (2012).

<sup>1002</sup> Itai Grinberg, Implementing a Progressive Consumption Tax: Advantages of Adopting the VAT Credit-Method System, 59 Nat’l Tax J. 929 (2006).

<sup>1003</sup> Alan Schenk, Victor Thuronyi, and Wei Cui, *Value Added Tax: A Comparative Approach*, Cambridge University Press, 2015. Staff Report on Comprehensive Tax Reform for 2015 and Beyond, Prepared by the Republican Staff of the Committee on Finance United States Senate, S. Prt. No. 113-31 (Dec. 2014), at 47-55. Consistent with the OECD *International VAT/GST Guidelines*, *supra*, the term VAT is used to refer to all broad-based final consumption taxes, regardless of the acronym used to identify. Thus, many countries that denominate their national consumption tax as a GST (general sales tax) are included in the estimate of the number of countries with a VAT.

<sup>1004</sup> Nearly all countries use the credit-invoice method of calculating value added to determine VAT liability. Under the credit-invoice method, a tax is imposed on the seller for all of its sales. The tax is calculated by applying the tax rate to the sales price of the good or service, and the amount of tax is generally disclosed on the sales invoice. A business credit is provided for all VAT levied on purchases of taxable goods and services (*i.e.*, “inputs”) used in the seller’s business. The ultimate consumer (*i.e.*, a non-business purchaser), however, does not receive a credit with respect to his or her purchases. The VAT credit for inputs prevents the imposition of multiple layers of tax with respect to the total final purchase price (*i.e.*, a “cascading” of the VAT). As a result, the net tax paid at a particular stage of production or distribution is based on the value added by that taxpayer at that stage of production or distribution. In theory, the total amount of tax paid with respect to a good or service from all levels of production and distribution should equal the sales price of the good or service to the ultimate consumer multiplied by the VAT rate.

However, the majority of the States have enacted sales or use taxes, including both origin-based taxes and destination-based taxes.<sup>1005</sup>

With respect to cross-border transactions, the OECD has recommended that the destination principle be adopted for all indirect taxes, in part to conform to the treatment of such transactions for purposes of customs duties. The OECD defines the destination principle as “the principle whereby, for consumption tax purposes, internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption.”<sup>1006</sup> A jurisdiction may determine the place of use or consumption by adopting the convention that the place of business or residence of a customer is the place of consumption. Use of such proxies are needed to determine the location of businesses that are juridical entities, which are more able than natural persons to move the location of use of goods, services or intangibles in response to imposition of tax.

## 2. Source and residence principles

Exercise of taxing authority based on a person’s residence may be based on status as a national, resident, or domiciliary of a jurisdiction and may reach worldwide activities of such persons. As such, it is the broadest assertion of taxing authority. For individuals, the test for residence may depend upon nationality, or a physical presence test, or some combination of the two. For all other persons, determining residency may require more complex consideration of the level of activities within a jurisdiction, management, control or place of incorporation. Such rules generally reflect a policy decision about the requisite level of activity within, or contact with, a jurisdiction by a person that is sufficient to warrant assertion of taxing jurisdiction.

Source-based exercise of taxing authority taxes income from activities that occur, or property that is located, within the territory of the taxing jurisdiction. If a person conducts business or owns property in a jurisdiction, or if a transaction occurs in whole or in part in a jurisdiction, the resulting taxation may require allocation and apportionment of expenses attributable to the activity in order to ensure that only the portion of profits that have the required nexus with the territory are subject to tax. Most jurisdictions, including the United States, have

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In order to receive an input credit with respect to any purchase, a business purchaser is generally required to possess an invoice from a seller that contains the name of the purchaser and indicates the amount of tax collected by the seller on the sale of the input to the purchaser. At the end of a reporting period, a taxpayer may calculate its tax liability by subtracting the cumulative amount of tax stated on its purchase invoices from the cumulative amount of tax stated on its sales invoices.

<sup>1005</sup> EY, *Worldwide VAT, GST and Sales Tax Guide 2015*, p. 1021, available at [http://www.ey.com/Publication/vwLUAssets/Worldwide-VAT-GST-and-sales-tax-guide-2015/\\$FILE/Worldwide%20VAT,%20GST%20and%20Sales%20Tax%20Guide%202015.pdf](http://www.ey.com/Publication/vwLUAssets/Worldwide-VAT-GST-and-sales-tax-guide-2015/$FILE/Worldwide%20VAT,%20GST%20and%20Sales%20Tax%20Guide%202015.pdf).

<sup>1006</sup> See, OECD, “Recommendation of the Council on the application of value added tax/goods and services tax to the international trade in services and intangibles as approved on September 27, 2016,” [C(2016)120], appendix, page 3, reproduced in the appendix, OECD, *International VAT/GST Guidelines*, OECD Publishing, 2017.

rules for determining the source of items of income and expense in a broad range of categories such as compensation for services, dividends, interest, royalties and gains.

Regardless of which of these two bases of taxing authority is chosen by a jurisdiction, a jurisdiction's determination of whether a transaction, activity or person is subject to tax requires that the jurisdiction establish the limits on its assertion of authority to tax.

### **3. Resolving overlapping or conflicting jurisdiction to tax**

Countries have developed norms about what constitutes a reasonable regulatory action by a sovereign state that will be respected by other sovereign states. Consensus on what constitutes a reasonable limit on the extent of one state's jurisdiction helps to minimize the risk of conflicts arising as a result of extraterritorial action by a state or overlapping exercise of authority by states. Mechanisms to eliminate double taxation have developed to address those situations in which the source and residency determinations of the respective jurisdictions result in duplicative assertion of taxing authority. For example, asymmetry between different standards adopted in two countries for determining residency of persons, source of income, or other basis for taxation may result in income that is subject to taxation in both jurisdictions.

When the rules of two or more countries overlap, potential double taxation is usually mitigated by operation of bilateral tax treaties or by legislative measures permitting credit for taxes paid to another jurisdiction. The United States is a partner in numerous bilateral agreements that have as their objective the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. The United States Model Income Tax Convention ("U.S. Model Treaty of 2016") with an accompanying Preamble by the Department of Treasury, reflects the most recent comprehensive statement of U.S. negotiating position with respect to tax treaties.<sup>1007</sup> Bilateral agreements are also used to permit limited mutual administrative assistance between jurisdictions.<sup>1008</sup>

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<sup>1007</sup> The current U.S. Model treaty was published February 17, 2016, and is available at <https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf>; the Preamble is available at <https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US%20Model-2016.pdf>. The U.S. Model treaty is updated periodically to reflect developments in the negotiating position of the United States. Such changes include provisions that were successfully included in bilateral treaties concluded by the United States, as well as new proposed measures not yet included in a bilateral agreement.

<sup>1008</sup> Although U.S. courts extend comity to foreign judgments in some instances, they are not required to recognize or assist in enforcement of foreign judgments for collection of taxes, consistent with the common law "revenue rule" in *Holman v. Johnson*, 1 Cowp. 341, 98 Eng. Rep. 1120 (K.B.1775). American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States*, sec. 483, (1987). The rule retains vitality in U.S. case law. *Pasquantino v. United States*, 544 U.S. 349; 125 S. Ct. 1766; 161 L. Ed. 2d 619 (2005) (a conviction for criminal wire fraud arising from an intent to defraud Canadian tax authorities was found not to conflict "with any well-established revenue rule principle[,] and thus was not in derogation of the revenue rule). To the extent it is abrogated, it is done so in bilateral treaties, to ensure reciprocity. At present, the United States has such agreements in force with five jurisdictions: Canada; Denmark; France; Netherlands; and Sweden.



In addition to entering into bilateral treaties, countries have worked in multilateral organizations to develop common principles to alleviate double taxation. Those principles are generally reflected in the provisions of the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (the “OECD Model treaty”),<sup>1009</sup> a precursor of which was first developed by a predecessor organization in 1958, which in turn has antecedents from work by the League of Nations in the 1920s.<sup>1010</sup> As a consensus document, the OECD Model treaty is intended to serve as a model for countries to use in negotiating a bilateral treaty that would settle issues of double taxation as well as to avoid inappropriate double nontaxation. The provisions have developed over time as practice with actual bilateral treaties leads to unexpected results and new issues are raised by parties to the treaties.<sup>1011</sup>

#### **4. International principles as applied in the U.S. system**

Present law combines taxation of all U.S. persons on their worldwide income, whether derived in the United States or abroad, with limited deferral of taxation of income earned by foreign subsidiaries of U.S. companies and source-based taxation of the U.S.-source income of nonresident aliens and foreign entities. Under this system (sometimes described as the U.S. hybrid system), the application of the Code differs depending on whether income arises from outbound investment or inbound investment. Outbound investment refers to the foreign activities of U.S. persons, while inbound investment is investment by foreign persons in U.S. assets or activities, although certain rules are common to both inbound and outbound activities.

##### **B. Principles Common to Inbound and Outbound Taxation**

Although the U.S. tax rules differ depending on whether the activity in question is inbound or outbound, there are certain concepts that apply to both inbound and outbound investment. Such areas include the transfer pricing rules, entity classification, the rules for determination of source, and whether a corporation is foreign or domestic.

##### **1. Residence**

U.S. persons are subject to tax on their worldwide income. The Code defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships,

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<sup>1009</sup> OECD (2014), Model Tax Convention on Income and on Capital: Condensed Version 2014, OECD Publishing, 2014, available at [http://dx.doi.org/10.1787/mtc\\_cond-2014-en](http://dx.doi.org/10.1787/mtc_cond-2014-en). The multinational organization was first established in 1961 by the United States, Canada and 18 European countries, dedicated to global development, and has since expanded to 35 members.

<sup>1010</sup> “Report by the Experts on Double Taxation,” League of Nation Document E.F.S. 73\F19 (1923), a report commissioned by the League at its second assembly. See also, Lara Friedlander and Scott Wilkie, “Policy Forum: The History of Tax Treaty Provisions--And Why It Is Important to Know About It,” 54 *Canadian Tax Journal* No. 4 (2006).

<sup>1011</sup> For example, the OECD initiated a multi-year study on base-erosion and profit shifting in response to concerns of multiple members. For an overview of that project, see Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015. This document can also be found on the Joint Committee on Taxation website at [www.jct.gov](http://www.jct.gov).

corporations, estates and certain trusts.<sup>1012</sup> The term “resident” is defined only with respect to natural persons. Noncitizens who are lawfully admitted as permanent residents of the United States in accordance with immigration laws (colloquially referred to as green card holders) are treated as residents for tax purposes. In addition, noncitizens who meet a substantial presence test and are not otherwise exempt from U.S. taxation are also taxable as U.S. residents.<sup>1013</sup>

For legal entities, the Code determines whether an entity is subject to U.S. taxation on its worldwide income on the basis of its place of organization. For purposes of U.S. tax law, a corporation or partnership is treated as domestic if it is organized or created under the laws of the United States or of any State, unless, in the case of a partnership, the Secretary prescribes otherwise by regulation.<sup>1014</sup> All other partnerships and corporations (that is, those organized under the laws of foreign countries) are treated as foreign.<sup>1015</sup> In contrast, place of organization is not determinative of residence under taxing jurisdictions that use factors such as situs, management and control to determine residence. As a result, legal entities may have more than one tax residence, or, in some case, no residence.<sup>1016</sup> Only domestic corporations are subject to U.S. tax on a worldwide basis. Foreign corporations are taxed only on income that has a sufficient connection with the United States.

Tax benefits otherwise available to a domestic corporation that migrates its tax home from the United States to foreign jurisdiction may be denied to such corporation, in which case it continues to be treated as a domestic corporation for ten years following such migration.<sup>1017</sup> These sanctions generally apply to a transaction in which, pursuant to a plan or a series of related transactions: (1) a domestic corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 60 percent but less than 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction (this stock often being referred to as “stock held by reason of”); and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (that is, the “expanded affiliated group”), does not have substantial business activities

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<sup>1012</sup> Sec. 7701(a)(30).

<sup>1013</sup> Sec. 7701(b).

<sup>1014</sup> Sec. 7701(a)(4).

<sup>1015</sup> Secs. 7701(a)(5) and 7701(a)(9). Entities organized in a possession or territory of the United States are not considered to have been organized under the laws of the United States.

<sup>1016</sup> “The notion of corporate residence is an important touchstone of taxation, however, in many foreign income tax systems[,]” with the result that the bilateral treaties are often relied upon to resolve conflicting claims of taxing jurisdiction. Joseph Isenbergh, Vol. 1 *U.S. Taxation of Foreign Persons and Foreign Income*, Para. 7.1 (Fourth Ed. 2016).

<sup>1017</sup> Sec. 7874.

in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.<sup>1018</sup>

The Treasury Department and the IRS have promulgated detailed guidance, through both regulations and several notices, addressing these requirements under section 7874 since the section was enacted in 2004,<sup>1019</sup> and have sought to expand the reach of the section or reduce the tax benefits of inversion transactions. For example, Notice 2014-52 announced Treasury's and the IRS's intention to issue regulations and took a two-pronged approach. First, it addressed the treatment of cross-border combination transactions themselves. Second, it addressed post-transaction steps that taxpayers may undertake with respect to US-owned foreign subsidiaries making it more difficult to access foreign earnings without incurring added U.S. tax. On November 19, 2015, Treasury and the IRS issued Notice 2015-79, which announced their intent to issue further regulations to limit cross-border merger transactions, expanding on the guidance issued in Notice 2014-52. In 2016, Treasury and the IRS issued proposed and temporary regulations that incorporate the rules previously announced in Notice 2014-52 and Notice 2015-79 and a new multiple domestic entity acquisition rule.<sup>1020</sup>

In early 2017, Treasury issued final and temporary regulations<sup>1021</sup> that adopt, with few changes, the 2016 temporary and proposed regulations.

## 2. Entity classification

Certain entities are eligible to elect their classification for Federal tax purposes under the "check-the-box" regulations adopted in 1997.<sup>1022</sup> Those regulations simplified the entity classification process for both taxpayers and the IRS by making the entity classification of unincorporated entities explicitly elective in most instances.<sup>1023</sup> The eligibility to elect and the

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<sup>1018</sup> Section 7874(a). In addition, an excise tax may be imposed on certain stock compensation of executives of companies that undertake inversion transactions. Sec. 4985.

<sup>1019</sup> Notice 2015-79, 2015 I.R.B. LEXIS 583 (Nov. 19, 2015), which announced their intent to issue further regulations to limit cross-border merger transactions, expanding on the guidance issued in Notice 2014-52. On April 4, 2016, Treasury and the IRS issued proposed and temporary regulations (T.D. 9761) that incorporate the rules previously announced in Notice 2014-52 and Notice 2015-79 and a new multiple domestic entity acquisition rule. On January 13, 2017, Treasury and the IRS issued final and temporary regulations under section 7874 (T.D. 9812), which adopt, with few changes, prior temporary and proposed regulations, which identify certain stock of an acquiring foreign corporation that is disregarded in calculating the ownership of the foreign corporation for purposes of section 7874.

<sup>1020</sup> T.D. 9761, April 4, 2016. But see, *Chamber of Commerce v Internal Revenue Service*, Cause No 1:16-CV-944-LY (W.D. Tex. Sept. 29, 2017), granting summary judgment to plaintiff in challenge to temporary regulations based on lack of compliance with Administrative Procedure Requirements.

<sup>1021</sup> T.D. 9812, January 13, 2017.

<sup>1022</sup> Treas. Reg. sec. 301.7701-1, *et seq.*

<sup>1023</sup> The check-the-box regulations replaced Treas. Reg. sec. 301.7701-2, as in effect prior to 1997, under which the classification of unincorporated entities for Federal tax purposes was determined on the basis of a four characteristics indicative of status as a corporation: continuity of life, centralization of management, limited

breadth of an entity's choices depend upon whether it is a "per se corporation" and its number of beneficial owners. Foreign as well as domestic entities may make the election. As a result, it is possible for an entity that operates across countries to be treated as a hybrid entity. A hybrid entity is one which is treated as a flow-through or disregarded entity for U.S. tax purposes but as a corporation for foreign tax purposes. For "reverse hybrid entities," the opposite is true. The election can affect the determination of the source of the income, availability of tax credits, and other tax attributes.

### 3. Source of income rules

The rules for determining the source of certain types of income are specified in the Code and described briefly below. Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor, the status or nationality of the recipient, the location of the recipient's activities that generate the income, and the location of the assets that generate the income. To the extent that the source of income is not specified by statute, the Treasury Secretary may promulgate regulations that explain the appropriate treatment. However, many items of income are not explicitly addressed by either the Code or Treasury regulations, sometimes resulting in nontaxation of the income. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.<sup>1024</sup>

#### Interest

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation.<sup>1025</sup> Special rules apply to treat as foreign-source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial

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liability, and free transferability of interests. An entity that possessed three or more of these characteristics was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership. Thus, to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these corporate characteristics. The advent and proliferation of limited liability companies ("LLCs") under State laws allowed business owners to create customized entities that possessed a critical common feature—limited liability for investors—as well as other corporate characteristics the owners found desirable. As a consequence, classification was effectively elective for well-advised taxpayers.

<sup>1024</sup> See, e.g., *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

<sup>1025</sup> Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1).

institutions.<sup>1026</sup> Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.<sup>1027</sup>

### Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.<sup>1028</sup> Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income.<sup>1029</sup>

### Rents and royalties

Rental income is sourced by reference to the location or place of use of the leased property.<sup>1030</sup> The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible.

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid.<sup>1031</sup> This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

### Income from sales of personal property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.<sup>1032</sup> For this purpose, special definitions of the terms "U.S. resident" and "nonresident" are provided. A nonresident is defined as any person who is not a U.S. resident,<sup>1033</sup> while the term "U.S. resident" comprises any juridical entity which is a U.S. person, all U.S. citizens, as well as any individual who is a U.S. resident without a tax home in a

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<sup>1026</sup> Secs. 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations the source rule in section 861(a)(1)(B) does not apply to interest paid by the foreign branch of a domestic financial institution. This results in the payment being treated as a withholdable payment. Sec. 1473(1)(C).

<sup>1027</sup> Sec. 884(f)(1).

<sup>1028</sup> Secs. 861(a)(2), 862(a)(2).

<sup>1029</sup> Sec. 861(a)(2)(B).

<sup>1030</sup> Sec. 861(a)(4).

<sup>1031</sup> *Ibid.*

<sup>1032</sup> Sec. 865(a).

<sup>1033</sup> Sec. 865(g)(1)(B).

foreign country or a nonresident alien with a tax home in the United States.<sup>1034</sup> As a result, nonresident includes any foreign corporation.<sup>1035</sup>

Several special rules apply. For example, income from the sale of inventory property is generally sourced to the place of sale, which is determined by where title to the property passes.<sup>1036</sup> However, if the sale is by a nonresident and is attributable to an office or other fixed place of business in the United States, the sale is treated as income from U.S. sources without regard to the place of sale, unless it is sold for use, disposition, or consumption outside the United States and a foreign office materially participates in the sale.<sup>1037</sup> Income from the sale of inventory property that a taxpayer produces (in whole or in part) in the United States and sells outside the United States, or that a taxpayer produces (in whole or in part) outside the United States and sells in the United States, is treated as partly U.S.-source and partly foreign-source.<sup>1038</sup>

In determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS has taken the position that to the extent that there is unrealized gain attributable to partnership assets that are effectively connected with the U.S. business, the foreign person's gain or loss from the sale or exchange of a partnership interest is effectively connected gain or loss to the extent of the partner's distributive share of such unrealized gain or loss, and not capital gain or loss. Similarly, to the extent that the partner's distributive share of unrealized gain is attributable to a permanent establishment of the partnership under an applicable treaty provision, it may be subject to U.S. tax under a treaty.<sup>1039</sup>

Gain on the sale of depreciable property is divided between U.S.-source and foreign-source in the same ratio that the depreciation was previously deductible for U.S. tax purposes.<sup>1040</sup>

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<sup>1034</sup> Sec. 865(g)(1)(A).

<sup>1035</sup> Sec. 865(g).

<sup>1036</sup> Secs. 865(b), 861(a)(6), 862(a)(6); Treas. Reg. sec. 1.861-7(c).

<sup>1037</sup> Sec. 865(e)(2).

<sup>1038</sup> Sec. 863(b). A taxpayer may elect one of three methods for allocating and apportioning income as U.S.- or foreign-source: (1) the 50-50 method under which 50 percent of the income from the sale of inventory property in such a situation is attributable to the production activities and 50 percent to the sales activities, with the income sourced based on the location of those activities; (2) independent factory price ("IFP") method under which, in certain circumstances, an IFP may be established by the taxpayer to determine income from production activities; (3) the books and records method under which, with advance permission, the taxpayer may use books of account to detail the allocation of receipts and expenditures between production and sales activities. Treas. Reg. sec. 1.863-3(b), (c). If production activity occurs only within the United States, or only within foreign countries, then all income is sourced to where the production activity occurs; when production activities occur in both the United States and one or more foreign countries, the income attributable to production activities must be split between U.S. and foreign sources. Treas. Reg. sec. 1.863-3(c)(1). The sales activity is generally sourced based on where title to the property passes. Treas. Reg. secs. 1.863-3(c)(2), 1.861-7(c).

<sup>1039</sup> Rev. Rul. 91-32, 1991-1 C.B. 107. But see, Grecian Magnesite Mining, Industrial & Shipping Co. SA v Commissioner, 149 T.C. No. 3 (2017).

<sup>1040</sup> Sec. 865(c).

Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible property.<sup>1041</sup>

### Personal services income

Compensation for labor or personal services is generally sourced to the place-of-performance. Thus, compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain *de minimis* criteria.<sup>1042</sup> Compensation for services performed both within and without the United States is allocated between U.S.-and foreign-source.<sup>1043</sup>

### Insurance income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.<sup>1044</sup>

### Transportation income

Transportation income is 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>1045</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. Sources rules generally provide that income from furnishing transportation that both begins and ends in the United States is U.S.-source income,<sup>1046</sup> and 50-percent of income attributable to transportation that either begins or the ends in the United States is treated as U.S.-source income. However, to the extent that the operator of a shipping or cruise line is foreign, its ownership structure and the maritime law<sup>1047</sup> applicable

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<sup>1041</sup> Sec. 865(d).

<sup>1042</sup> Sec. 861(a)(3). Gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship is generally treated as foreign-source income.

<sup>1043</sup> Treas. Reg. sec. 1.861-4(b).

<sup>1044</sup> Sec. 861(a)(7).

<sup>1045</sup> Sec. 863(c)(3).

<sup>1046</sup> Sec. 863(c).

<sup>1047</sup> U.S. law on navigation is codified in U.S. Code at title 33, and is 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. 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

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.<sup>1048</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.<sup>1049</sup> 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.<sup>1050</sup>

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>1051</sup> A similar exemption from U.S. tax is provided for gross income derived by a foreign corporation from the international operation of an aircraft, provided that the foreign country in which the corporation is organized grants an equivalent exemption to corporations organized in the United States.<sup>1052</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.

#### Income from space or ocean activities or international communications

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to the principles of the treaty other than those portions regarding deep seabed exploitation, even in the absence of ratification of the treaty.

<sup>1048</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. 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.

<sup>1049</sup> Sec. 887(a). Special rules for determining whether transportation income is effectively connected with the conduct of a U.S. trade or business are also provided, and for coordinating the application of sections 871, 882, and 887.

<sup>1050</sup> Sec. 887(b)(1).

<sup>1051</sup> Sec. 872(b)(1).

<sup>1052</sup> Sec. 883(a)(2).



In the case of a foreign person, generally no income from a space or ocean activity or from international communications is treated as U.S.-source income.<sup>1053</sup> With respect to the latter, an exception is provided if the foreign person maintains an office or other fixed place of business in the United States, in which case the international communications income attributable to such fixed place of business is treated as U.S.-source income.<sup>1054</sup> For U.S. persons, all income from space or ocean activities and 50 percent of income from international communications is treated as U.S.-source income.

#### Amounts received with respect to guarantees of indebtedness

Amounts received, directly or indirectly, from a noncorporate resident or from a domestic corporation for the provision of a guarantee of indebtedness of such person are income from U.S. sources.<sup>1055</sup> This includes payments that are made indirectly for the provision of a guarantee. For example, U.S.-source income under this rule includes a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for instance, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the additional interest payments made by the subsidiary are treated as indirect payments of the guarantee fee and, therefore, as income from U.S. sources.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person that is effectively connected with the conduct of a U.S. trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign-source income if they are not from sources within the United States under section 861(a)(9).

## **4. Intercompany transfers**

### Transfer pricing

A basic U.S. tax principle applicable in dividing profits from transactions between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in similar

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<sup>1053</sup> Sec. 863(d).

<sup>1054</sup> Sec. 863(e).

<sup>1055</sup> Sec. 861(a)(9). This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner*, 134 T.C. 122 (February 17, 2010), aff'd 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011), in which the Tax Court held that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were more closely analogous to compensation for services than to interest, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

transactions with unrelated parties. The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign company through pricing that does not reflect an arm's-length result.<sup>1056</sup> Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing. The arm's-length standard is difficult to administer in situations in which no unrelated party market prices exist for transactions between related parties. When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in part by the same transfer pricing rules of section 482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances among related business entities<sup>1057</sup> when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate.<sup>1058</sup> The regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length. For income from intangible property, section 482 provides "in the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion in income of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.<sup>1059</sup>

#### Gain recognition on outbound transfers

If a transfer of intangible property to a foreign affiliate occurs in connection with certain corporate transactions, nonrecognition rules that may otherwise apply are suspended. The transferor of intangible property must recognize gain from the transfer as though he had sold the intangible (regardless of the stage of development of the intangible property) in exchange for payments contingent on the use, productivity or disposition of the transferred property in amounts that would have been received either annually over the useful life of the property or

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<sup>1056</sup> For a detailed description of the U.S. transfer pricing rules, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 18-50.

<sup>1057</sup> The term "related" as used herein refers to relationships described in section 482, which refers to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

<sup>1058</sup> Section 1059A buttresses section 482 by limiting the extent to which costs used to determine custom valuation can also be used to determine basis in property imported from a related party. A taxpayer that imports property from a related party may not assign a value to the property for cost purposes that exceeds its customs value.

<sup>1059</sup> H.R. Rep. No. 99-426, p. 423.

upon disposition of the property after the transfer.<sup>1060</sup> The appropriate amounts of those imputed payments are determined using transfer-pricing principles. Final regulations issued in 2016 eliminate an exception under temporary regulations that permitted nonrecognition of gain from outbound transfers of foreign goodwill and going concern value. However, the Secretary announced that reinstatement of an exception for active trade or business is under consideration for cases with little potential for abuse and administrative difficulties.<sup>1061</sup>

### **C. U.S. Tax Rules Applicable to Nonresident Aliens and Foreign Corporations (Inbound)**

Nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability and the mechanism by which it is taxed. The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income: U.S.-source income that is “fixed or determinable annual or periodical gains, profits, and income” (“FDAP income”) or income that is “effectively connected with the conduct of a trade or business within the United States” (“ECI”). FDAP income generally is subject to a 30-percent gross-basis tax withheld at its source, while ECI is generally subject to the same U.S. tax rules that apply to business income derived by U.S. persons. That is, deductions are permitted in determining taxable ECI, which is then taxed at the same rates applicable to U.S. persons. Much FDAP income and similar income is, however, exempt from tax or is subject to a reduced rate of tax under the Code<sup>1062</sup> or a bilateral income tax treaty.<sup>1063</sup>

#### **1. Gross-basis taxation of U.S.-source income**

Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, which is collected by withholding at the source of the payment. As explained below, the categories of income subject to the 30-percent tax and the categories for which withholding is required are generally coextensive, with the result that determining the withholding tax liability determines the substantive liability.

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<sup>1060</sup> Sec. 367(d).

<sup>1061</sup> See, T.D. 9803, 81 F.R. 91012 (December 17, 2016). Treas. Reg. sec. 1.367(d)-1(b) now provides that the rules of section 367(d) apply to transfers of intangible property as defined under Treas. Sec. 1.367(a)-1(d)(5) after September 14, 2015, and to any transfers occurring before that date resulting from entity classification elections filed on or after September 15, 2015. Noting that commenters on the regulations had cited legislative history that contemplated active business exceptions, Treasury announced the reconsideration of the rule. U.S. Treasury Department, *Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Executive Order 13789* October 2, 2017, TNT Doc 2017-72131. The relevant legislative history is found at in H.R. Rep. No. 98-432, 98<sup>th</sup> Cong., 2d Sess. 1318-1320 (March 5, 1984) and Conference Report, H.R. Rep. No. 98-861, 98<sup>th</sup> Cong. 2d Sess. 951-957 (June 23, 1984).

<sup>1062</sup> *E.g.*, the portfolio interest exception in section 871(h) (discussed below).

<sup>1063</sup> Because each treaty reflects considerations unique to the relationship between the two treaty countries, treaty withholding tax rates on each category of income are not uniform across treaties.

The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30-percent includes FDAP income that is not effectively connected with the conduct of a U.S. trade or business.<sup>1064</sup> The items enumerated in defining FDAP income are illustrative; the common characteristic of types of FDAP income is that taxes with respect to the income may be readily computed and collected at the source, in contrast to the administrative difficulty involved in determining the seller's basis and resulting gain from sales of property.<sup>1065</sup> The words "annual or periodical" are "merely generally descriptive" of the payments that could be within the purview of the statute and do not preclude application of the withholding tax to one-time, lump sum payments to nonresident aliens.<sup>1066</sup>

With respect to income from shipping, the gross basis tax potentially applicable is four percent,<sup>1067</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.<sup>1068</sup>

### Types of FDAP income

FDAP income encompasses a broad range of types of gross income, but has limited application to gains on sales of property, including market discount on bonds and option premiums.<sup>1069</sup> Capital gains received by nonresident aliens present in the United States for fewer than 183 days are generally treated as foreign source and are thus not subject to U.S. tax, unless the gains are effectively connected with a U.S. trade or business; capital gains received by

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<sup>1064</sup> Secs. 871(a), 881. If the FDAP income is also ECI, it is taxed on a net basis, at graduated rates.

<sup>1065</sup> *Commissioner v. Wodehouse*, 337 U.S. 369, 388-89 (1949). After reviewing legislative history of the Revenue Act of 1936, the Supreme Court noted that Congress expressly intended to limit taxes on nonresident aliens to taxes that could be readily collectible, *i.e.*, subject to withholding, in response to "a theoretical system impractical of administration in a great number of cases. H.R. Rep. No. 2475, 74th Cong., 2d Sess. 9-10 (1936)." In doing so, the Court rejected P.G. Wodehouse's arguments that an advance royalty payment was not within the purview of the statutory definition of FDAP income.

<sup>1066</sup> *Commissioner v. Wodehouse*, 337 U.S. 369, 393 (1949).

<sup>1067</sup> Sec. 887.

<sup>1068</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). Comparable rules under section 872(b)(1) apply to income of nonresident alien individuals from shipping operations.

<sup>1069</sup> Although technically insurance premiums paid to a foreign insurer or reinsurer are FDAP income, they are exempt from withholding under Treas. Reg. sec. 1.1441-2(a)(7) if the insurance contract is subject to the excise tax under section 4371. Treas. Reg. secs. 1.1441-2(b)(1)(i) and 1.1441-2(b)(2).

nonresident aliens present in the United States for 183 days or more<sup>1070</sup> that are treated as income from U.S. sources are subject to gross-basis taxation.<sup>1071</sup> In contrast, U.S.-source gains from the sale or exchange of intangibles are subject to tax and withholding if they are contingent upon the productivity of the property sold and are not effectively connected with a U.S. trade or business.<sup>1072</sup>

Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S.-source income but are not subject to the U.S. tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.<sup>1073</sup> Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. tax (regardless of whether the recipient is engaged in a U.S. trade or business).<sup>1074</sup> Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. tax when paid to a foreign person.<sup>1075</sup> Additionally, there is generally no information reporting required with respect to payments of such amounts.<sup>1076</sup>

Although FDAP income includes U.S.-source portfolio interest, such interest is specifically exempt from the 30-percent gross-basis tax. Portfolio interest is any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person.<sup>1077</sup> For obligations issued before March 19, 2012, portfolio interest also includes interest paid on an obligation that is not in registered form, provided that the obligation is shown to be targeted to foreign investors under the conditions

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<sup>1070</sup> For purposes of this rule, whether a person is considered a resident in the United States is determined by application of the rules under section 7701(b).

<sup>1071</sup> Sec. 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as effectively connected income (or in some instances as dividend income) under the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”).

<sup>1072</sup> Secs. 871(a)(1)(D), 881(a)(4).

<sup>1073</sup> Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

<sup>1074</sup> Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

<sup>1075</sup> Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

<sup>1076</sup> Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A), (B). Regulations require a bank to report interest if the recipient is a nonresident alien who resides in a country with which the United States has a satisfactory exchange of information program under a bilateral agreement and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5) and 1.6049-8. The IRS publishes lists of the countries whose residents are subject to the reporting requirements, and those countries with respect to which the reported information will be automatically exchanged. Rev. Proc. 2017-31, available at <https://www.irs.gov/pub/irs-drop/rp-17-31.pdf>, supplementing Rev. Proc. 2014-64.

<sup>1077</sup> Sec. 871(h)(2).

sufficient to establish deductibility of the payment of such interest.<sup>1078</sup> Portfolio interest, however, does not include interest received by a 10-percent shareholder,<sup>1079</sup> certain contingent interest,<sup>1080</sup> interest received by a controlled foreign corporation from a related person,<sup>1081</sup> or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.<sup>1082</sup>

### Imposition of gross-basis tax and reporting by U.S. withholding agents

The 30-percent tax on FDAP income is generally collected by means of withholding.<sup>1083</sup> Withholding on FDAP payments to foreign payees is required unless the withholding agent,<sup>1084</sup> *i.e.*, the person making the payment to the foreign person receiving the income, can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.<sup>1085</sup> The principal statutory exemptions from the 30-percent tax apply to interest on bank deposits, and portfolio interest, described above.<sup>1086</sup>

In many instances, the income subject to withholding is the only income of the foreign recipient that is subject to any U.S. tax. No U.S. Federal income tax return from the foreign recipient is generally required with respect to the income from which tax was withheld, if the recipient has no ECI income and the withholding is sufficient to satisfy the recipient's liability. Accordingly, although the 30-percent gross-basis tax is a withholding tax, it is also generally the final tax liability of the foreign recipient (unless the foreign recipients files for a refund).

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report and pay over any amounts of U.S. tax withheld. The reports are due to be filed

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<sup>1078</sup> Sec. 163(f)(2)(B). The exception to the registration requirements for foreign targeted securities was repealed in 2010, effective for obligations issued two years after enactment, thus narrowing the portfolio interest exemption for obligations issued after March 18, 2012. See Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).

<sup>1079</sup> Sec. 871(h)(3).

<sup>1080</sup> Sec. 871(h)(4).

<sup>1081</sup> Sec. 881(c)(3)(C).

<sup>1082</sup> Sec. 881(c)(3)(A).

<sup>1083</sup> Secs. 1441, 1442.

<sup>1084</sup> Withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

<sup>1085</sup> Secs. 871, 881, 1441, 1442; Treas. Reg. sec. 1.1441-1(b).

<sup>1086</sup> A reduced rate of withholding of 14 percent applies to certain scholarships and fellowships paid to individuals temporarily present in the United States. Sec. 1441(b). In addition to statutory exemptions, the 30-percent tax with respect to interest, dividends and royalties may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to tax is resident.

with the IRS by March 15 of the calendar year following the year in which the payment is made. Two types of reports are required: (1) a summary of the total U.S.-source income paid and withholding tax withheld on foreign persons for the year and (2) a report to both the IRS and the foreign person of that person's U.S.-source income that is subject to reporting.<sup>1087</sup> The nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.<sup>1088</sup>

To the extent that the withholding agent deducts and withholds an amount, the withheld tax is credited to the recipient of the income.<sup>1089</sup> If the agent withholds more than is required, and results in an overpayment of tax, the excess may be refunded to the recipient of the income upon filing of a timely claim for refund.

#### Excise tax on foreign reinsurance premiums

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.<sup>1090</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.

Many U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Japan, Switzerland, and the United Kingdom.<sup>1091</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>1092</sup>

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<sup>1087</sup> Treas. Reg. sec. 1.1461-1(b), (c).

<sup>1088</sup> See Treas. Reg. sec. 1.1441-7(a) (definition of withholding agent includes foreign persons).

<sup>1089</sup> Sec. 1462.

<sup>1090</sup> Secs. 4371-4374.

<sup>1091</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>1092</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

## 2. Net-basis taxation of U.S.-source income

The United States taxes on a net basis the income of foreign persons that is “effectively connected” with the conduct of a trade or business in the United States.<sup>1093</sup> Any gross income derived by the foreign person that is not effectively connected with the person’s U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person’s income from the business.<sup>1094</sup>

### U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged.<sup>1095</sup>

The question whether a foreign person is engaged in a U.S. trade or business is factual and has generated much case law. Basic issues include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States in respect of the business is sufficient to attribute those functions to the foreign person.

The trade or business rules differ from one activity to another. The term “trade or business within the United States” expressly includes the performance of personal services within the United States.<sup>1096</sup> If, however, a nonresident alien individual performs personal services for a foreign employer, and the individual’s total compensation for the services and period in the United States are minimal (\$3,000 or less in total compensation and 90 days or fewer of physical presence in a year), the individual is not considered to be engaged in a U.S. trade or business.<sup>1097</sup> Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.<sup>1098</sup> A foreign person who trades in stock or securities or commodities in the United States through an independent agent generally is not treated as engaged in a U.S. trade or business if the foreign person does not have an office

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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.

<sup>1093</sup> Secs. 871(b), 882.

<sup>1094</sup> Secs. 871(b)(2), 882(a)(2).

<sup>1095</sup> Sec. 875.

<sup>1096</sup> Sec. 864(b).

<sup>1097</sup> Sec. 864(b)(1).

<sup>1098</sup> Sec. 864(b)(2).



or other fixed place of business in the United States through which trades are carried out. A foreign person who trades stock or securities or commodities for the person's own account also generally is not considered to be engaged in a U.S. business so long as the foreign person is not a dealer in stock or securities or commodities.

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation. Under each treaty, the United States is permitted to tax business profits only to the extent those profits are attributable to a U.S. permanent establishment of the foreign person. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business. For example, a permanent establishment typically requires the maintenance of a fixed place of business over a significant period of time.

#### Effectively connected income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is “effectively connected” with the business. Specific statutory rules govern whether income is ECI.<sup>1099</sup>

In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross basis U.S. taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the amount (the “asset use” and “business activities” tests).<sup>1100</sup> Under the asset use and business activities tests, due regard is given to whether the income, gain, or asset was accounted for through the U.S. trade or business. All other U.S.-source income is treated as ECI.<sup>1101</sup>

A foreign person who is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI.<sup>1102</sup> Foreign-source income not included in one of these categories (described next) generally is exempt from U.S. tax.

A foreign person's income from foreign sources generally is considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income is in one of the following categories: (1) rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trade-marks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) interest or dividends derived in the active conduct of a banking, financing, or

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<sup>1099</sup> Sec. 864(c).

<sup>1100</sup> Sec. 864(c)(2).

<sup>1101</sup> Sec. 864(c)(3).

<sup>1102</sup> This income is subject to net-basis U.S. taxation after allowance of a credit for any foreign income tax imposed on the income. Sec. 906.

similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) income derived from the sale or exchange (outside the United States), through the U.S. office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange.<sup>1103</sup> Foreign-source dividends, interest, and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 percent (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income.<sup>1104</sup>

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if the agent either has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or has a stock of merchandise from which he regularly fills orders on behalf of the foreign person.<sup>1105</sup> If a foreign person has a U.S. office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office was a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived.<sup>1106</sup>

Special rules apply in determining the ECI of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code is treated as ECI if the income is attributable to its United States business.<sup>1107</sup>

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S. trade or business in that year.<sup>1108</sup> If, however, income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the determination whether the income or gain is taxable on a net basis is made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year.<sup>1109</sup> If any

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<sup>1103</sup> Sec. 864(c)(4)(B).

<sup>1104</sup> Sec. 864(c)(4)(D)(i).

<sup>1105</sup> Sec. 864(c)(5)(A).

<sup>1106</sup> Sec. 864(c)(5)(B).

<sup>1107</sup> Sec. 864(c)(4)(C).

<sup>1108</sup> Sec. 864(c)(1)(B).

<sup>1109</sup> Sec. 864(c)(6).

property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within 10 years after the cessation, the determination whether any income or gain attributable to the disposition of the property is taxable on a net basis is made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business and without regard to the requirement that the taxpayer be engaged in a U.S. business during the taxable year for which the income or gain is taken into account.<sup>1110</sup>

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 of such income of the foreign person is attributable to regularly scheduled transportation.<sup>1111</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 net-basis taxation. Income from the international operation of a ship or aircraft may be eligible for an exemption under section 883, provided that the foreign jurisdiction has extended reciprocity for U.S. businesses;<sup>1112</sup> whether the party claiming an exemption is eligible for the tax relief,<sup>1113</sup> and the activities that give rise to the income qualify under relevant regulations.

#### Allowance of deductions

Taxable ECI is computed by taking into account deductions associated with gross ECI. For this purpose, the apportionment and allocation of deductions is addressed in detailed regulations. The regulations applicable to deductions other than interest expense set forth general guidelines for allocating deductions among classes of income and apportioning deductions between ECI and non-ECI. In some circumstances, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. More specific guidelines are provided for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Detailed regulations under section 861 address the allocation and apportionment of interest deductions. In general, interest is allocated and apportioned based on assets rather than income.

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<sup>1110</sup> Sec. 864(c)(7).

<sup>1111</sup> Sec. 887(b)(4).

<sup>1112</sup> 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. Rev. Rul. 2008-17, 2008-1 C.B. 626, modified by Ann. 2008-57, 2008-C.B. 1192, 2008.

<sup>1113</sup> Sec. 883(c) and regulations thereunder.

### 3. Special rules

#### FIRPTA

A foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") is treated as ECI and, therefore, as taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of ECI.<sup>1114</sup> In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as ECI ("FIRPTA income") is generally required to withhold U.S. tax from the payment.<sup>1115</sup> The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total ECI and deductions (if any) for the taxable year.

#### Branch profits taxes

A domestic corporation owned by foreign persons is subject to U.S. income tax on its net income. The earnings of the domestic corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As described previously, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to U.S. tax. To approximate these second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign parent corporations, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest that are deducted by, the U.S. branch of the foreign corporation. These branch taxes may be reduced or eliminated under an applicable income tax treaty.<sup>1116</sup>

Under the branch profits tax, the United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount."<sup>1117</sup> The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its ECI.<sup>1118</sup>

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<sup>1114</sup> Sec. 897(a).

<sup>1115</sup> Sec. 1445 and Treasury regulations thereunder.

<sup>1116</sup> See Treas. Reg. sec. 1.884-1(g), -5.

<sup>1117</sup> Sec. 884(a).

<sup>1118</sup> Sec. 884(b).

Limited categories of earnings and profits attributable to a foreign corporation's ECI are excluded in calculating the dividend equivalent amount.<sup>1119</sup>

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (that is, the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business).<sup>1120</sup> The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore is subject to U.S. 30-percent withholding tax (if the interest is paid to a foreign person and a Code or treaty exemption or reduction would not be available if the interest were actually paid by a domestic corporation).<sup>1121</sup> Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to U.S. 30-percent withholding tax.<sup>1122</sup> For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by the trade or business.

### Earnings stripping

Taxpayers are limited in their ability to reduce the U.S. tax on the income derived from their U.S. operations through certain earnings stripping transactions that involve 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>1123</sup> Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;<sup>1124</sup> to unrelated parties in certain

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<sup>1119</sup> See sec. 884(d)(2) (excluding, for example, earnings and profits attributable to gain from the sale of domestic corporation stock that constitutes a U.S. real property interest described in section 897).

<sup>1120</sup> Sec. 884(b).

<sup>1121</sup> Sec. 884(f)(1)(A).

<sup>1122</sup> Sec. 884(f)(1)(B).

<sup>1123</sup> Sec. 163(j).

<sup>1124</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).

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.

## **D. U.S. Tax Rules Applicable to Foreign Activities of U.S. Persons (Outbound)**

### **1. In general**

In general, income earned directly by a U.S. person from the conduct of a foreign business is taxed on a current basis,<sup>1125</sup> but income earned indirectly from a separate legal entity operating the foreign business is not. Instead, active foreign business income earned by a U.S. person indirectly through an interest in a foreign corporation generally is not subject to U.S. tax until the income is distributed as a dividend to the U.S. person. Certain anti-deferral regimes may cause the U.S. owner to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by the foreign corporation regardless of whether the income has been distributed as a dividend to the U.S. owner. The main anti-deferral regimes that provide such exceptions are the controlled foreign corporation (“CFC”) rules of subpart F<sup>1126</sup> and the passive foreign investment company (“PFIC”) rules.<sup>1127</sup> A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation’s income under one of the anti-deferral regimes.<sup>1128</sup>

### **2. Anti-deferral regimes**

#### **Subpart F**

Subpart F,<sup>1129</sup> applicable to CFCs and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A CFC generally is defined as any

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<sup>1125</sup> A U.S. citizen or resident living abroad may be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs under section 911. For a description of this exclusion, see *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011, p. 52.

<sup>1126</sup> Secs. 951-964.

<sup>1127</sup> Secs. 1291-1298.

<sup>1128</sup> Secs. 901, 902, 960, 1293(f).

<sup>1129</sup> Secs. 951-964.

foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that are within the meaning of the term "United States shareholder," which refers only to those U.S. persons who own at least 10 percent of the stock (measured by vote only).<sup>1130</sup>

### Subpart F income

Under the subpart F rules, the United States generally taxes the 10-percent U.S. shareholders of a CFC on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.<sup>1131</sup> In effect, the United States treats the 10-percent U.S. shareholders of a CFC as having received a current distribution of the corporation's subpart F income. With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,<sup>1132</sup> insurance income,<sup>1133</sup> and certain income relating to international boycotts and other violations of public policy.<sup>1134</sup>

Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.<sup>1135</sup>

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Finally, special rules apply under subpart F with respect to related person insurance income<sup>1136</sup> in order to address captive insurance

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<sup>1130</sup> Secs. 951(b), 957, 958. The term "United States shareholder" is used interchangeably herein with "U.S. shareholder."

<sup>1131</sup> Sec. 951(a).

<sup>1132</sup> Sec. 954.

<sup>1133</sup> Sec. 953.

<sup>1134</sup> Sec. 952(a)(3)-(5).

<sup>1135</sup> Sec. 954.

<sup>1136</sup> Sec. 953(c). 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.

companies.<sup>1137</sup> Under these rules, the threshold for determining control is reduced to 25 percent, and any level of stock ownership by a U.S. person in such corporation is sufficient for the person to be treated as a U.S. shareholder.

### Investments in U.S. property

The 10-percent U.S. shareholders of a CFC also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's untaxed earnings invested in certain items of U.S. property.<sup>1138</sup> This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.<sup>1139</sup> There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.<sup>1140</sup> The inclusion rule for investment of earnings in U.S. property is intended to prevent taxpayers from avoiding U.S. tax on dividend repatriations by repatriating CFC earnings through non-dividend payments, such as loans to U.S. persons.

### Subpart F exceptions

Several exceptions to the broad definition of subpart F income permit continued deferral for income from certain transactions, dividends, interest and certain rents and royalties received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized.<sup>1141</sup> The same-country exception is not available to the extent that the payments reduce the subpart F income of the payor. A second exception from foreign base company income and insurance income is available for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).<sup>1142</sup>

A provision colloquially referred to as the "CFC look-through" rule excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to non-subpart-F income of the payor.<sup>1143</sup> The look-through

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<sup>1137</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 968.

<sup>1138</sup> Secs. 951(a)(1)(B), 956.

<sup>1139</sup> Sec. 956(c)(1).

<sup>1140</sup> Sec. 956(c)(2).

<sup>1141</sup> Sec. 954(c)(3).

<sup>1142</sup> Sec. 954(b)(4).

<sup>1143</sup> Sec. 954(c)(6).



rule applies to taxable years of foreign corporations beginning before January 1, 2020, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.<sup>1144</sup>

There is also an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of banking or financing business (“active financing income”), which applies to all taxable years of the foreign corporation beginning after December 31, 2014, and for taxable years of the shareholders that end during or within such taxable years of the corporation.<sup>1145</sup> With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (“QBU”) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country’s tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met.

In the case of a securities dealer, an exception from foreign personal holding company income applies to any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer’s trade or business as a dealer in securities within the meaning of section 475.<sup>1146</sup> In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that, for securities dealers, this exception generally takes precedence over the exception for active financing income.

Income is treated as active financing income only if, among other requirements, it is derived by a CFC or by a QBU of that CFC. Certain activities conducted by persons related to the CFC or its QBU are treated as conducted directly by the CFC or QBU.<sup>1147</sup> An activity qualifies under this rule if the activity is performed by employees of the related person and if the related person is an eligible CFC, the home country of which is the same as the home country of

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<sup>1144</sup> See section 144 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114-113), H.R. 2029 [“the PATH Act of 2015”], which extended section 954(c)(6) for five years. Congress has previously extended the application of section 954(c)(6) several times, most recently in the Tax Increase Prevention Act of 2014, Pub. L. No. 113-295; Pub. L. No. 107-147, sec. 614, 2002; Pub. L. No. 106-170, sec. 503, 1999; Pub. L. No. 105-277, 1998.

<sup>1145</sup> Sec. 954(h). See section 128 of the PATH Act of 2015, which made the active financing exception permanent.

<sup>1146</sup> Sec. 954(c)(2)(C).

<sup>1147</sup> Sec. 954(h)(3)(E).

the related CFC or QBU; the activity is performed in the home country of the related person; and the related person receives arm's-length compensation that is treated as earned in the home country. Income from an activity qualifying under this rule is excluded from subpart F income so long as the other active financing requirements are satisfied.

Certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch or within the CFC's country of creation or organization are also excepted from foreign personal holding company income, provided that certain requirements are met. Further, additional exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions, including reserve requirements, are met.<sup>1148</sup>

#### Exclusion of previously taxed earnings and profits

A 10-percent U.S. shareholder of a CFC may exclude from its income actual distributions of earnings and profits from the CFC that were previously included in the 10-percent U.S. shareholder's income under subpart F.<sup>1149</sup> Any income inclusion (under section 956) resulting from investments in U.S. property may also be excluded from the 10-percent U.S. shareholder's income when such earnings are ultimately distributed.<sup>1150</sup> Ordering rules provide that distributions from a CFC are treated as coming first out of earnings and profits of the CFC that have been previously taxed under subpart F, then out of other earnings and profits.<sup>1151</sup>

#### Basis adjustments

In general, a 10-percent U.S. shareholder of a CFC receives a basis increase with respect to its stock in the CFC equal to the amount of the CFC's earnings that are included in the 10-percent U.S. shareholder's income under subpart F.<sup>1152</sup> Similarly, a 10-percent U.S. shareholder of a CFC generally reduces its basis in the CFC's stock in an amount equal to any distributions that the 10-percent U.S. shareholder receives from the CFC that are excluded from its income as previously taxed under subpart F.<sup>1153</sup>

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<sup>1148</sup> Subject to approval by the IRS, a taxpayer may establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

<sup>1149</sup> Sec. 959(a)(1).

<sup>1150</sup> Sec. 959(a)(2).

<sup>1151</sup> Sec. 959(c).

<sup>1152</sup> Sec. 961(a).

<sup>1153</sup> Sec. 961(b).

## **Passive foreign investment companies**

The Tax Reform Act of 1986<sup>1154</sup> established the PFIC anti-deferral regime. A PFIC is generally 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>1155</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 PFICs that are qualified electing funds, under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.<sup>1156</sup> A second set of rules applies to PFICs that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.<sup>1157</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 and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."<sup>1158</sup>

Under the PFIC regime, passive income is any income which is of a 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>1159</sup> In applying the insurance exception, the IRS analyzes whether risks assumed under contracts issued by a foreign company organized as an insurer are truly insurance risks, whether the risks are limited under the terms of the contracts, and the status of the company as an insurance company.<sup>1160</sup>

## **Other anti-deferral rules**

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<sup>1154</sup> Pub. L. No. 99-514.

<sup>1155</sup> Sec. 1297.

<sup>1156</sup> Secs. 1293-1295.

<sup>1157</sup> Sec. 1291.

<sup>1158</sup> Sec. 1296.

<sup>1159</sup> Sec. 1297(b)(2)(B).

<sup>1160</sup> Notice 2003-34, 2003-C.B. 1 990, June 9, 2003. See also, Prop. Treas. Reg. sec. 1.1297-4, 26 CFR Part 1, REG-108214-15, April 24, 2015.

The subpart F and PFIC rules are not the only anti-deferral regimes. Other rules that impose current U.S. taxation on income earned through corporations include the accumulated earnings tax rules<sup>1161</sup> and the personal holding company rules.

Rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a PFIC with respect to a particular shareholder if the corporation is also a CFC and the shareholder is a 10-percent U.S. shareholder. Thus, subpart F is allowed to trump the PFIC rules.

### 3. Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed to claim credit for foreign income taxes they pay. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a “deemed-paid” credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed as a dividend or is included in the domestic corporation’s income under the anti-deferral rules.<sup>1162</sup>

The foreign tax credit generally is limited to a taxpayer’s U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.<sup>1163</sup> The limit is computed by multiplying a taxpayer’s total U.S. tax liability for the year by the ratio of the taxpayer’s foreign-source taxable income for the year to the taxpayer’s total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer’s foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.<sup>1164</sup>

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each limitation category (described below) by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category, on the other. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.<sup>1165</sup> However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.<sup>1166</sup> In the case of interest

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<sup>1161</sup> Secs. 531-537.

<sup>1162</sup> Secs. 901, 902, 960, 1291(g).

<sup>1163</sup> Secs. 901, 904.

<sup>1164</sup> Sec. 904(c).

<sup>1165</sup> Treas. Reg. sec. 1.861-8(b), Temp. Treas. Reg. sec. 1.861-8T(c).

<sup>1166</sup> Temp. Treas. Reg. sec. 1.861-9T, Treas. Reg. sec. 1.861-17.

expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.<sup>1167</sup>

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.<sup>1168</sup> These rules exclude foreign corporations from an affiliated group.<sup>1169</sup> Interest expense allocation rules permitting a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis were modified in 2004, and initially effective for taxable years beginning after December 31, 2008.<sup>1170</sup> The effective date of the modified rules has been delayed to January 1, 2021.<sup>1171</sup> A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group. The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

The foreign tax credit limitation is applied separately to passive category income and to general category income.<sup>1172</sup> Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. All other income is in the general category. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is highly taxed (that is, if the foreign tax rate is determined to exceed the highest rate of tax

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<sup>1167</sup> Sec. 864(e)(1), (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

<sup>1168</sup> Secs. 864(e)(5), 1504.

<sup>1169</sup> Sec. 1504(b)(3).

<sup>1170</sup> Sec. 864(f); "American Jobs Creation Act of 2004" ("AJCA"), Pub. L. 108-357, sec. 401(a).

<sup>1171</sup> Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 551(a).

<sup>1172</sup> Sec. 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Before AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations (also known as "10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). A number of other provisions of the Code, including several enacted in 2010 as part of Pub. L. No. 111-226, create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, e.g., secs. 865(h), 901(j), 904(d)(6), 904(h)(10).

specified in Code section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made.<sup>1173</sup> Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.<sup>1174</sup>

Special rules apply to the allocation of income and losses from foreign and U.S. sources within each category of income.<sup>1175</sup> Foreign losses from one category will first be used to offset income from foreign sources of other categories. If there remains an overall foreign loss, it will be deducted against income from U.S. sources. The same principle applies to losses from U.S. sources. In subsequent years, the losses that were deducted against another category or source of income will be recaptured. That is, an equal amount of income from the same category or source that generated a loss in the prior year will be recharacterized as income from the other category or source against which the loss was deducted. Up to 50 percent of income from one source in any subsequent year will be recharacterized as income from the other source, whereas foreign-source income in a particular category can be fully recharacterized as income in another category until the losses from prior years are fully recaptured.<sup>1176</sup>

In addition to the foreign tax credit limitation just described, a taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.<sup>1177</sup>

#### **4. Special rules**

##### Dual consolidated loss rules

Under the rules applicable to corporations filing consolidated returns, a dual consolidated loss ("DCL") is any net operating loss of a domestic corporation if the corporation is subject to an income tax of a foreign country without regard to whether such income is from sources in or outside of such foreign country, or if the corporation is subject to such a tax on a residence basis (a "dual resident corporation").<sup>1178</sup> A DCL generally cannot be used to reduce the taxable

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<sup>1173</sup> Sec. 904(d)(3). The subpart F rules applicable to CFCs and their 10-percent U.S. shareholders are described below.

<sup>1174</sup> Sec. 904(d)(4).

<sup>1175</sup> Secs. 904(f), (g).

<sup>1176</sup> Secs. 904(f)(1), (g)(1).

<sup>1177</sup> Sec. 909.

<sup>1178</sup> Sec. 1503(d).

income of any member of the corporation's affiliated group. Losses of a separate unit of a domestic corporation (a foreign branch or an interest in a hybrid entity owned by the corporation) are subject to this limitation in the same manner as if the unit were a wholly owned subsidiary of such corporation. An exemption is available under Treasury regulations in the case of DCLs for which a domestic use election (that is, an election to use the loss only for domestic, and not foreign, tax purposes) has been made.<sup>1179</sup> Recapture is required, however, upon the occurrence of certain triggering events, including the conversion of a separate unit to a foreign corporation and the transfer of 50 percent or more of the assets of a separate unit within a twelve-month period.<sup>1180</sup>

#### Temporary dividends-received deduction for repatriated foreign earnings

AJCA section 421 added to the Code section 965, a temporary provision intended to encourage U.S. multinational companies to repatriate foreign earnings. Under section 965, for one taxable year certain dividends received by a U.S. corporation from its CFCs were eligible for an 85-percent dividends-received deduction. At the taxpayer's election, this deduction was available for dividends received either during the taxpayer's first taxable year beginning on or after October 22, 2004, or during the taxpayer's last taxable year beginning before such date.

The temporary deduction was subject to a number of general limitations. First, it applied only to cash repatriations generally in excess of the taxpayer's average repatriation level calculated for a three-year base period preceding the year of the deduction. Second, the amount of dividends eligible for the deduction was generally limited to the amount of earnings shown as permanently invested outside the United States on the taxpayer's recent audited financial statements. Third, to qualify for the deduction, dividends were required to be invested in the United States according to a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.<sup>1181</sup>

No foreign tax credit (or deduction) was allowed for foreign taxes attributable to the deductible portion of any dividend.<sup>1182</sup> For this purpose, the taxpayer was permitted to specifically identify which dividends were treated as carrying the deduction and which dividends were not. In other words, the taxpayer was allowed to choose which of its dividends were treated as meeting the base-period repatriation level (and thus carry foreign tax credits, to the extent otherwise allowable), and which of its dividends were treated as part of the excess eligible for the deduction (and thus subject to proportional disallowance of any associated foreign tax

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<sup>1179</sup> Treas. Reg. sec. 1.1503(d)-6(d).

<sup>1180</sup> See Treas. Reg. sec. 1.1503(d)-6(e)(1).

<sup>1181</sup> Section 965(b)(4). The plan was required to provide for the reinvestment of the repatriated dividends in the United States, including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for the purposes of job retention or creation.

<sup>1182</sup> Sec. 965(d)(1).

credits).<sup>1183</sup> Deductions were disallowed for expenses that were directly allocable to the deductible portion of any dividend.<sup>1184</sup>

### Domestic international sales corporations

A domestic international sales corporation (“DISC”) is a domestic corporation that satisfies the following conditions: 95 percent of its gross receipts must be qualified export receipts; 95 percent of the sum of the adjusted bases of all its assets must be attributable to the sum of the adjusted bases of qualified export assets; the corporation must have no more than one class of stock; the par or stated value of the outstanding stock must be at least \$2,500 on each day of the taxable year; and an election must be in effect to be taxed as a DISC.<sup>1185</sup> In general, a DISC is not subject to corporate-level tax and offers limited deferral of tax liability to its shareholders.<sup>1186</sup> DISC income attributable to a maximum of \$10 million annually of qualified export receipts is generally exempt from income tax at both the corporate and shareholder level. Shareholders must pay interest to account for the benefit of deferring the tax liability on undistributed DISC income related to this \$10 million maximum annual amount.<sup>1187</sup> Such entities are also referred to as interest charge DISCs, or IC-DISCs. Shareholders of a DISC are deemed to receive a dividend out of current earnings and profits from qualified export receipts in excess of \$10 million.<sup>1188</sup> Gain on the sale of DISC stock is treated as a dividend to the extent of accumulated DISC income.<sup>1189</sup> The shareholders of a corporation which is not a DISC, but was a DISC in a previous taxable year, and which has previously taxed income or accumulated DISC income, are also required to pay interest on the deferral benefit, and gain on the sale or exchange of stock in such corporation is treated as a dividend.

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<sup>1183</sup> Accordingly, taxpayers generally were expected to pay regular dividends out of high-taxed CFC earnings (thereby generating deemed-paid credits available to offset foreign-source income) and section 965 dividends out of low-taxed CFC earnings (thereby availing themselves of the 85-percent deduction).

<sup>1184</sup> Sec. 965(d)(2).

<sup>1185</sup> Secs. 992(a) and (b). If a corporation fails to satisfy either or both of the 95-percent tests, it is deemed to satisfy such tests if it makes a pro rata distribution of its gross receipts which are not qualified export receipts and the fair market value of its assets which are not qualified export assets. Sec. 992(c).

<sup>1186</sup> Sec. 991. Prior to the 1984 Revenue Act (Pub. L. 98-369), DISCs were eligible for more generous tax benefits that were eliminated in favor of the since-repealed foreign sales corporation regime (“FSC”). An overview of the history of the DISCs and FSCs regimes is provided in Joseph Isenbergh, Vol. 3 *U.S. Taxation of Foreign Persons and Foreign Income*, Para. 81. (Fourth Ed. 2016).

<sup>1187</sup> The rate is the average of one-year constant maturity Treasury yields. The deferral benefit is the excess of the amount of tax for which the shareholder would be liable if deferred DISC income were included as ordinary income over the actual tax liability of such shareholder. Sec. 995(f).

<sup>1188</sup> The amount of the deemed distribution is the sum of several items, including qualified export receipts in excess of \$10 million. See sec. 955(b).

<sup>1189</sup> Sec. 995(c).



## PART I – OUTBOUND TRANSACTIONS

### 1. Deduction for foreign-source portion of dividends received by domestic corporations from specified 10-percent owned foreign corporations (sec. 14101 of the bill and new sec. 245A of the Code)

#### Reasons for Change

In moving the U.S. international tax system to a territorial system, a key component is the treatment of foreign income earned by U.S. corporations through their foreign affiliates. Under current law, foreign income earned by a foreign subsidiary of a U.S. corporation is not subject to U.S. tax until it is distributed to the U.S. parent corporation as a dividend. Such dividends, minus credits for foreign taxes paid, are considered taxable income for the U.S. parent corporation. In a territorial system, income earned outside the United States is not taxed in the United States. In this provision, this is accomplished by means of a deduction for the U.S. portion of dividends received by U.S. corporations from foreign affiliates.

The provision would allow U.S. companies to compete on a more level playing field against foreign multinationals when selling products and services abroad by eliminating an additional level of tax.

The provision would eliminate the “lock-out” effect under current law, which means U.S. businesses avoid bringing their foreign earnings back into the United States to avoid the U.S. residual tax on those earnings.

#### Explanation of Provision

##### In general

The provision allows an exemption for certain foreign income. This exemption is provided for by means of a 100-percent deduction for the foreign-source portion of dividends received from specified 10-percent owned foreign corporations by domestic corporations that are United States shareholders of those foreign corporations within the meaning of section 951(b)<sup>1190</sup> (referred to here as “DRD”).<sup>1191</sup>

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<sup>1190</sup> Under section 951(b), a domestic corporation is a United States shareholder of a foreign corporation if it owns, within the meaning of section 958(a), or is considered as owning by applying the rules of section 958(b), 10-percent or more of the voting stock of the foreign corporation.

<sup>1191</sup> The Committee intends that in the case of a domestic corporation that is a partner in a domestic partnership that is a United States shareholder of a specified foreign corporation, the DRD applies to such partner’s distributive share of a dividend received by the partnership if the partner would be a United States shareholder of such foreign corporation determined by applying the rules of section 958(a) and (b) as if the domestic partnership were a foreign partnership.

A specified 10-percent owned foreign corporation is any foreign corporation (other than a PFIC that is not also a CFC) with respect to which any domestic corporation is a U.S. shareholder.<sup>1192</sup>

### **Foreign-source portion of a dividend**

The DRD is available only for the foreign-source portion of dividends received by a domestic corporation from specified 10-percent owned foreign corporations. The foreign-source portion of any dividend is the amount that bears the same ratio to the dividend as the undistributed foreign earnings bears to the total undistributed earnings of the foreign corporation. Undistributed earnings are the amount of the earnings and profits of a specified 10-percent owned foreign corporation<sup>1193</sup> as of the close of the taxable year of the specified 10-percent owned foreign corporation in which the dividend is distributed and not reduced by dividends<sup>1194</sup> distributed during that taxable year. Undistributed foreign earnings are the portion of the undistributed earnings attributable to neither income described in section 245(a)(5)(A) nor section 245(a)(5)(B), without regard to section 245(a)(12).

### **Hybrid Dividends**

The DRD is not available for any dividend received by a U.S. shareholder from a controlled foreign corporation if the dividend is a hybrid dividend. A hybrid dividend is an amount received from a controlled foreign corporation for which a deduction would be allowed under this provision and for which the specified 10-percent owned foreign corporation received a deduction (or other tax benefit) from taxes imposed by a foreign country.

If a controlled foreign corporation with respect to which a domestic corporation is a U.S. shareholder receives a hybrid dividend from any other controlled foreign corporation with respect to which the domestic corporation is also a U.S. shareholder, then the hybrid dividend is treated for purposes of section 951(a)(1)(A) as subpart F income of the recipient controlled foreign corporation for the taxable year of the controlled foreign corporation in which the dividends was received and the U.S. shareholder includes in gross income an amount equal to the shareholder's pro rata share of the subpart F income, determined in the same manner as section 951(a)(2).

### **Foreign tax credit disallowance**

No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a dividend that qualifies for the DRD.

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<sup>1192</sup> Secs. 1297, 1298.

<sup>1193</sup> Computed in accordance with secs. 964(a) and 986.

<sup>1194</sup> Pursuant to section 959(d), a distribution of previously taxed income does not constitute a dividend even if it reduces earnings and profits.

For purposes of computing the section 904(a) foreign tax credit limitation, a domestic corporation that is a U.S. shareholder of a specified 10-percent owned foreign corporation must compute its foreign-source taxable income by disregarding the foreign-source portion of any dividend received from that foreign corporation for which the DRD is taken, and any deductions properly allocable or apportioned to that foreign-source portion or the stock with respect to which it is paid.

### **Holding period requirement**

A domestic corporation is not permitted a DRD in respect of any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. For this purpose, the holding period requirement is treated as met only if the specified 10-percent owned foreign corporation is a specified 10-percent owned foreign corporation at all times during the period and the taxpayer is a U.S. shareholder with respect to such specified 10-percent owned foreign corporation at all times during the period.

### **Effective Date**

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

## **2. Special rules relating to sales or transfers involving specified 10-percent owned foreign corporations (sec. 14102 of the bill, and secs. 367(a)(3)(C), 961, 1248 and new sec. 91 of the Code)**

### **Reasons for Change**

A participation exemption system could provide double tax benefits in certain circumstances. In particular, a distribution from a foreign subsidiary that is eligible for a DRD would reduce the value of the foreign subsidiary, reducing any built-in gain or increasing any built-in loss in the shareholder's stock of the subsidiary. Reducing gain in this manner is consistent with the application of section 1248(a) (or section 964(e)) to recharacterize gain as a dividend for which a DRD may be allowed. Increasing loss in this manner, however, creates a double U.S. tax benefit for receiving a tax-free distribution from a foreign subsidiary.

In addition, taxpayers may arbitrage the application of the participation exemption system to foreign subsidiaries but not foreign branches. Specifically, a taxpayer may deduct losses from a foreign branch operation against U.S. taxable income and then incorporate that branch once it becomes profitable. Present law provides an array of loss recapture rules to address such a fact pattern,<sup>1195</sup> but those rules generally rely on the worldwide system of taxation to recapture losses in excess of built-in gains by taxing future earnings when repatriated. Instead of only recapturing such losses upon a later repatriation of earnings, the Committee wishes to recapture the U.S. tax

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<sup>1195</sup> See, e.g., secs. 367(a)(3)(C), 904(f)(3), 1503(d).

benefits of these losses immediately upon the incorporation of a foreign branch that has generated losses. This is to avoid the negative tax consequences of the repatriation of foreign earnings, which is one of the reasons for moving to a participation exemption system of taxation.

### **Explanation of Provision**

#### **Sales by United States persons of stock**

In the case of the sale or exchange by a domestic corporation of stock in a foreign corporation held for one year or more, any amount received by the domestic corporation which is treated as a dividend for purposes of section 1248, is treated as a dividend for purposes of applying the provision

#### **Reduction in basis of certain foreign stock**

Solely for the purpose of determining a loss, a domestic corporate shareholder's adjusted basis in the stock of a specified 10-percent owned foreign corporation (as defined in this provision) is reduced by an amount equal to the portion of any dividend received with respect to such stock from such foreign corporation that was not taxed by reason of a dividends received deduction allowable under section 245A in any taxable year of such domestic corporation. This rule applies in coordination with section 1059, such that any reduction in basis required pursuant to this provision will be disregarded, to the extent the basis in the specified 10-percent owned foreign corporation's stock has already been reduced pursuant to section 1059.

#### **Sale by a CFC of a lower-tier CFC**

If for any taxable year of a CFC beginning after December 31, 2017, an amount is treated as a dividend under section 964(e)(1) because of a sale or exchange by the CFC of stock in another foreign corporation held for a year or more, then: (i) the foreign-source portion of the dividend is treated as subpart F income of the selling CFC for purposes of section 951(a)(1)(A), (ii) a United States shareholder with respect to the selling CFC includes in gross income for the taxable year of the shareholder with or within the taxable year of the CFC ends, an amount equal to the shareholder's pro rata share (determined in the same manner as under section 951(a)(2)) of the amount treated as subpart F income under (i), and (iii) the deduction under section 245A(a) is allowable to the United States shareholder with respect to the subpart F income included in gross income under (ii) in the same manner as if the subpart F income were a dividend received by the shareholder from the selling CFC.

In the case of a sale or exchange by a CFC of stock in another corporation in a taxable year of the selling CFC beginning after December 31, 2017, to which this provision applies if gain were recognized, the earnings and profits of the selling controlled foreign corporation is not reduced by any loss from the sale or exchange.

#### **Inclusion of transferred loss amount in certain assets transfers**

Under the provision, if a domestic corporation transfers substantially all of the assets of a foreign branch (within the meaning of section 367(a)(3)(C)) to a specified 10-percent owned foreign corporation with respect to which it is a U.S. shareholder after the transfer, the domestic

corporation includes in gross income an amount equal to the transferred loss amount, subject to certain limitations.

The transferred loss amount is the excess (if any) of: (1) losses incurred by the foreign branch after December 31, 2017, and before the transfer, for which a deduction was allowed to the domestic corporation, over (2) the sum of certain taxable income earned by the foreign branch and gain recognized by reason of an overall foreign loss recapture arising out of disposition of assets on account of the underlying transfer. For the purposes of (2), only taxable income of the foreign branch in taxable years after the loss is incurred through the close of the taxable year of the transfer, is included. The transferred loss amount is reduced by the amount of gain recognized by the taxpayer (other than gain recognized by reason of an overall foreign loss recapture) on account of the transfer.

The amount of loss included in the gross income of the taxpayer under the proposed rule above for any taxable year cannot exceed the amount allowed as a deduction under new section 245A for the taxable year (taking into account dividends received from all specified 10-percent owned foreign corporations with respect to which the taxpayer is a U.S. shareholder). Any amount not included in gross income for a taxable year because of this proposed rule is included in gross income in the succeeding taxable year.

Amounts included in gross income by reason of the provision are treated as derived from sources within the United States. Consistent with regulations or guidance that the Secretary of the Treasury may prescribe, proper adjustments are made in the adjusted basis of the taxpayer's stock in the specified 10-percent owned foreign corporation to which the transfer is made, and in the transferee's adjusted basis in the property transferred, to reflect amounts included in gross income under this provision.

### **Repeal of active trade or business exception**

Section 367 is amended to provide that in connection with any exchange described in section 332, 351, 354, 356, or 361, if a U.S. person transfers property used in the active conduct of a trade or business to a foreign corporation, such foreign corporation shall be not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.

### **Effective Date**

The provision relating to reduction of basis in certain foreign stock for the purposes of determining a loss is effective for dividends received in taxable years beginning after December 31, 2017.

The provision relating to transfer of loss amounts from foreign branches to certain foreign corporations is effective for transfers after December 31, 2017.

### **3. Treatment of deferred foreign income upon transition to participation exemption system of taxation (sec. 14103 of the bill and secs. 78, 172, 904, 907, and 965 of the Code)**

#### **Reasons for Change**

In transitioning to a new participation exemption system, the Committee seeks to enhance both the global competitiveness of U.S. businesses and to encourage investment in the United States. The Committee is aware that many U.S.-parented companies have accumulated significant untaxed and undistributed foreign earnings as a result. The Committee is also aware that such companies are eligible for a 100-percent dividend-received deduction with respect to any distributions made under the new participation exemption system. To ensure that all distributions from foreign subsidiaries are treated in the same manner under the participation exemption system, the Committee believes that it is appropriate to tax such earnings as if they had been repatriated under present law, but at a reduced rate.

The Committee believes the tax on accumulated foreign earnings should apply without requiring an actual distribution of earnings, and further believes that the tax rate should take into account the liquidity of the accumulated earnings. Accordingly, the provision establishes a bifurcated rate, i.e., 10 percent for earnings held in liquid form and 5 percent for accumulated foreign earnings that have been reinvested in the foreign subsidiary's business. Finally, the Committee has provided procedures for payment and collection of the transition tax that mitigate the burden on taxpayers.

In response to reports that taxpayers are engaging in tax minimization strategies to artificially reduce their tax liability under this section, the Committee provides an extended limitations period or assessment of tax. The Committee intends to provide the Internal Revenue Service with sufficient time to audit tax minimization transactions and ensure the accuracy of amounts (such as accumulated earnings and profits) reported pursuant to this section.

### **Explanation of Provision**

#### **In general**

The provision generally requires that, for the last taxable year beginning before January 1, 2018, any U.S. shareholder of a specified foreign corporation must include in income its pro rata share of the accumulated post-1986 deferred foreign income of the corporation. For purposes of this provision, a specified foreign corporation is any foreign corporation that has at least one U.S. shareholder. It excludes PFICs that are not also CFCs. A portion of that pro rata share of foreign earnings is deductible; the amount of the deductible portion depends upon whether the deferred earnings are held in cash or other assets. The deduction results in a reduced rate of tax with respect to income from the required inclusion of pre-effective date earnings. A corresponding portion of the credit for foreign taxes is disallowed, thus limiting the credit to the taxable portion of the included income. The separate foreign tax credit limitation rules of present law section 904 apply, with coordinating rules. The increased tax liability generally may be paid over an eight-year period. Special rules are provided for S corporations and real estate investment trusts ("REITs").

#### **Subpart F**

The mechanism for requiring an inclusion of pre-effective-date foreign earnings is subpart F. The provision provides that in the last taxable year of a deferred foreign income corporation that begins before January 1, 2018, which is that foreign corporation's last taxable

year before the transition to the new corporate tax regime elsewhere in the bill goes into effect, the subpart F income of the foreign corporation is increased by the greater of the accumulated post-1986 deferred foreign income of the corporation, determined as of November 9, 2017, or as of December 31, 2017 (“measurement date”). The amount so determined is includible in gross income under section 951 (hereinafter, the section 951 inclusion).

The transition rule applies to all U.S. shareholders<sup>1196</sup> of a deferred foreign income corporation. “Deferred foreign income corporation” is any specified foreign corporation with accumulated post-1986 deferred income that is greater than zero. A specified foreign corporation is defined as any CFC as well as any section 902 corporation, as defined in section 909(d)(5) prior to date of enactment of this bill, *i.e.*, any foreign corporation in which a U.S. person owns 10 percent of the voting stock. Consistent with the general operation of subpart F, each U.S. shareholder of a deferred foreign income corporation must include in income the shareholder’s pro rata share of the foreign corporation’s subpart F income attributable to its section 951 inclusion.<sup>1197</sup>

### **Accumulated post-1986 deferred foreign income**

A specified foreign corporation’s accumulated post-1986 deferred foreign income on the measurement date is based on all post-1986 foreign earnings and profits (“E&P”) that are not previously taxed and are neither (1) attributable to income that is effectively connected with the conduct of a trade or business in the United States and subject to U.S. income tax nor (2) subpart F income (determined without regard to the section 951 inclusion) included in the gross income of a U.S. shareholder. The potential pool of includible earnings includes all undistributed foreign earnings accumulated in taxable years beginning after 1986, computed in accordance with sections 964(a) and 986, taking into account only periods when the foreign corporation was a specified corporation. The pool of post-1986 foreign earnings and profits is not reduced by distributions during the taxable year to which section 965 applies.

#### **Reductions of amounts included in income of U.S. shareholder of foreign corporations with deficits in E&P**

The pool of post-1986 earnings and profits taken into consideration in computing the section 951 inclusion required of a U.S. shareholder under this transition rule generally is reduced by foreign earnings and profits deficits that are properly allocated to that person. The U.S. shareholder must determine its aggregate E&P deficit based on its interest in each specified foreign corporation with a deficit in post-1986 foreign earnings and profits as of the measurement date (“E&P deficit foreign corporation”).

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<sup>1196</sup> Sec. 951(b), which defines United States shareholder as any U.S. person that owns 10 percent or more of combined voting classes of stock of a foreign corporation.

<sup>1197</sup> For purposes of taking into account its subpart F income under this rule, a noncontrolled section 902 corporation is treated as a CFC.

The U.S. shareholder's aggregate E&P deficit is then allocated among the deferred foreign income corporations in the same ratio as the U.S. shareholder's pro rata share of post-1986 deferred income in that corporation bears to the U.S. shareholder's pro rata share of accumulated post-1986 deferred foreign income from all deferred foreign income corporations with respect to which the shareholder is a U.S. shareholder. For the portion of aggregate E&P deficits that include qualified deficits, the portion of the deficit that is attributable to a qualified deficit, and the qualified activity, must be identified. The provision does not permit intragroup netting among U.S. shareholders within an affiliated group.

In taxable years beginning after 2017, amounts by which the section 951 inclusion was reduced by aggregate E&P deficits are considered as amounts included in the gross income of the U.S. shareholder. The shareholder's pro rata share of the E&P of an E&P deficit foreign corporation that used qualified deficits to reduce its section 951 inclusion is increased by the amount of such deficit and attributed to the same activity to which the income was attributed.

### **Deductions from section 951 inclusion**

To determine the taxable portion of the section 951 inclusion, the U.S. shareholders with accumulated deferred foreign income may deduct a portion of the section 951 inclusion in an amount that depends upon the proportion of aggregate earnings and profits attributable to cash assets rather than noncash assets, in the nature of a partial dividends-received deduction. A U.S. shareholder may deduct 71.4 percent of the aggregate earnings and profits attributable to cash assets, and 85.7 percent of the remainder of the aggregate earnings and profits in the section 951 inclusion.<sup>1198</sup>

A U.S. shareholder may elect, no later than with a timely filed return for the taxable year, not to apply its net operating loss deduction to the deemed repatriation. If so, neither the section 951 inclusion nor any related deemed paid foreign tax credits may be taken into account in computing the net operating loss deduction for that year.

### **Cash position**

The aggregate earnings and profits attributable to cash assets for a U.S. shareholder is the greater of the pro rata share of the cash position of all specified foreign corporations as of the last day of the last taxable year beginning before January 1, 2018, or the average of the cash position determined on the last day of each of the two taxable years ending immediately before November 9, 2017. For purposes of this computation, the cash position of certain non-corporate entities that would be treated as specified foreign corporations if they were foreign corporations is also included. The cash position of an entity consists of all cash, net accounts receivables, and the fair market value of similarly liquid assets, specifically including personal property that is actively traded on an established financial market (other than stock in the specified foreign

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<sup>1198</sup> The Committee intends that the deduction be treated as exempting the deducted income from tax. Thus, for example, the deducted income, if earned by a partnership, could give rise to an increase in a partner's basis under section 705(a)(1)(B).



corporation) government securities, certificates of deposit, commercial paper, and short-term obligations.

To avoid double counting of cash assets, a U.S. shareholder may disregard accounts receivable and short-term obligations of a specified foreign corporation if that shareholder can establish that the amounts were already taken into account by that shareholder with respect to another specified foreign corporation.

The Secretary may identify other assets that are economically equivalent to the enumerated assets that are treated as cash. The provision also authorizes the Secretary to disregard transactions that are determined to have the principal purpose of reducing the aggregate foreign cash position.

### **Foreign tax credit**

A portion of foreign income tax that is deemed paid or accrued with respect to the section 951 inclusion is not creditable or deductible against the Federal income tax attributable to the inclusion. The disallowed portion of foreign tax credits is 71.4 percent of foreign taxes paid attributable to the portion of the section 965 inclusion attributable to the aggregate cash position plus, 85.7 percent of foreign taxes paid attributable to the remaining portion of the section 965 inclusion.<sup>1199</sup> The provision coordinates the disallowance of foreign tax credits with the requirement<sup>1200</sup> that a domestic corporate shareholder is deemed to receive a dividend in an amount equal to foreign taxes it is deemed to have paid and for which it claimed a credit.

### **Limitations on assessment extended**

The provision also allows an exception to the otherwise applicable limitations period for assessment of tax to ensure that the period for assessment of underpayments in tax related to the treatment of the pre-effective date foreign earnings does not expire prior to six years from the date on which the return initially reflecting the section 951 inclusion was filed.

### **Installment payments**

A U.S. shareholder may elect to pay the net tax liability resulting from the section 951 inclusion in eight installments. If installment payment is elected, the payments for each of the first five years equals 8 percent of the net tax liability. The amount of the sixth installment is 15 percent of the net tax liability, increasing to 20 percent for the seventh installment and the remaining balance of 25 percent in the eighth year.

The net tax liability that may be paid in installments is the excess of the U.S. shareholder's net income tax for the taxable year in which the section 951 inclusion occurs over

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<sup>1199</sup> Other foreign tax credits used by a taxpayer against tax liability resulting from the deemed inclusion apply in full.

<sup>1200</sup> Sec. 78.

the taxpayer's net income tax for that year determined without regard to the section 951 inclusion. Net income tax means net income tax as defined for purposes of the general business credit, but reduced by the amount of that credit.

An election to pay tax in installments must be made by the due date for the tax return for the taxable year in which the section 951 inclusion is included in income. The Treasury Secretary has authority to prescribe the manner of making the election. The first installment must be paid on the due date (determined without regard to extensions) for the tax return for the taxable year of the income inclusion. Succeeding installments must be paid annually no later than the due dates (without extensions) for the income tax return of each succeeding year. If a deficiency is later determined with respect to the net tax liability, the additional tax due may be prorated among all installment payments in most circumstances. The portions of the deficiency prorated to an installment that was due before the deficiency was assessed must be paid upon notice and demand. The portion prorated to any remaining installment is payable with the timely payment of that installment payment, unless the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax, in which case the entire deficiency is payable upon notice and demand.

The timely payment of an installment does not incur interest. If a deficiency is determined that is attributable to an understatement of the net tax liability due under this provision, the deficiency is payable with underpayment interest for the period beginning on the date on which the net tax liability would have been due, without regard to an election to pay in installments, and ending with the payment of the deficiency. Furthermore, any amount of deficiency prorated to a remaining installment also bears interest on the deficiency, but not on the original installment amount.

The provision also includes an acceleration rule. If (1) there is a failure to pay timely any required installment, (2) there is a liquidation or sale of substantially all of the U.S. shareholder's assets (including in a bankruptcy case), (3) the U.S. shareholder ceases business, or (4) another similar circumstance arises, the unpaid portion of all remaining installments is due on the date of the event (or, in a bankruptcy proceeding or similar case, the day before the petition is filed).

### **Special rule for S corporations**

A special rule permits deferral of the transition net tax liability for shareholders of a U.S. shareholder that is a flow-through entity known as an S corporation.<sup>1201</sup> The S corporation is required to report on its income tax return the amount includible in gross income by reason of this provision, as well as the amount of deduction that would be allowable, and provide a copy of such information to its shareholders. Any shareholder of the S corporation may elect to defer the net tax liability until the shareholder's taxable year in which a triggering event occurs. The election to defer the tax is due not later than the due date for the return of the S corporation for its last taxable year that begins before January 1, 2018.

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<sup>1201</sup> Section 1361 defines an S corporation as a domestic small business corporation that has an election in effect for status as an S corporation, with no more than 100 shareholders, none of whom are nonresident aliens, and all of whom are individuals, estates, trusts or certain exempt organizations.

Three types of events may trigger an end to deferral of the net tax liability. The first type of triggering event is a change in the status of the corporation as an S corporation. The second category includes liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, including reorganization in bankruptcy. The third type of triggering event is a transfer of shares of stock in the S corporation by the electing taxpayer, whether by sale, death or otherwise, unless the transferee of the stock agrees with the Secretary to be liable for net tax liability in the same manner as the transferor. Partial transfers trigger the end of deferral only with respect to the portion of tax properly allocable to the portion of stock sold.

If a shareholder of an S corporation has elected deferral under the special rule for S corporation shareholders and a triggering event occurs, the S corporation and the electing shareholder are jointly and severally liable for any net tax liability and related interest or penalties. The period within which the IRS may collect such liability does not begin before the date of an event that triggers the end of the deferral. If an election to defer payment of the net tax liability is in effect for a shareholder, that shareholder must report the amount of the deferred net tax liability on each income tax return due during the period that the election is in effect. Failure to include that information with each income tax return will result in a penalty equal to five-percent of the amount that should have been reported.

After a triggering event occurs, a shareholder in the S corporation may elect to pay the net tax liability in eight equal installments, subject to rules similar to those generally applicable absent deferral. Whether or not a shareholder may elect to pay in installments depends upon the type of event that triggered the end of deferral. If the triggering event is liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, the installment payment election is generally unavailable without the consent of the Secretary; instead, the entire net tax liability is due upon notice and demand. The installment election is due with the timely return for the year in which the triggering event occurs. The first installment payment is required by the due date of the same return, determined without regard to extensions of time to file.

### **Special rules for REITs**

To alleviate burden of compliance with this section by REITs, special rules are provided if a U.S. shareholder is a REIT. First, although it must determine its pro rata share of the increase in subpart F income in accordance with the rules described above, the REIT is not required to take into account the section 951 inclusion for purposes of determining the REIT's amount of qualified REIT gross income.<sup>1202</sup> The section 951 inclusion is, however, taken into account for purposes of determining the income potentially required to be included in taxable

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<sup>1202</sup> To qualify as a REIT, an entity must meet certain income requirements. 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. Secs. 856. In addition, a REIT is required to distribute at least 90 percent of REIT income (other than net capital gain) annually. Sec. 857. 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.

income under section 857(b). Unlike a regular subchapter C corporation, a REIT is able to deduct the portion of its income that is distributed to its shareholders as a dividend or qualifying liquidating distribution each year.<sup>1203</sup> The distributed income of the REIT is not taxed at the entity level; instead, it is taxed once, at the investor level. As a result, a required inclusion under this section may trigger a requirement that the REIT distribute an amount equal to 90 percent of that inclusion despite the fact that it received no distribution from the deferred foreign income corporation.

To avoid requiring that any distribution requirement be satisfied in one year, an election to defer the section 951 inclusion is permitted. Under a timely election, a REIT may instead take the amounts into income over a period of eight years. It must include 8 percent in each of the five years beginning with the initial year in which the section 951 inclusion is determined, 15 percent in the sixth year, 20 percent in the seventh year and 25 percent in the eighth year. In each of those years, it may claim a partial dividends-received deduction in the applicable percentages in proportion to the amount included in each of the eight years. Neither the REIT nor the recipient of the distribution may elect to use the installment payment.

In the event that a REIT liquidates, ceases to operate its business, or distributes substantially all its assets (or any other similar event occurs), any portion of the required inclusion not yet taken into income is accelerated and required to be included as gross income as of the day before the event.

### **Recapture from expatriated entities**

The provision denies any deduction claimed with respect to the mandatory subpart F inclusion and imposes a 35-percent tax on the entire inclusion if a U.S. shareholder becomes an expatriated entity within the meaning of section 7874(a)(2) at any point within the ten-year period following enactment of the Tax Cuts and Jobs Act. An entity that becomes a surrogate foreign corporation that is treated as a domestic corporation under section 7874(b) is not within the scope of this recapture provision. Although the amount due is computed by reference to the year in which the deemed subpart F income was originally reported, the additional tax arises and is assessed for the taxable year in which the U.S. shareholder becomes an expatriated entity. No foreign tax credits are permitted with respect to the additional tax due as a result of the recapture rule. The Secretary is authorized to prescribe rules necessary to carry out the provision.

### **Regulatory authority**

A specific grant of regulatory authority to carry out the intent of this provision is included. For example, the Secretary may identify instances in which it is appropriate to grant relief from potential double-counting of earnings and profits, which may occur due to different measurement dates applicable to specified foreign corporations within an affiliated group, or the timing of intragroup distributions. It also specifies that the Secretary shall prescribe rules or

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<sup>1203</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).

guidance in order to deter tax avoidance through use of entity classification elections and accounting method changes, among other possible strategies.

### **Effective Date**

The provision is effective for the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to U.S. shareholders, for the taxable years in which or with which such taxable years of the foreign corporations end.

## **4. Current year inclusion of global intangible low-taxed income by United States shareholders (sec. 14201 of the bill and new sec. 951A of the Code)**

### **Reasons for Change**

The Committee recognizes that, without any base protection measures, the participation exemption system established by the bill creates an incentive for U.S. corporations to allocate income that would otherwise be subject to the full U.S. corporate tax rate to foreign affiliates operating in low- or zero-tax jurisdictions, where the income could potentially be distributed back to the U.S. corporation with no U.S. tax imposed. As a result, U.S. corporations may have an incentive serve the U.S. market and foreign markets through their foreign affiliates rather than U.S. affiliates. To address this possible source of erosion of the U.S. tax base, and the potential migration of economic activity from the United States to other countries, the provision subjects certain income earned by CFCs to current U.S. tax.<sup>1204</sup> Subjecting that income to current U.S. tax reduces the tax benefit of allocating that income to low- or zero-tax jurisdictions. However, the Committee recognizes that taxing that income at the full U.S. corporate tax rate may hurt the competitive position of U.S. corporations relative to their foreign counterparts, and has decided to tax that income at a reduced rate (with a portion of foreign tax credits available to offset U.S. tax).<sup>1205</sup>

The Committee believes the type of income that is most readily allocated to low- or zero-tax jurisdictions is income derived from intangible property, or intangible income. Intangible income is mobile and constitutes a large portion of the foreign-source income earned by U.S. corporations, and significant erosion of the U.S. tax base could result if no base protection measure were adopted in a move to a participation exemption system. At the same time, if intangible income is located in a jurisdiction with a sufficiently high tax rate, the Committee believes there is limited base erosion concern. Consequently, the Committee believes that taxing global intangible low-taxed income (“GILTI”) on a current basis addresses the primary source of base erosion arising from a move toward a participation exemption system.

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<sup>1204</sup> Sec. 14401 of the bill, which establishes a base erosion and anti-abuse tax (new sec. 59A) that is based on a taxpayer’s deductible payments to foreign related parties, addresses base erosion that results from U.S. and foreign companies serving the U.S. market through foreign affiliates located in low- or zero-tax jurisdictions, rather than through U.S. affiliates.

<sup>1205</sup> The reduced rate of tax is achieved in sec. 14202 of the bill and new sec. 250.

The Committee views the most difficult problem with identifying GILTI as identifying intangible income, and believes that calculating intangible income based on facts and circumstances may be both complicated and administratively difficult. As a result, the provision adopts a formulaic approach to calculating intangible income to make the determination simpler and more administrable. The formula is based on the premise that directly calculating tangible income is simpler than calculating intangible income.

The provision approximates a U.S. corporation's tangible income earned through its CFCs as a 10-percent return on the U.S. corporation's aggregate pro rata share of the adjusted basis in tangible depreciable property across each CFC with respect to which it is a U.S. shareholder. Intangible income is a residual amount generally determined by subtracting tangible income from the total amount of certain income earned by each CFC. The Committee believes that tangible property, and the associated tangible income, are relatively immobile and an indicator of the extent to which a CFC has active business operations and presence in any particular jurisdiction. Therefore, the provision exempts tangible income from U.S. tax. However, it generally subjects the corporation's GILTI to current U.S. tax at a reduced rate, with 80 percent of foreign tax credits available to offset U.S. tax.

GILTI is calculated at the U.S. shareholder level after aggregating both certain income and adjusted basis in tangible depreciable property on a pro rata basis across each CFC with respect to which it is a U.S. shareholder. GILTI is treated as subpart F income, and the aggregate nature of the GILTI calculation is a departure from present law, under which subpart F income is calculated at the CFC level. The Committee believes that calculating GILTI on an aggregate basis, instead of on a CFC-by-CFC basis, reflects the interconnected nature of a U.S. corporation's global operations and is a more accurate way of determining a U.S. corporation's global intangible income.

The provision does not permit full foreign tax credits with respect to GILTI. The Committee believes that permitting a full foreign tax credit with respect to GILTI would make taxpayers indifferent between paying U.S. tax and foreign tax, and may reduce the incentive for taxpayers to minimize the foreign tax they pay or encourage foreign countries to adopt "soak-up" taxes knowing that a taxpayer's combined U.S. and foreign tax liability may remain unchanged with the adoption of the soak-up tax if foreign tax credits were allowed in full. The Committee believes that allowing for partial foreign tax credits with respect to GILTI will result in an increase in the amount of U.S. tax revenue collected and decrease the amount of foreign tax revenue collected (relative to the case where full foreign tax credits are permitted with respect to GILTI).

The Committee believes that certain items of income earned by CFCs should be excluded from the GILTI, either because they should be exempt from U.S. tax—as they are generally not the type of income that is the source of base erosion concerns—or are already taxed currently by the United States. Items of income excluded from GILTI because they are exempt from U.S. tax under the bill include foreign oil and gas extraction income (which is generally immobile) and income subject to high levels of foreign tax. Items of income excluded from GILTI because they are taxed currently by the United States include ECI and subpart F income earned by CFCs. CFC look-through payments are also excluded from GILTI to help implement the dividend exemption system established by the bill.

## Explanation of Provision

### In general

Under the provision, a U.S. shareholder of any CFC must include in gross income for a taxable year its global intangible low-taxed income (“GILTI”) in a manner generally similar to inclusions of subpart F income. GILTI means, with respect to any U.S. shareholder for the shareholder’s taxable year, the excess (if any) of the shareholder’s net CFC tested income over the shareholder’s net deemed tangible income return. The shareholder’s net deemed tangible income return is an amount equal to 10 percent of the aggregate of the shareholder’s pro rata share of the qualified business asset investment (“QBAI”) of each CFC with respect to which it is a U.S. shareholder.

The formula for GILTI, which is calculated at the U.S. shareholder level, is:

$$GILTI = \text{Net CFC Tested Income} - (10\% \times QBAI)$$

### Net CFC tested income

Net CFC tested income means, with respect to any U.S. shareholder, the excess of the aggregate of the shareholder’s pro rata share of the tested income of each CFC with respect to which it is a U.S. shareholder over the aggregate of its pro rata share of the tested loss of each CFC with respect to which it is a U.S. shareholder. Pro rata shares are determined under the rules of section 951(a)(2).

The formula for net CFC tested income, which is calculated at the U.S. shareholder level, is:

$$\text{Net CFC Tested Income} = \text{Sum of CFC Tested Income} - \text{Sum of CFC Tested Loss}$$

The tested income of a CFC means the excess (if any) of the gross income of the corporation—determined without regard to certain exceptions to tested income—over deductions (including taxes) properly allocable to such gross income (referred to in this document as “tested gross income”). The exceptions to tested income are: (1) the corporation’s ECI under section 952(b); (2) any gross income taken into account in determining the corporation’s subpart F income; (3) any gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under section 954(b)(4); (4) any dividend received from a related person (as defined in section 954(d)(3)); and (5) any foreign oil and gas extraction income (as defined in section 907(c)(1)).

The tested loss of a CFC means the excess (if any) of deductions (including taxes) properly allocable to the corporation’s gross income—determined without regard to the tested income exceptions—over the amount of such gross income.

### Qualified business asset investment

QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified

tangible property used in its trade or business and of a type with respect to which a deduction is generally allowable under section 167. The adjusted basis in any property must be determined using the alternative depreciation system under current section 168(g), notwithstanding any provision of law (or any other section of this bill) which is enacted after the date of enactment of this provision (unless such later enacted law specifically and directly amends this provision's definition).

Specified tangible property means any property used in the production of tested income.<sup>1206</sup> If such property was used in the production of both tested income and income that is not tested income (*i.e.*, dual-use property), the property is treated as specified tangible property in the same proportion that the amount of tested gross income produced with respect to the property bears to the total amount of gross income produced with respect to the property.<sup>1207</sup>

For purposes of determining QBAI, the Secretary is authorized to issue anti-avoidance regulations or other guidance as the Secretary determines appropriate, including regulations or other guidance that provide for the treatment of property if the property is transferred or held temporarily, or if avoidance was a factor in the transfer or holding of the property.

### **Coordination with subpart F**

Although GILTI inclusions do not constitute subpart F income, GILTI inclusions are generally treated similarly to subpart F inclusions. Thus they are generally treated in the same manner as amounts included under section 951(a)(1)(A) for purposes of applying sections 168(h)(2)(B), 535(b)(10), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4). However, the Secretary may provide rules for coordinating the GILTI inclusion with provisions of law in which the determination of subpart F income is required to be made at the CFC level.

The provision requires that the amount of GILTI included by a U.S. shareholder be allocated across each CFC with respect to which it is a U.S. shareholder. The portion of GILTI treated as being with respect to a CFC equals zero for a CFC with no tested income and, for a CFC with tested income, the portion of GILTI which bears the same ratio to the total amount of GILTI as the U.S. shareholder's pro rata amount of tested income of the CFC bears to the aggregate amount of the U.S. shareholder's pro rata amount of the tested income of each CFC with respect to which it is a U.S. shareholder. For a CFC with tested income, the following formula expresses how to determine the portion of GILTI treated as being with respect to the CFC:

$$CFC's\ GILTI = GILTI \times \left( \frac{Share\ of\ CFC's\ Tested\ Income}{Share\ of\ Agg.\ CFC\ Tested\ Income} \right)$$

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<sup>1206</sup> Specified tangible property does not include property used in the production of tested loss, so that a CFC that has a tested loss in a taxable year does not have QBAI for the taxable year.

<sup>1207</sup> For example, if a building produces \$1,000 of tested gross income and \$250 of subpart F income for a taxable year, then 80 percent (= \$1,000/\$1,250) of a domestic corporation's average adjusted basis in the building is included in QBAI for that taxable year.



where *Share of CFC's Tested Income* is the U.S. shareholder's pro rata amount of the tested income of a CFC and *Share of Agg. CFC Tested Income* is the aggregate amount of the U.S. shareholder's pro rata amount of the tested income of each CFC with respect to which it is a U.S. shareholder.

For purposes of the GILTI inclusion, a person is treated as a U.S. shareholder of a CFC for any taxable year only if such person owns (within the meaning of section 958(a)) stock in the corporation on the last day, in such year, on which the corporation is a CFC. A corporation is generally treated as a CFC for any taxable year if the corporation is a CFC at any time during the taxable year.

### **Deemed-paid credit for taxes properly attributable to tested income**

For any amount of GILTI included in the gross income of a domestic corporation, the corporation's deemed-paid credit equals 80 percent of the product of the corporation's inclusion percentage multiplied by the aggregate tested foreign income taxes paid or accrued, with respect to tested income, by each CFC with respect to which the domestic corporation is a U.S. shareholder.

The inclusion percentage means, with respect to any domestic corporation, the ratio (expressed as a percentage) of such corporation's GILTI amount divided by the aggregate amount of its pro rata share of the tested income of each CFC with respect to which it is a U.S. shareholder (referred to as "aggregate tested income" in the formulas below). Tested foreign income taxes means, with respect to any domestic corporation that is a U.S. shareholder of a CFC, the foreign income taxes paid or accrued by the CFC that are properly attributable to the CFC's tested income.<sup>1208</sup>

The deemed-paid credit with respect to the GILTI inclusion can be expressed in the following formula:

*Deemed-Paid Credit*

$$= 80\% \times \frac{GILTI}{Aggregate\ Tested\ Income} \times Aggregate\ Tested\ Foreign\ Income\ Tax$$

The provision creates a separate foreign tax credit basket for GILTI, with no carryforward or carryback available for excess credits. For purposes of determining the foreign tax credit limitation, GILTI is not general category income, and income that is both GILTI and passive category income is considered passive category income. As described in section 14301 of the bill and new section 78, the taxes deemed to have been paid are treated as an increase in GILTI for purposes of section 78, determined by taking into account 100 percent of the product of the inclusion percentage and aggregate tested foreign income taxes (instead of 80 percent in the determination of the deemed-paid credit). Therefore, the section 78 gross-up can be expressed in the following formula:

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<sup>1208</sup> Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).

*Section 78 Gross-Up*

$$= 100\% \times \frac{GILTI}{Aggregate\ Tested\ Income} \times Aggregate\ Tested\ Foreign\ Income\ Tax$$

### **Effective Date**

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

## **5. Deduction for foreign-derived intangible income and global intangible low-taxed income (sec. 14202 of the bill and new sec. 250 of the Code)**

### **Reasons for Change**

The Committee believes that the current U.S. system of worldwide taxation (with deferral), and its 35 percent corporate tax rate, encourages U.S. corporations to locate intangible income abroad, particularly in low- or zero-tax jurisdictions. The location of intangible income in those jurisdictions may require, or be facilitated by, the location of valuable economic activity in those jurisdictions. One of the Committee's goals in tax reform is to remove the tax incentive to locate intangible income abroad and encourage U.S. taxpayers to locate intangible income, and potentially valuable economic activity, in the United States.

The Committee believes that offering similar, preferential rates for intangible income derived from serving foreign markets, whether through U.S.-based operations or through CFCs, reduces or eliminates the tax incentive to locate or move intangible income abroad, thereby limiting one margin where the Code distorts business investment decisions.

In addition, the Committee recognizes that many countries in the OECD have preferential tax regimes for income related to certain forms of intellectual property. These regimes, sometimes referred to as patent box or intellectual property regimes, put the United States at a competitive tax disadvantage. The Committee believes that establishing a deduction for foreign-derived intangible income earned by domestic corporations helps the United States compete with countries that offer preferential rates for intellectual property.

### **Explanation of Provision**

#### **In general**

The provision provides domestic corporations with reduced rates of U.S. tax on their foreign-derived intangible income ("FDII") and global intangible low-taxed income ("GILTI").<sup>1209</sup> GILTI is defined in section 14201 of the bill and new section 951A, while a domestic corporation's FDII is the portion of its intangible income, determined on a formulaic

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<sup>1209</sup> The deduction for FDII and GILTI is only available to domestic corporations. U.S. shareholders that are not domestic corporations are subject to full U.S. tax on their GILTI.

basis, that is derived from serving foreign markets. When this provision becomes effective, the effective tax rate on FDII is 12.5 percent and the effective U.S. tax rate on GILTI is 10 percent. For taxable years beginning after December 31, 2025, the effective tax rate on FDII rises to 15.625 percent, while the effective U.S. tax rate on GILTI rises to 12.5 percent. As described in more detail below, since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate at which no U.S. residual tax is owed on a domestic corporation's GILTI generally matches the tax rate on FDII.

## **Deduction for FDII and GILTI**

### Deduction for FDII and GILTI and taxable income limitation

In the case of domestic corporations for taxable years beginning after December 31, 2017, and before January 1, 2026, the provision generally allows as a deduction an amount equal to the sum of 37.5 percent of its FDII plus 50 percent of its GILTI (if any). For taxable years beginning after December 31, 2025, the deduction for FDII is reduced to 21.875 percent and the deduction for GILTI is lowered to 37.5 percent.<sup>1210</sup>

If the sum of a domestic corporation's FDII and GILTI amounts exceeds its taxable income determined without regard to this provision, then the amount of FDII and GILTI for which a deduction is allowed is reduced by an amount determined by such excess. The reduction in FDII for which a deduction is allowed equals such excess multiplied by a percentage equal to the corporation's FDII divided by the sum of its FDII and GILTI. The reduction in GILTI for which a deduction is allowed equals the remainder of such excess.<sup>1211</sup>

### Effective tax rates on FDII and GILTI

As a result of the deductions, and with respect to domestic corporations, the effective tax rate on FDII is 12.5 percent and the effective U.S. tax rate on GILTI is 10 percent for taxable years beginning after December 31, 2017, and before January 1, 2026. Since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed by a domestic corporation is 12.5 percent.<sup>1212</sup> If the foreign tax rate on GILTI is zero percent, then the U.S. residual tax rate

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<sup>1210</sup> The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax. Thus, for example, the deduction for global intangible low-taxed income could give rise to an increase in a domestic corporate partner's basis in a domestic partnership under section 705(a)(1)(B).

<sup>1211</sup> For example, consider a domestic corporation with \$1,250 of FDII, \$750 of GILTI, and taxable income (determined without regard to this provision) of \$1,500. The sum of the corporation's FDII and GILTI amounts is \$2,000, which exceeds \$1,500 by \$500. For purposes of this provision, the amount of FDII for which a deduction is allowed is reduced by \$500 multiplied by  $\$1,250/\$2,000$ , or \$312.50. The amount of GILTI for which a deduction is allowed is reduced by the remainder of the excess, or \$187.50 ( $= \$500 \times \$750/\$2,000$ ).

<sup>1212</sup> 12.5 percent equals the effective GILTI rate of 10 percent divided by 80 percent. If the foreign tax rate on GILTI is 12.5 percent, and domestic corporations are allowed a credit equal to 80 percent of foreign taxes paid, then the post-credit foreign tax rate on GILTI equals 10 percent ( $= 12.5 \text{ percent} \times 80 \text{ percent}$ ), which equals the effective GILTI rate of 10 percent. Therefore, no U.S. residual tax is owed.

on GILTI is 10 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 12.5 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10 percent and 12.5 percent. At foreign tax rates greater than or equal to 12.5 percent, there is no residual U.S. tax owed on GILTI, so that the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.

For taxable years beginning after December 31, 2025, and with respect to domestic corporations, the effective tax rate on FDII is 15.625 percent and the effective U.S. tax rate on GILTI is 12.5 percent. The minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed is 15.625 percent.<sup>1213</sup>

## **FDII**

The FDII of any domestic corporation is the amount which bears the same ratio to the corporation's deemed intangible income as its foreign-derived deduction eligible income bears to its deduction eligible income. In other words, a domestic corporation's FDII is its deemed intangible income multiplied by the percentage of its deduction eligible income that is foreign-derived. The calculation can also be expressed as the following:

$$FDII = \text{Deemed Intangible Income} \times \frac{\text{Foreign-Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

The Secretary is authorized to prescribe regulations or other guidance as may be necessary or appropriate to carry out this provision.

## **Deduction eligible income**

Deduction eligible income means, with respect to any domestic corporation, the excess (if any) of the gross income of the corporation—determined without regard to certain exceptions to deduction eligible income—over deductions (including taxes) properly allocable to such gross income (referred to in this document as “deduction eligible gross income”). The exceptions to deduction eligible income are: (1) the subpart F income of the corporation determined under section 951; (2) the GILTI of the corporation; (3) any dividend received from a CFC with respect to which the corporation is a U.S. shareholder; and (4) any domestic oil and gas income of the corporation; and (5) any foreign branch income (as defined in section 904(d)(2)(J)) of the corporation.

The formula for deduction eligible income can generally be written as follows:<sup>1214</sup>

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<sup>1213</sup> If the foreign tax rate on GILTI is zero percent, then the U.S. residual tax rate on GILTI is 12.5 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 15.625 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 12.5 percent and 15.625 percent. At foreign tax rates greater than or equal to 15.625 percent, there is no residual U.S. tax on GILTI, and the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.

<sup>1214</sup> This formula assumes that the excess described in the preceding paragraph is positive. Otherwise there is no deduction eligible income.

$$\text{Deduction Eligible Income} = \text{Gross Income} - \text{Exceptions} - \text{Allocable Deductions}$$

where *Exceptions* refers to the exceptions to deduction eligible income and *Allocable Deductions* encompass all deductions (including taxes) property allocable to deduction eligible gross income.

### **Deemed intangible income**

The domestic corporation's deemed intangible income means the excess (if any) of its deduction eligible income over its deemed tangible income return.<sup>1215</sup> The deemed tangible income return means, with respect to any corporation, an amount equal to 10 percent of the corporation's qualified business asset investment ("QBAI"). Deemed intangible income can be calculated as follows:<sup>1216</sup>

$$\text{Deemed Intangible Income} = \text{Deduction Eligible Income} - (10\% \times \text{QBAI})$$

For purposes of computing its FDII, a domestic corporation's QBAI is the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is allowable under section 167. The adjusted basis in any property must be determined using the alternative depreciation system under section 168(g), notwithstanding any provision of law (or any other section of this bill) which is enacted after the date of enactment of this provision (unless such later enacted law specifically and directly amends this provision's definition).

Specified tangible property means any tangible property used in the production of deduction eligible income. If such property was used in the production of deduction eligible income and income that is not deduction eligible income (*i.e.*, dual-use property), the property is treated as specified tangible property in the same proportion that the amount of deduction eligible gross income produced with respect to the property bears to the total amount of gross income produced with respect to the property.<sup>1217</sup> In other words, the percentage of a domestic corporation's adjusted basis in dual-use property that is included in QBAI equals the deduction eligible gross income produced with respect to the property divided by the total gross income produced with respect to the property.

### **Foreign-derived deduction eligible income**

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<sup>1215</sup> The calculation of the deemed tangible income return for purposes of determining FDII is intentionally similar to the calculation of the net deemed tangible income return for purposes of determining GILTI under sec. 14201 of the bill and new sec. 951A.

<sup>1216</sup> If the quantity in this formula is negative, deemed intangible income is zero.

<sup>1217</sup> For example, if a building is used in the production of \$1,000 of total gross income for a taxable year, \$250 of which was domestic oil and gas extraction income and the remaining \$750 of which was deduction eligible gross income, then 75 percent of a domestic corporation's average adjusted basis in the building is included in QBAI for that taxable year.

Foreign-derived deduction eligible income means, with respect to a taxpayer for its taxable year, any deduction eligible income of the taxpayer that is derived in connection with (1) property that is sold by the taxpayer to any person who is not a United States person and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use<sup>1218</sup> or (2) services provided by the taxpayer that the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States. Foreign use means any use, consumption, or disposition that is not within the United States.<sup>1219</sup> Special rules for determining foreign use apply to transactions that involve property or services provided to domestic intermediaries or related parties.

For purposes of the provision, the terms “sold,” “sells,” and “sale” include any lease, license, exchange, or other disposition.

#### Property or services provided to domestic intermediaries

If a taxpayer sells property to another person (other than a related party) for further manufacture or modification within the United States, the property is not treated as sold for a foreign use even if such other person subsequently uses such property for foreign use.<sup>1220</sup> Deduction eligible income derived in connection with services provided to another person (other than a related party) located within the United States is not treated as foreign-derived deduction eligible income, even if the other person uses the services in providing services the income from which is considered foreign-derived deduction eligible income.

#### Special rules with respect to related party transactions

If property is sold to a related foreign party, the sale is not treated as for a foreign use unless the property is sold by the related foreign party to another person who is unrelated and is not a U.S. person and the taxpayer establishes to the satisfaction of the Secretary that such property is for a foreign use. Income derived in connection with services provided to a related party who is not located in the United States is not treated as foreign-derived deduction eligible income unless the taxpayer establishes to the satisfaction of the Secretary that such service is not substantially similar to services provided by the related party to persons located within the United States.

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<sup>1218</sup> If property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use.

<sup>1219</sup> The reporting and penalty provision in sec. 15001 of the bill and new sec. 6050Z describes additional reporting requirements and penalties related to validating whether a domestic corporation’s income is foreign-derived deduction eligible income.

<sup>1220</sup> In other words, the fact that a component is included in a piece of property that is eventually sold for a foreign use is insufficient for the sale of the component to be considered for a foreign use.

For purposes of applying these rules, a related party means any member of an affiliated group as defined in section 1504(a) determined by substituting “more than 50 percent” for “at least 80 percent” each place it appears and without regard to sections 1504(b)(2) and 1504(b)(3). Any person (other than a corporation) is treated as a member of the affiliated group if the person is controlled by members of the group (including any entity treated as a member of the group by reason of this sentence) or controls any member, with control being determined under the rules of section 954(d)(3).

#### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

### **6. Special rules for transfers of intangible property from controlled foreign corporations to United States shareholders (sec. 14203 of the bill and new sec. 966 of the Code)**

#### **Reasons for Change**

The Committee believes that innovation is an important source of economic growth and seeks to encourage businesses to locate intangible property in the United States. The bill as a whole provides reduced corporate tax rates for intangible income and makes a number of changes intended to promote tax neutrality with respect to where businesses locate intangible property and the income derived from such property. While the Committee believes that these changes, by themselves, will encourage U.S. corporations to bring back existing intangible property that is currently held by their CFCs, it seeks to facilitate this process by giving taxpayers a limited period of time in which they can distribute intangible property held by CFCs back to the U.S. parent corporation without triggering tax on the gain from the distribution.

This provision is intended to serve as a transition rule and is not intended to benefit intangible property that is developed or acquired by CFCs after the date of enactment of this provision, as the Committee believes that the international tax reforms contained in the bill will provide strong incentives for businesses to locate and develop intangible property in the United States once those reforms go into effect.

#### **Explanation of Provision**

For certain distributions of intangible property held by a CFC on the date of enactment of this provision, the fair market value of the property on the date of the distribution is treated as not exceeding the adjusted basis of the property immediately before the distribution. If the distribution is not a dividend, a U.S. shareholder’s adjusted basis in the stock of the CFC with respect to which the distribution is made is increased by the amount (if any) of the distribution that would, but for this provision, be includible in gross income. The adjusted basis of the property in the hands of the U.S. shareholder immediately after the distribution is the adjusted basis immediately before the distribution, reduced by the amount of the increase (if any) described previously.

For purposes of the provision, intangible property means intangible property as described in section 936(h)(3)(B) and computer software as described in section 197(e)(3)(B).

The provision applies to distributions that are (1) received by a domestic corporation from a CFC with respect to which it is a U.S. shareholder and (2) made by the CFC before the last day of the third taxable year of the CFC beginning after December 31, 2017.

#### **Effective Date**

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

### **7. Elimination of inclusion of foreign base company oil related income (sec. 14211 of the bill and sec. 954(a) of the Code)**

#### **Reasons for Change**

The Committee believes that the base protection measure contained in section 14201 of the bill and new section 951A of the Code adequately address any base erosion concerns with respect to foreign oil related income, which is a mobile type of income to the extent that oil related refining and transportation activities are mobile and capable of being located in low-tax jurisdiction. Consequently, the subpart F category of foreign base company oil related income is no longer necessary.

#### **Explanation of Provision**

The provision eliminates foreign base company oil related income as a category of foreign base company income.

#### **Effective Date**

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

### **8. Inflation adjustment of *de minimis* exception for foreign base company income (sec. 14212 of the bill and sec. 954(b)(3) of the Code)**

#### **Reasons for Change**

The Committee believes that the current *de minimis* amount of \$1,000,000 for foreign base company income, which was set in 1986 and has not been changed since, no longer serves its intended purpose of reducing compliance burdens for taxpayers, and should be adjusted for inflation to adapt to changes in the economic environment.

#### **Explanation of Provision**

The provision amends the *de minimis* exception of present law, which permits a CFC to exclude its foreign base company income if the sum of its total foreign base company income and gross insurance income is the lesser of 5 percent of its gross income or \$1,000,000. In the



case of any taxable year beginning after 2017, the provision indexes for inflation the \$1,000,000 *de minimis* amount for foreign base company income, with all increases rounded to the nearest multiple of \$50,000.

#### **Effective Date**

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

### **9. Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment (sec. 14213 of the bill and sec. 955 of the Code)**

#### **Reasons for Change**

The Committee believes that the provisions of section 955 are no longer necessary. In the transition to a participation exemption system, foreign earned income that is not subject to immediate inclusion in the U.S. shareholder's gross income under the subpart F regime will generally be exempt from U.S. taxation upon repatriation through a dividend paid from a specified foreign corporation to its U.S. shareholder. Foreign base company shipping income was repealed as a type of foreign base company income (and therefore, subpart F income) in 2004.<sup>1221</sup>

#### **Explanation of Provision**

The provision repeals section 955. As a result, a U.S. shareholder in a CFC that invested its previously excluded subpart F income in qualified foreign base company shipping operations is no longer required to include in income a pro rata share of the previously excluded subpart F income when the CFC decreases such investments.

#### **Effective Date**

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders within which or with which such taxable years of foreign corporations end.

### **10. Modification of stock attribution rules for determining status as a controlled foreign corporation (sec. 14214 of the bill secs. 318 and 958 of the Code).**

#### **Reasons for Change**

The Committee is aware of certain transactions used to avoid subpart F provisions. One such transaction involves effectuating "de-control" of a foreign subsidiary, by taking advantage of the section 958(b)(4) rule that effectively turns off the constructive stock ownership rules of

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<sup>1221</sup> American Jobs Creation Act, Pub. L 108-357, 118 Stat. 1511 (Oct. 22, 2004).

318(a)(3) when to do otherwise would result in a U.S. person being treated as owning stock owned by a foreign person. Accordingly, such a transaction converts former CFCs to non-CFCs, despite continuous ownership by U.S. shareholders. The Committee believes this provision is necessary to render de-controlling transactions ineffective as a means of avoiding the subpart F provisions.

#### **Explanation of Provision**

The provision amends the ownership attribution rules of section 958(b) so that certain stock of a foreign corporation owned by a foreign person is attributed to a related U.S. person for purposes of determining whether the related U.S. person is a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. In other words, the provision requires “downward attribution” from a foreign person to a related U.S. person in circumstances in which present law does not so provide. The pro rata share of a CFC’s subpart F income that a United States shareholder is required to include in gross income, however, continues to be determined based on direct or indirect ownership of the CFC, without application of the new downward attribution rule.

This provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is not a related person (within the meaning of section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4).

#### **Effective Date**

The provision is effective for the last taxable year of foreign corporations beginning before January 1, 2018, and all subsequent taxable years of such foreign corporations and for the taxable years of U.S. shareholders in which or within which such taxable years of foreign corporations end.

### **11. Modification of definition of United States shareholder (sec. 14215 of the bill and sec. 951 of the Code)**

#### **Reasons for Change**

The Committee is aware of certain transactions used to avoid U.S. shareholder status and consequently subpart F provisions. One such transaction involves restricting or diluting the voting power of a foreign subsidiary through the issuance of different classes of stock.

#### **Explanation of Provision**

This provision expands the definition of U.S. shareholder under subpart F to include any U.S. person who owns 10 percent or more of the total value of shares of all classes of stock of a foreign corporation.

#### **Effective Date**

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

**12. Elimination of requirement that corporation must be controlled for 30 days before subpart F inclusions apply (sec. 14216 of the bill and sec. 951(a)(1) of the Code)**

**Reasons for Change**

The Committee believes the original purpose for the 30-day rule—to facilitate tax administration—is no longer necessary in light of the availability of technology to track owner and corporate attributes on a daily basis. At the same time, the Committee believes the 30-day rule under present law provides inappropriate opportunities for taxpayers to structure transactions to avoid U.S. tax.

**Explanation of Provision**

The provision eliminates the requirement that a corporation must be controlled for an uninterrupted period of 30 days before subpart F inclusions apply.

**Effective Date**

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

**13. Look-thru rule for related controlled foreign corporations made permanent (sec. 14217 of the bill and sec. 954 of the Code)**

**Reasons for Change**

As was the case when section 954(c)(6) was originally enacted, today most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring additional tax that companies based in many other countries never incur, the Committee believes that the provision will continue to enable U.S. companies to make more sales overseas and thus produce more goods in the United States. These benefits should be enhanced by making this provision permanent, thereby eliminating uncertainty as to its future application.

**Explanation of Provision**

The provision makes permanent the exclusion from foreign personal holding company income for certain dividends, interest (including factoring income that is treated as equivalent to interest under section 954(c)(1)(E)), rents, and royalties received or accrued by one CFC from a related CFC.

### Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

#### **14. Corporations eligible for deductions for dividends exempted from subpart F inclusions for increased investments in United States property (secs. 14218 of the bill and sec. 956 of the Code)**

### Reasons for Change

The Committee believes that it is unnecessary to apply the requirements of section 956 to taxpayers that are entitled to a 100-percent deduction for dividends received by domestic corporations from foreign corporations under the new participation exemption system, when the CFC could pay a dividend or distribute property to the domestic corporate shareholder in a manner that would be tax-free. The Committee further believes that retention of such a rule would needlessly discourage investment in the United States. However, because the participation exemption does not extend to individuals, section 956 should remain in effect with respect to individuals who are United States shareholders of CFCs.

### Explanation of Provision

The provision excepts domestic corporations that are U.S. shareholders in the CFC from the requirement that they recognize income when the CFC increases its investment in U.S. property.

### Effective Date

The provision is effective for taxable years of controlled foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end.

#### **15. Denial of deduction for interest expense of United States shareholders which are members of worldwide affiliated groups with excess domestic indebtedness (sec. 14221 of the bill and new sec. 163(n) of the Code)**

### Reasons for Change

The Committee believes that it is important to provide measures to discourage excessive leverage directly in conjunction with the adoption of a participation exemption system. The Committee further believes that the provision would prevent multinational companies from generating excessive interest deductions in the United States on debt that is issued to foreign affiliates or that is incurred to produce exempt foreign income in a dividend exemption system in a manner that applies equally to foreign and U.S. companies in order to provide a level playing field while recognizing standard non-tax business practices that involve parent corporations incurring debt to finance the acquisition or establishment of subsidiaries. The fungibility of money and the ease with which multinational enterprises may generally redeploy capital among

affiliates within the group provides multinational enterprises with significant flexibility in locating interest expense within the group. Under present law, this enables multinational enterprises to locate significant interest expense in high-tax jurisdictions such as the United States in order to maximize the tax benefits of interest deductions, irrespective of the location of the operations funded by the debt proceeds. Furthermore, U.S. subsidiaries of foreign-parented multinationals have an incentive to issue related-party debt to increase the interest deductions allowed against U.S. taxable income. Present law provides a limited set of rules to combat these concerns.<sup>1222</sup>

The provision further addresses base erosion that results from excessive and disproportionate borrowing in the United States by limiting the deductibility of interest paid or accrued by U.S. corporations that are members of a worldwide affiliated group. The provision reduces the deduction for interest paid or accrued by U.S. members of a worldwide affiliated group by the product of the U.S. corporation's net interest expense and the "debt to equity differential percentage" of the worldwide affiliated group. In applying such a limitation, the Committee is cognizant of the imperative to provide U.S. and foreign companies with a level playing field. Accordingly, the Committee's approach applies equally to U.S. - and foreign-parented multinationals.

### **Explanation of Provision**

For any domestic corporation that is a member of a worldwide affiliated group (hereinafter referred to as the "U.S. corporate members"), the provision reduces the deduction for interest paid or accrued by the corporation by the product of the net interest expense of the domestic corporation multiplied by the debt-to-equity differential percentage of the worldwide affiliated group. Net interest expense means the excess (if any) of: (1) interest paid or accrued by the taxpayer during the taxable year, over (2) the amount of interest includible in the gross income of the taxpayer for the taxable year.<sup>1223</sup>

A worldwide affiliated group is one or more chains of corporations, connected through stock ownership with a common parent that would qualify as an affiliated group under section 1504(a), with two differences. First, the ownership threshold of section 1504(a)(2) is applied using 50 percent rather than 80 percent. Second, the restrictions on inclusion described in sections 1504(b)(2), (b)(3) and (b)(4) are disregarded for purposes of identifying the worldwide affiliated group.

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<sup>1222</sup> With respect to the former concern, interest expense allocation rules generally limit the availability of foreign tax credits to the extent a U.S. shareholder deducts interest to fund the operations of its foreign subsidiaries. See Treas. Reg. secs. 1.861-8 through -13T. With respect to the latter concern, sections 163(j), 267(a)(3), and 482 limit the deductibility of related-party interest payments in certain circumstances, and the subpart F rules limit the U.S. tax benefits of issuing debt to a foreign subsidiary. Additionally, recent regulations issued under section 385 limit the deductibility of related-party interest payments in certain cases by recharacterizing intercompany debt instruments as equity.

<sup>1223</sup> The Secretary is provided is regulatory authority to provide for adjustments in determining the amount of net interest expense.

The debt-to-equity differential percentage means, with respect to any worldwide affiliated group, the excess domestic indebtedness of the group divided by the total indebtedness of the domestic corporations that are members of the group. All U.S. corporate members of the worldwide affiliated group are treated as one member when determining whether the group has excess domestic indebtedness as a result of a debt-to-equity differential. Excess domestic indebtedness is the amount by which the total indebtedness of the U.S. corporate members exceeds 110 percent of the total indebtedness those members would hold if their total indebtedness to total equity ratio equaled the ratio of total indebtedness to total equity for the worldwide affiliated group. Total equity means, with respect to one or more corporations, the excess (if any) of: (1) the money and all other assets of such corporations, over (2) the total indebtedness of such corporations. For purposes of this computation, intragroup debt and equity interests are disregarded, and assets of the U.S. corporate members of the worldwide affiliated group exclude any interest held by any U.S. corporate member in any foreign corporation that is a member of the group.

The amount of any interest not allowed as a deduction for any taxable year by reason of this provision or new section 163(j) (depending on whichever imposes the lower limitation with respect to such taxable year) can be carried forward indefinitely.

The Secretary is provided regulatory authority to provide rules for: (1) the prevention of the avoidance of this provision, (2) adjustments in the case of corporations which are members of an affiliated group as may be appropriate to carry out the purposes of the provision, (3) the coordination of this provision with section 884, (4) the treatment of partnership indebtedness, allocation of partnership debt, interest, or distributive shares, and (5) the coordination of this provision with new section 163(j).

#### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

### **16. Limitations on income shifting through intangible property transfers (sec. 14222 of the bill and secs. 367 and 482 of the Code)**

#### **Reasons for Change**

The Committee is concerned that base erosion continues to occur by means of aggressive use of transfer pricing methodologies with respect to income from exploitation or transfers of intangibles. In particular, the Committee believes that the identification of intangibles and their valuation have presented administrative difficulties that require statutory clarification.

#### **Explanation of Provision**

The provision addresses recurring definitional and methodological issues that have arisen in controversies<sup>1224</sup> in transfers of intangible property for purposes of sections 367(d) and 482,

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<sup>1224</sup> *Veritas v. Commissioner*, 133 T.C. No. 14 (December 10, 2009), *non-acq.*, IRB 2010-49 (December 6, 2010). (stating that including goodwill and going concern value within the definition would “expand[]” that

both of which use the statutory definition of intangible property in section 936(h)(3)(B). The provision revises that definition and confirms the authority to require certain valuation methods. It does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property.

Under the provision, workforce in place, goodwill (both foreign and domestic), and going concern value are intangible property within the meaning of section 936(h)(3)(B), as is the residual category of “any similar item” the value of which is not attributable to tangible property or the services of an individual. The flush language at the end of that subparagraph is removed, to make clear that the source or amount of value is not relevant to whether property that is one of the specified types of intangible property is within the scope of the definition.

The provision clarifies the authority of the Secretary to specify the method to be used to determine the value of intangible property, both with respect to outbound restructurings of U.S. operations and to intercompany pricing allocations,<sup>1225</sup> by amending 482 as well as the grant of regulatory authority under section 367 regarding the use of aggregate basis valuation and the application of the realistic alternative principle.

With respect to aggregate basis valuation, the provision requires use of that method of valuation in the case of transfers of multiple intangible properties in one or more related transactions if the Secretary determines that an aggregate basis achieves a more reliable result than an asset-by-asset approach. The provision is consistent with the position that the additional value that results from the interrelation of intangible assets can be properly attributed to the underlying intangible assets in the aggregate, where doing so yields a more reliable result. This approach is also consistent with Tax Court decisions in cases outside of the section 482 context, where collections of multiple, related intangible assets were viewed by the Tax Court in the aggregate.<sup>1226</sup> Finally, it is also consistent with the cost-sharing regulations.<sup>1227</sup>

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definition, and that “taxpayers are merely required to be compliant, not prescient”); *Amazon v. Commissioner*, 148 T.C. No. 8 (2017) (holding that “workforce in place, going concern value, goodwill, and what trial witnesses described as ‘growth options’ and corporate ‘resources’ or ‘opportunities’” all fell outside the definition under present law).

<sup>1225</sup> Secs. 367(d) and 482.

<sup>1226</sup> See, e.g., *Kraft Foods Co. v. Commissioner*, 21 T.C. 513 (1954) (thirty-one related patents must be valued as a group and the useful life for depreciation should be based on the average of the patents’ useful lives); *Standard Conveyor Co. v. Commissioner*, 25 B.T.A. 281, p. 283 (1932) (“[I]t is evident that it is impossible to value these seven patents separately. Their value, as in the case of many groups of patents representing improvements on the prior art, appears largely to consist of their combination.”); *Massey-Ferguson, Inc. v. Commissioner*, 59 T.C. 220 (1972) (taxpayer who abandoned a distribution network of contracts with separate distributorships was entitled to an abandonment loss for the entire network in the taxable year during which the last of the contracts was terminated because that was the year in which the entire intangible value was lost).

<sup>1227</sup> See Treas. Reg. sec. 1.482-7(g)(2)(iv) (if multiple transactions in connection with a cost-sharing arrangement involve platform, operating and other contributions of resources, capabilities or rights that are reasonably anticipated to be interrelated, then determination of the arm’s-length charge for platform contribution

The provision codifies use of the realistic alternative principles to determine valuation with respect to intangible property transactions. The realistic alternative principle is predicated on the notion that a taxpayer will only enter into a particular transaction if none of its realistic alternatives is economically preferable to the transaction under consideration. For example, under the existing regulations provide the IRS with the ability to determine an arm's-length price by reference to a transaction (such as the owner of intangible property using it to make a product itself) that is different from the transaction that was actually completed (such as the owner of that same intangible property licensing the manufacturing rights and then buying the product from the licensee).

### **Effective Date**

The provision applies to transfers in taxable years beginning after December 31, 2017. No inference is intended with respect to application of section 936(h)(3)(B) or the authority of the Secretary to provide by regulation for such application with respect to taxable years beginning before January 1, 2018.

### **17. Certain related party amounts paid or accrued in hybrid transactions or with hybrid entities (sec. 14223 of the bill and new sec. 267A of the Code)**

#### **Reasons for Change**

The tax laws of the United States may treat a particular cross-border arrangement differently from the arrangement's treatment under the tax laws of another country and thus result in a hybrid arrangement. The Committee believes that hybrid arrangements exploit differences in the tax treatment of a transaction or entity under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. The Committee further believes that these types of hybrid arrangements have an overall negative impact on competition, efficiency, transparency and fairness.

The provision matches items of income and expense by denying the deductibility of certain interest and royalty payments or accruals to a hybrid transaction or by, or to, a hybrid entity. The Committee believes that the provision is consistent with many of the approaches to the same or similar problems taken in the Code, the OECD base erosion and profit shifting project ("BEPS"), bilateral income tax treaties, and provisions or rules of other countries.

#### **Explanation of Provision**

The provision denies a deduction for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such

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transactions and other transactions on an aggregate basis may provide the most reliable measure of an arm's-length result).



related party is a resident for tax purposes or is subject to tax, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country. A disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under section 951(a). A related party for these purposes is determined under the rules of section 954(d)(3), except that such section applies with respect to the payor as opposed to the CFC otherwise referred to in such section.

A hybrid transaction is any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for Federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax. A hybrid entity is any entity which is either: (1) treated as fiscally transparent for Federal income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or (2) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax but not so treated for Federal income tax purposes.

The provision grants the Secretary authority to issue regulations or other guidance as may be necessary or appropriate to carry out the purposes of the provision, including regulations or other guidance providing rules for: (1) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity, (2) the application of this provision to foreign branches, (3) applying this provision to certain structured transactions, (4) denying all or a portion of a deduction claimed for an interest or a royalty payment that, as a result of the hybrid transaction or entity, is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25 percent, (5) denying all of a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system which provides for the exclusion or deduction of a substantial portion of such amount, (6) rules for determining the tax residence of a foreign entity if the foreign entity is otherwise considered a resident of more than one country or of no country, (7) exceptions to the general rule set forth in the provision, and (8) requirements for record keeping and information in addition to any requirements imposed by section 6038A.

#### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

### **18. Termination of special rules for domestic international sales corporations (sec. 14224 of the bill; secs. 991 through 997 of the Code and new section 998 of the Code)**

#### **Reasons for Change**

The Committee is aware that the use of interest charge DISCs has increased in recent years, in order to take advantage of a preferential rate of tax applicable to certain qualifying dividends under section 1(h). Use of the IC-DISC to achieve a preferential rate on dividend income is inconsistent with both the policy underlying the preferential rates in section 1(h) and to

the continuation of the DISC regime after the reforms in 1984. Accordingly, the Committee believes that the DISC provisions are no longer desirable.

### **Explanation of Provision**

The provision repeals the special Code rules for DISCs and IC-DISCs, by terminating any corporate election to be treated as a DISC that is in effect for the corporation's last taxable year beginning in 2018. The termination is effective for the corporation's immediately succeeding taxable year (and all years thereafter). The provision also prohibits any new corporate election to be treated as a DISC for any taxable year beginning after December 31, 2018.

As a result of the provision's termination of existing corporate DISC elections and its prohibition of new DISC elections, the special rules that apply to DISCs, IC-DISCs and their shareholders will no longer have effect. In particular, corporations will no longer be permitted the exemption from corporate level tax allowed under the DISC rules, and individual shareholders of corporations for which DISC elections are terminated will be subject to shareholder-level taxation in respect of the earnings of the corporations in which they are shareholders under all the normal rules for shareholder-level taxation of corporate earnings.

The provision includes a transition rule for shareholders of corporations the DISC elections of which are terminated. Under this transition rule, a shareholder of a corporation whose DISC election is terminated is deemed to have received, in the first taxable year for which the termination is effective, a distribution to which the section 995(b)(2) deemed distribution rules apply. The provision provides that this deemed distribution – and any actual distribution after termination of the DISC election to the extent paid out of the corporation's accumulated DISC income – is not a qualifying dividend under section 1(h)(11)(B). Consequently, an individual DISC shareholder is not eligible for the preferential tax rate allowed under section 1(h)(11) with respect to such distributions.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2018.

## **19. Shareholders of surrogate foreign corporations not eligible for reduced rate on dividends (sec. 14225 of the bill and sec. 1 of the Code)**

### **Reasons for Change**

The reduced tax rate on dividends is intended to encourage certain kinds of equity investments. Investments in surrogate foreign corporations is not the kind of investment the Committee believes fits within this parameter.

### **Explanation of Provision**

Any individual shareholder who receives a dividend from a corporation which is a surrogate foreign corporation as defined in section 7874(a)(2)(B), other than a foreign

corporation which is treated as a domestic corporation under section 7874(b), is not entitled to the lower rates on qualified dividends provided for in section 1(h).

### **Effective Date**

The provision is effective for dividends paid in taxable years beginning after December 31, 2017.

## **20. Repeal of section 902 indirect foreign tax credits; determination of section 960 credit on current year basis (sec. 14301 of the bill and secs. 78, 902 and 960 of the Code)**

### **Reasons for Change**

The Committee believes that a section 902 credit is not appropriate in a participation exemption system under which 100 percent of dividends received by certain domestic corporate shareholders of specified foreign corporations are exempt from U.S. taxation. To continue to offer section 902 credits for taxes deemed paid would result in a double benefit to the U.S. shareholder, by first allowing a dividend to be recognized in income with no U.S. tax liability associated therewith, and by further reducing existing U.S. tax liability with a credit for taxes paid on foreign source income. Rather, offering deemed paid foreign tax credits on a current year basis solely under section 960 reflects what the Committee believes to be a simpler and more appropriate application of the foreign tax credit regime in a 100 percent participation exemption system.

### **Explanation of Provision**

The provision repeals the deemed-paid credit with respect to dividends received by a domestic corporation that owns 10 percent or more of the voting stock of a foreign corporation.

A deemed-paid credit is provided with respect to any income inclusion under subpart F. The deemed-paid credit is limited to the amount of foreign income taxes properly attributable to the subpart F inclusion. Foreign income taxes under the provision include income, war profits, or excess profits taxes paid or accrued by the CFC to any foreign country or possession of the United States. The provision eliminates the need for computing and tracking cumulative tax pools.

Additionally, the provision provides rules applicable to foreign taxes attributable to distributions from previously taxed earnings and profits, including distributions made through tiered-CFCs.

The Secretary is granted authority under the provision to provide regulations and other guidance as may be necessary and appropriate to carry out the purposes of this provision. It is anticipated that the Secretary would provide regulations with rules for allocating taxes similar to rules in place for purposes of determining the allocation of taxes to specific foreign tax credit baskets.<sup>1228</sup> Under such rules, taxes are not attributable to an item of subpart F income if the

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<sup>1228</sup> See Treas. Reg. sec. 1.904-6(a).

base upon which the tax was imposed does not include the item of subpart F income. For example, if foreign law exempts a certain type of income from its tax base, no deemed-paid credit results from the inclusion of such income as subpart F. Tax imposed on income that is not included in subpart F income, is not considered attributable to subpart F income.

In addition to the rules described in this section, the provision makes several conforming amendments to various other sections of the Code reflecting the repeal of section 902 and the modification of section 960. These conforming amendments include amending the section 78 gross-up provision to apply solely to taxes deemed paid under the amended section 960.

#### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017.

### **21. Separate foreign tax credit limitation basket for foreign branch income (sec. 14302 of the bill and sec. 904 of the Code)**

#### **Reasons for Change**

Under present law, multinational enterprises have the ability to cross-credit foreign taxes attributable to low-tax subpart F income with those attributable to high-tax branch income and minimize overall tax liability. Changing the U.S. international tax system from a worldwide system of taxation to a participation exemption system of taxation exacerbates the incentive under present law to shift profits abroad. The Committee believes that this provision would operate to prevent excess foreign taxes credits generated in high-tax branch countries to be used to reduce U.S. tax owed on income generated in a low-tax country.

#### **Explanation of Provision**

The provision requires foreign branch income to be allocated to a specific foreign tax credit basket. Foreign branch income is the business profits of a United States person which are attributable to one or more QBUs in one or more foreign countries.

Under this provision, business profits of a QBU shall be determined under rules established by the Secretary. Business profits of a QBU shall not, however, include any income which is passive category income.

#### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

### **22. Acceleration of election to allocate interest, etc., on a worldwide basis (sec. 14303 of the bill and sec. 864 of the Code)**

#### **Reasons for Change**

Section 864(f) was added to the Code by the American Jobs Creation Act of 2004 (“AJCA”).<sup>1229</sup> At that time, Congress observed that a U.S.-based multinational corporate group with a significant portion of its assets overseas was required to allocate a significant portion of its interest expense to foreign-source income, which reduced the foreign tax credit limitation and thus the credits allowable, even though the interest expense incurred in the United States would not be deductible in computing the actual tax liability under foreign law. Congress believed that this approach unduly limited such a taxpayer’s ability to claim foreign tax credits and left it excessively exposed to double taxation of foreign-source income. The AJCA modified the interest expense allocation rules by providing a one-time election under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally would be determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation).

The Committee agrees that interest expense should be allocated using an elective “worldwide fungibility” approach, under which interest expense incurred in the United States is allocated against foreign-source income only if the debt-to-asset ratio is higher for U.S. than foreign investments. Accordingly, the provision accelerates the effective date of section 864(f).

#### **Explanation of Provision**

This provision accelerates the effective date of the worldwide interest allocation rules to apply to taxable years beginning after December 31, 2017, rather than to taxable years beginning after December 31, 2020.

#### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

### **23. Source of income from sales of inventory determined solely on basis of production activities (sec. 14304 of the bill and sec. 863 of the Code)**

#### **Reasons for Change**

The Committee acknowledges that current administrative guidance, which sources sales income, in part, based on the place of destination rather than the place of production, may be appropriate in the context of our current tax system. However, the Committee believes this approach is not appropriate under a participation exemption system with lower tax rates. Rather than providing targeted relief to particular kinds of income, the Committee is instead reducing tax rates for all taxpayers, while also modernizing the U.S. system for taxing cross-border income. Therefore, the Committee believes changing present law in this area will more accurately measure foreign-source taxable income.

#### **Explanation of Provision**

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<sup>1229</sup> Pub. L. No. 108-357, 118 Stat. 1418 (October 22, 2004).

Under this provision, gains, profits, and income from the sale or exchange of inventory property produced partly in, and partly outside, the United States is allocated and apportioned on the basis of the location of production with respect to the property. For example, income derived from the sale of inventory property to a foreign jurisdiction is sourced wholly within the United States if the property was produced entirely in the United States, even if title passage occurred elsewhere. Likewise, income derived from inventory property sold in the United States, but produced entirely in another country, is sourced in that country even if title passage occurs in the United States. If the inventory property is produced partly in, and partly outside, the United States, however, the income derived from its sale is sourced partly in the United States.

**Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## PART II – INBOUND TRANSACTIONS

### 1. Tax on base erosion payments of taxpayers with substantial gross receipts (sec. 14401 of the bill and sec. 6038A and new secs. 59A and 59B of the Code)

#### Reasons for Change

Foreign-owned U.S. subsidiaries are able to reduce their U.S. tax liability by making deductible payments to a foreign parent or foreign affiliates. This can erode the U.S. tax base if the payments are subject to little or no U.S. withholding tax. Foreign corporations often take advantage of deductions from taxable liability in their U.S. affiliates with payments of interest, royalties, management fees, or reinsurance payments. This provision aims to tax payments of this kind. This type of base erosion has corroded taxpayer confidence in the U.S. tax system.

Moreover, the current U.S. international tax system makes foreign ownership of almost any asset or business more attractive than U.S. ownership. This unfairly favors foreign-headquartered companies over U.S. headquartered companies, creating a tax-driven incentive for foreign takeovers of U.S. firms. Furthermore, it has created significant financial pressures for U.S. headquartered companies to re-domicile abroad and shift income to low-tax jurisdictions. Since 2000, the number of U.S.-headquartered multinationals among the 500 largest public companies has decreased by over 25 percent.

The Committee is also concerned about U.S. and foreign corporations outsourcing their U.S. business operations to foreign jurisdictions at the expense of the American worker. In certain circumstances, this may have the additional effect of reducing the U.S. income tax liability on such companies' profitable operations in the United States.

This provision aims to level the playing field between U.S. and foreign-owned multinational corporations in an administrable way. To the extent that corporations with significant gross receipts are able to utilize *deductible* related party payments to foreign affiliates to reduce their U.S. corporate tax liability below 10-percent, the Committee intends that the base erosion and anti-abuse tax function as a minimum tax to preclude such companies from significantly reducing their corporate tax liability by virtue of these payments. Significant gross receipts is defined as a corporation with \$500 million or more in annual gross receipts.

The Committee also concluded that this minimum tax should limit the extent to which tax credits permit large, profitable corporations with significant base erosion payments to avoid virtually all tax liability in the reformed corporate tax system. This is to ensure that those corporations with significant gross receipts and *deductible* foreign related party payments pay an appropriate amount of U.S. income tax on an annual basis.

The provision applies to a corporation irrespective of whether it is owned, directly or indirectly, by a parent corporation that is U.S. or foreign-headquartered. The Committee believes that this level playing field, along with a globally competitive corporate rate, will encourage economically efficient foreign direct investment. Such investment, whether foreign or domestic, is in the national interest of the United States and its workers.

#### Explanation of Provision

## **In general**

Under the provision, an applicable taxpayer is required to pay a tax equal to the base erosion minimum tax amount for the taxable year. The base erosion minimum tax amount is the excess of 10 percent of the modified taxable income of the taxpayer for the taxable year over an amount equal to the regular tax liability (defined in section 26(b)) of the taxpayer for the taxable year reduced (but not below zero) by the excess of an amount equal to the credits allowed under Chapter 1 less the credit allowed under section 38 (general business credits) for the taxable year allocable to the research credit under section 41(a). For taxable years beginning after December 31, 2025, two changes are made, (A) the 10-percent provided for above is changed to 12.5-percent, and (B) the regular tax liability is reduced by the aggregate amount of the credits allowed under Chapter 1 (and no other adjustment is made).

To determine its modified taxable income, the applicable taxpayer computes its taxable income for the year without regard to any base erosion tax benefit of a base erosion payment or base erosion percentage of any allowable net operating loss deduction.

## **Base erosion payments**

A base erosion payment generally includes any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable under Chapter 1. Such payments also include any amount paid or accrued by the taxpayer to the related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance of depreciation (or amortization in lieu of depreciation).

Base erosion payments do not include payments for cost of goods sold (which is not a deduction but rather a reduction to income). A base erosion payment includes any amount that constitutes reductions in gross receipts of the taxpayer that is paid or accrued by the taxpayer with respect to: (1) a surrogate foreign corporation which is a related party of the taxpayer, but only if such person first became a surrogate foreign corporation after November 9, 2017, or (2) a foreign person that is a member of the same expanded affiliated group as the surrogate foreign corporation. A surrogate foreign corporation has the meaning given in section 7874(a)(2), but does not include a foreign corporation treated as a domestic corporation under section 7874(b).

A base erosion payment does not apply to any amount paid or accrued by a taxpayer for services if such services meet the requirements for eligibility for use of the services cost method under section 482,<sup>1230</sup> determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure and such amount constitutes the total services cost with no markup.

A base erosion tax benefit means: (i) any deduction allowed under Chapter 1 for the taxable year with respect to a base erosion payment, (ii) in the case of a base erosion payment with respect to the purchase of property of a character subject to the allowance for depreciation

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<sup>1230</sup> Described in Treas. Reg. sec. 1.482-9(b).



(or amortization in lieu of depreciation), any deduction allowed in Chapter 1 for depreciation or amortization in lieu of depreciation with respect to the property acquired with such payment, or (iii) any reduction in gross receipts with respect to a payment described above with respect to a surrogate foreign corporation (as defined there) in computing gross income of the taxpayer for the taxable year.

Any base erosion tax benefit attributable to any base erosion payment on which tax is imposed by sections 871 or 881 and with respect to which tax has been deducted and withheld under sections 1441 or 1442, is not taken into account in computing modified taxable income as defined above. The amount not taken into account in computing modified taxable income is reduced under rules similar to the rules under section 163(j)(5)(B).<sup>1231</sup>

The base erosion percentage means for any taxable year, the percentage determined by dividing the aggregate amount of base erosion tax benefits of the taxpayer for the taxable year by the aggregate amount of the deductions allowable to the taxpayer under Chapter 1 for the taxable year, taking into account base erosion tax benefits described above and by not taking into account any deduction allowed under sections 172, 245A or 250 for the taxable year.

### **Applicable taxpayers and related parties**

Applicable taxpayer means with respect to any taxable year, a taxpayer: (A) which is a corporation other than a regulated investment company, a real estate investment trust, or an S corporation; (B) the average annual gross receipts of the corporation for the three-taxable-year period ending with the preceding taxable year are at least \$500 million, and (C) the base erosion percentage (as defined above) of the corporation for the taxable year is four percent or higher.

In the case of a foreign person the gross receipts of which are taken into account for purposes of this provision, only gross receipts which are taken into account in determining income effectively connected with the conduct of a trade or business within the United States is taken into account. If a foreign person's gross receipts are aggregated with a U.S. person's gross receipts for reasons described in the aggregation rules below, the preceding sentence does not apply to the gross receipts of any U.S. person which are aggregated with the taxpayer's gross receipts.

All persons treated as a single employer under section 52(a) are treated as one person for purposes of this provision, except that in applying section 1563 for purposes of section 52, the exception for foreign corporations under section 1563(b)(2)(C) is disregarded (called the "aggregation rules").

For purposes of this provision, foreign person has the meaning given in section 6038A(c)(3).

Related party means: (i) any 25-percent owner of the taxpayer, (ii) any person who is related to the taxpayer or any 25-percent owner of the taxpayer, within the meaning of sections

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<sup>1231</sup> As in effect before the date of enactment of Tax Cuts and Jobs Act.

267(b) or 707(b)(1), and (iii) any other person related to the taxpayer within the meaning of section 482. For these purposes, section 318 regarding constructive ownership of stock applies to these related party rules except that 10-percent is substituted for 50-percent in section 318(a)(2)(C), and for these purposes section 318(a)(3)(A), (B) and (C) do not cause a United States person to own stock owned by a person who is not a United States person.

The provision provides that the Secretary of the Treasury is to prescribe such regulations or other guidance necessary or appropriate, including regulations providing for such adjustments to the application of this section necessary to prevent avoidance of the provision, including through: (1) the use of unrelated persons, conduit transactions, or other intermediaries, or (2) transactions or arrangements designed in whole or in part: (A) to characterize payments otherwise subject to this provision as payments not subject to this provision, or (B) to substitute payments not subject to this provision for payments otherwise subject to this provision.

### **Information reporting requirements**<sup>1232</sup>

The provision authorizes the Secretary of the Treasury to prescribe additional reporting requirements under section 6038A relating to: (A) the name, principal place of business, and country or countries in which organized or resident of each person which: (i) is a related party to the reporting corporation, and (ii) had any transaction with the reporting corporation during its taxable year, (B) the manner of relation between the reporting corporation and the person referred to in (A), and (C) transactions between the reporting corporation and each related foreign person.

In addition, for purposes of information reporting under sections 6038A and 6038C, if the reporting corporation or the foreign corporation to which section 6038C applies is an applicable taxpayer under this provision, the information that may be required includes: (A) base erosion payments paid or accrued during the taxable year by the taxpayer to a foreign person which is a related party of the taxpayer, (B) such information as the Secretary of the Treasury finds necessary to determine the base erosion minimum amount of the taxpayer for the taxable year, and (C) such other information as the Secretary of the Treasury determines is necessary.

The penalties provided for under sections 6038A(D)(1) and (2) are both increased to \$25,000.

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<sup>1232</sup> Section 15006 of the bill (and new section 6050Z) establishes certain reporting requirements. These reporting requirements are effective for taxable years beginning after December 31, 2024, and continue to be required regardless of whether the revenue requirement is met. Any taxpayer who makes a payment to a foreign person who is a related party (as such term is defined in section 14401 of the bill and new section 59A) of the taxpayer during the taxable year is required to make a return, according to forms and regulations prescribed by the Secretary, setting forth (1) the amount of such payments by type and separately stated and (2) any amount paid that results in a reduction of gross receipts to the taxpayer (*e.g.*, cost of goods sold).

### **Effective Date**

The provision applies to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.

## **PART III - OTHER PROVISIONS**

### **1. Taxation of passenger cruise gross income of foreign corporations and nonresident alien individuals (sec. 14501 of the bill and secs. 873, 882, 883, and 887 of the Code)**

#### **Reasons for Change**

The Committee is aware that U.S.-sourced income attributable to passenger cruises operated by foreign corporations is generally exempt from U.S. income tax, despite the fact that a majority of the passengers are from the United States. In addition, the Committee is aware that these corporations rely on services of U.S. government agencies, including the services of the U.S. Coast Guard. The Committee believes that it is appropriate to ensure that such firms pay taxes toward support of the government resources on which they rely.

#### **Explanation of Provision**

The provision creates a category of income defined as effectively connected 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.

Effectively connected passenger cruise gross income is the U.S. territorial waters percentage of all gross income from the operation of a commercial vessel on a covered voyage (hereafter referred to as “passenger cruise gross income”). A covered voyage is generally defined in as a voyage that would be subject to the passenger tax. An antiabuse provision is included such that if passengers embark a ship in the United States and more than 10 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 a covered voyage.

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.

Effectively connected passenger cruise gross income equals the U.S. territorial waters percentage multiplied by passenger cruise gross income. With respect to the operation of a ship in a covered voyage, the U.S. territorial waters percentage equals the number of days of the voyage during which the ship operated in U.S. territorial waters divided by the total number of days of the voyage. U.S. territorial waters consists of those waters that are within 12 nautical miles from low tide on the U.S. coastline or within the international boundary between the United States and a contiguous country. 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 passenger cruise gross income considered to be effectively connected under general rules without regard to this provision continues to be treated as such, even if the U.S. territorial waters percentage of passenger cruise gross income is a lesser amount.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

## **2. Restriction on insurance business exception to the passive foreign investment company rules (sec. 14502 of the bill and sec. 1297 of the Code)<sup>1233</sup>**

### **Reasons for Change**

The Committee is concerned about a lack of clarity and precision in the exception to the passive foreign investment company rules for income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business. This lack of clarity and precision makes the scope of the exception difficult to ascertain and to enforce. In particular, the Committee is concerned about the lack of precision regarding how much insurance or reinsurance business the company must do to qualify under the exception. The Committee has been informed of offshore arrangements applying the present-law exception that reinsure risks and that invest in U.S. hedge funds, and that have been structured in a manner that raises concerns about the potential for base erosion.<sup>1234</sup> The Committee believes that a more mechanical, formulaic rule that is more straightforward to enforce and to apply is appropriate while still preserving the opportunity for a corporation to present facts and circumstances showing it is predominantly engaged in the insurance business, provided the corporation's applicable insurance liabilities are at least 10 percent of its total assets. The Committee also believes that it is important to separately treat different categories of reserves to more accurately determine whether a company meets the insurance exception.

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<sup>1233</sup> For a description of present law, see part D.2 of the description of present law for Title IV of the bill, above, relating to passive foreign investment companies.

<sup>1234</sup> The hedge fund reinsurance arrangement is said to provide indefinite deferral of U.S. taxation of the hedge fund's investment earnings, such as interest and dividends. At the time the taxpayer liquidates the investment, ordinary investment earnings are said to be converted to capital gains, which are subject to a lower rate of tax. Press reports have discussed the arrangements. See, e.g., Hal Lux, "The Great Hedge Fund Reinsurance Tax Game," *Institutional Investor*, April 2001, pages 52-58, <http://www.institutionalinvestor.com/Article/1027978/The-Great-hedge-fund-reinsurance-tax-ame.html> ; Steven Davidoff Solomon, "With Lax Regulation, a Risky Industry Flourishes Offshore," Deal Book, *New York Times*, September 4 2012, [http://dealbook.nytimes.com/2012/09/04/with-lax-regulation-a-risky-industryflourishes-offshore/?\\_php=true&\\_type=blogs&\\_r=0](http://dealbook.nytimes.com/2012/09/04/with-lax-regulation-a-risky-industryflourishes-offshore/?_php=true&_type=blogs&_r=0) .

### **Explanation of Provision**

The provision modifies the requirements for a corporation the income of which is not included in passive income for purposes of the PFIC rules. The provision replaces the test based on whether a corporation is predominantly engaged in an insurance business with a test based on the corporation's insurance liabilities.<sup>1235</sup> The requirement that the foreign corporation would be subject to tax under subchapter L if it were a domestic corporation is retained.

Under the provision, passive income for purposes of the PFIC rules does not include income derived in the active conduct of an insurance business by a corporation (1) that would be subject to tax under subchapter L if it were a domestic corporation; and (2) the applicable insurance liabilities of which constitute more than 25 percent of its total assets as reported on the company's applicable financial statement for the last year ending with or within the taxable year.

For the purpose of the provision's exception from passive income, applicable insurance liabilities means, with respect to any property and casualty or life insurance business (1) loss and loss adjustment expenses, (2) reserves (other than deficiency, contingency, or unearned premium reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks. This includes loss reserves for property and casualty, life, and health insurance contracts and annuity contracts. Unearned premium reserves with respect to any type of risk are not treated as applicable insurance liabilities for purposes of the provision. For purposes of the provision, the amount of any applicable insurance liability may not exceed the lesser of such amount (1) as reported to the applicable insurance regulatory body in the applicable financial statement (or, if less, the amount required by applicable law or regulation), or (2) as determined under regulations prescribed by the Secretary.

An applicable financial statement is a statement for financial reporting purposes that (1) is made on the basis of generally accepted accounting principles, (2) is made on the basis of international financial reporting standards, but only if there is no statement made on the basis of generally accepted accounting principles, or (3) except as otherwise provided by the Secretary in regulations, is the annual statement required to be filed with the applicable insurance regulatory body, but only if there is no statement made on either of the foregoing bases. Unless otherwise

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<sup>1235</sup> Treasury regulations proposed in 2015 have taken a different approach that is based on the current statutory rule. Prop. Treas. Reg. sec. 1.1297-4, 26 CFR Part 1, REG-108214-15, April 24, 2015. The proposed regulations provide that "the term insurance business means the business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with those investment activities and administrative services that are required to support or are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation." The proposed regulations provide that an investment activity is an activity producing foreign personal holding company income, and that is "required to support or [is] substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation to the extent that income from the activities is earned from assets held by the foreign corporation to meet obligations under the contracts." The preamble to the proposed regulations specifically requests comments on the proposed regulations "with regard to how to determine the portion of a foreign insurance company's assets that are held to meet obligations under insurance contracts issued or reinsured by the company," for example, if the assets "do not exceed a specified percentage of the corporation's total insurance liabilities for the year." *Ibid.*

provided in regulations, it is intended that generally accepted accounting principles means U.S. GAAP.

The applicable insurance regulatory body means, with respect to any insurance business, the entity established by law to license, authorize, or regulate such insurance business and to which the applicable financial statement is provided. For example, in the United States, the applicable insurance regulatory body is the State insurance regulator to which the corporation provides its annual statement.

If a corporation fails to qualify solely because its applicable insurance liabilities constitute 25 percent or less of its total assets, a United States person who owns stock of the corporation may elect in such manner as the Secretary prescribes to treat the stock as stock of a qualifying insurance corporation if (1) the corporation's applicable insurance liabilities constitute at least 10 percent of its total assets, and (2) based on the applicable facts and circumstances, the corporation is predominantly engaged in an insurance business, and its failure to qualify under the 25 percent threshold is due solely to runoff-related or rating-related circumstances involving such insurance business.

Facts and circumstances that tend to show the firm may not be predominantly engaged in an insurance business include a small number of insured risks with low likelihood but large potential costs; workers focused to a greater degree on investment activities than underwriting activities; and low loss exposure. Additional relevant facts for determining whether the firm is predominantly engaged in an insurance business include: claims payment patterns for the current and prior years; the firm's loss exposure as calculated for a regulator such as the SEC or for a rating agency, or if those are not calculated, for internal pricing purposes; the percentage of gross receipts constituting premiums for the current and prior years; and the number and size of insurance contracts issued or taken on through reinsurance by the firm. The fact that a firm has been holding itself out as an insurer for a long period is not determinative either way.

Runoff-related or rating-related circumstances include, for example, the fact that the company is in runoff, that is, it is not taking on new insurance business (and consequently has little or no premium income), and is using its remaining assets to pay off claims with respect to pre-existing insurance risks on its books. Such circumstances also include, for example, the application to the company of specific requirements with respect to capital and surplus relating to insurance liabilities imposed by a rating agency as a condition of obtaining a rating necessary to write new insurance business for the current year.

#### **Effective Date**

The provision applies to taxable years beginning after December 31, 2017.

### **3. Repeal of fair market value of interest expense apportionment (sec. 14503 of the bill sec. 864 of the Code)**

#### **Reasons for Change**

The Committee believes that the ability to elect to allocate interest expense under section 864 on the basis of fair market value of assets has led to inappropriate results and needless complexity.

#### **Explanation of Provision**

The provision prohibits members of a U.S. affiliated group from allocating interest expense on the basis of the fair market value of assets for purposes of section 864(e). Instead, the members must allocate interest expense based on the adjusted tax basis of assets.

#### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

### **4. Modification to source rules involving possessions (sec. 14504 of the bill and secs. 865 and 937 of the Code)**

#### **Present Law**

##### **In general**

The U.S. Virgin Islands, Guam, and the Commonwealth of the Northern Mariana Islands have income tax systems that “mirror” the U.S. Code, with the latter two possessions being permitted under current law to delink and use their own tax systems provided certain conditions are met. The U.S. Virgin Islands may also impose certain local income taxes in addition to taxes imposed by the mirror Code. The Code provides rules for coordination of United States and U.S. Virgin Islands taxation.<sup>1236</sup> It permits the U.S. Virgin Islands to reduce or remit tax otherwise imposed by the mirror code if the tax is attributable to U.S. Virgin Islands source income or income effectively connected to the conduct of a trade or business in U.S. Virgin Islands.<sup>1237</sup> The U.S. Virgin Islands has exercised that authority to provide development incentives for certain types of businesses operating within its borders. Under such initiatives, companies can receive a 90 percent reduction in their tax liability on certain income.

##### **Taxation of individuals**

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<sup>1236</sup> Secs. 932 and 934.

<sup>1237</sup> Sec. 934. In general, a bona fide resident of the U.S. Virgin Islands is required to file and pay tax only to the possession. Persons incurring income tax liability in both the United States and the U.S. Virgin Islands are required to file tax returns and pay income tax to both jurisdictions.



Under the mirror Code, U.S. Virgin Islands citizens and residents are taxable on their worldwide income. A foreign tax credit is allowed for income taxes paid to the United States, foreign countries, and other possessions of the United States. In general, a bona fide resident of the U.S. Virgin Islands is required to file and pay tax only to the possession; compliance with that obligation satisfies any Federal income tax filing obligation. All other U.S. residents or citizens with income from U.S. Virgin Island sources are subject to a dual filing requirement.

In the case of an individual who is a U.S. citizen or alien residing in the United States or the U.S. Virgin Islands, only one tax is computed under the Code. If an individual is a bona fide resident of U.S. Virgin Islands for the entire taxable year, such tax is payable to the U.S. Virgin Islands and no U.S. tax is imposed. Otherwise, a citizen or resident of the United States who has income from sources within the U.S. Virgin Islands must determine the portion of income attributable to the U.S. Virgin Islands and the related tax payable to the U.S. Virgin Islands. The remaining portion is payable to the United States.<sup>1238</sup>

Concerns that U.S. citizens not resident in the U.S. Virgin Islands were improperly claiming residence in the U.S. Virgin Islands<sup>1239</sup> or forming entities in the U.S. Virgin Islands in order to recharacterize income earned in the United States as sourced in the U.S. Virgin Islands and claim the 90 percent economic development credit led to legislative changes in 2004.<sup>1240</sup> These changes provided a definition of bona fide residence in a possession and rules to determine source of income from possessions. They also impose a requirement that individuals report any change in residency status with respect to a possession during a taxable year.<sup>1241</sup>

### **Taxation of corporations**

If a corporation is formed in U.S. Virgin Islands, it is classified as a domestic corporation for U.S. Virgin Islands purposes and a foreign corporation for U.S. tax purposes. Such a corporation is only subject to U.S. tax if it has U.S.-source income or income effectively connected with the conduct of a trade or business in the United States. U.S. Virgin Islands taxes a domestic corporation on its worldwide income, but the company is allowed a foreign tax credit against U.S. Virgin Islands tax for taxes imposed by the United States, foreign countries and

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<sup>1238</sup> Sec. 932(b). See, Internal Revenue Service, *Tax Guide for Individuals with Income from U.S. Possessions* (Pub. 570), 2011, pp. 17-18.

<sup>1239</sup> In Notice 2004-45, 2004-2 C.B. 33 (2004), the IRS described several scenarios in which U.S. persons claimed to have satisfied U.S. liabilities by having filed a return with the U.S. Virgin Islands.

<sup>1240</sup> *McHenry v. Commissioner*, 2012 U.S. App. LEXIS 7562 (April 16, 2012) and *Huff v. Commissioner*, 135 T.C. 605 (2010).

<sup>1241</sup> Sec. 937. In the preamble to final regulations issued in 2008, certain *de minimis* exceptions are provided for the U.S. citizen or resident with income from U.S. Virgin Island sources, in recognition that “the interaction of section 937 and other sections of the Code relating to the territories requires a balance between implementing the policies Congress intended in section 937(b) while recognizing the territories’ efforts to retain and attract workers and businesses.” T.D. 9391, 73 F.R. 19350 (April 9, 2008); Treas. Reg. Sec. 1.937-2. Those required to report changes in residency status must use Form 8898, “Statement for Individuals Who Begin or End Bona Fide Residence in a U.S. Possession.”

other possessions. A corporation that is not formed in U.S. Virgin Islands is treated as a foreign corporation under the U.S. Virgin Islands mirror Code. A company not formed in U.S. Virgin Islands is only subject to U.S. Virgin Islands tax if it has U.S. Virgin Islands source income or income effectively connected with the conduct of a trade or business in U.S. Virgin Islands. The United States taxes its domestic corporations on their worldwide income, but allows a foreign tax credit for taxes imposed by foreign jurisdictions, including U.S. Virgin Islands.

### **Sourcing rules**

As a general rule, the principles for determining whether income is U.S. source are applicable for purposes of determining whether income is possession source. In addition, the principles for determining whether income is effectively connected with the conduct of a U.S. trade or business are applicable for purposes of determining whether income is effectively connected to the conduct of a possession trade or business. However, except as provided in regulations, any income treated as U.S. source income or as effectively connected with the conduct of a U.S. trade or business is not treated as income from within any possession or as effectively connected with a trade or business within any such possession.<sup>1242</sup> This rule applies regardless of where the office or fixed place of business connected to such trade or business is located.

Section 865(j)(3) was added by the Technical and Miscellaneous Revenue Act of 1988 (“TAMRA”),<sup>1243</sup> and states that Treasury is authorized to waive the requirements imposed by sections 865(e)(1)(B) and 865(g)(2) (both of which impose a 10 percent foreign tax requirement for source treatment of sales of personal property) for the purposes of determining Guam, American Samoa, Commonwealth of the Northern Mariana Islands, and Puerto Rico-source income (sections 931 and 933, respectively).

### **Reasons for Change**

The Committee believes that personal property sales within the U.S. Virgin Islands should be treated the same as personal property sales in other possessions.

### **Explanation of Provision**

The provision modifies the sourcing rule in section 937(b)(2) by modifying the U.S. income limitation to exclude only U.S. source (or effectively connected) income attributable to a U.S. office or fixed place of business. The provision also modifies section 865(j)(3) by providing Treasury with the authority to waive the 10% foreign tax requirement for source treatment of capital gains income earned by a U.S. Virgin Islands resident.

### **Effective Date**

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<sup>1242</sup> Sec. 937(b).

<sup>1243</sup> P.L. 100-647.

The provision is effective for taxable years beginning after December 31, 2018.

## **5. Repeal exclusion applicable to certain passenger aircraft operated by a foreign corporation (sec. 14505 of the bill and sec. 883 of the Code)**

### **Reasons for Change**

The Committee is aware of countries in which U.S. airlines are not permitted to compete on certain international routes that begin or end in the United States due to restrictions in the other country. As a result, their competitors are able to monopolize such routes, earning transportation income from U.S. sources that is exempted from tax under the reciprocal exemption in section 883. That exemption is based on the existence of similar tax exemption in the laws of their country of organization. Although nominally reciprocal, the tax exemption is not of benefit to the U.S. companies that are not permitted to operate on the routes beginning or ending in the jurisdiction offering the exemption. Accordingly, the Committee believes it is appropriate to bar grant of an exemption to the foreign airlines in such circumstances.

### **Explanation of Provision**

This provision modifies the conditions for granting a reciprocal exemption from U.S. tax for gross income derived by a foreign corporation from the international operation of a passenger airline. Under the provision, a foreign passenger airline is ineligible for the reciprocal exemption under section 883 if it is owned by a corporation organized in a country in which (1) residents are ineligible for reductions in rates of taxes under sections 881 or 882 and (2) there are fewer than two arrivals and departures per week by U.S.-owned passenger airline carriers that have gross operational revenues exceeding \$1,000,000,000. The threshold of \$1,000,000,000 is intended to assure that only arrivals or departures of major carriers<sup>1244</sup> are counted in determining the frequency of arrivals and departures by U.S.-owned carriers.

For purposes of this provision, an aircraft that lands in one country and subsequently departs from that country is treated as having engaged in one arrival and departure.

The provision indexes the operating revenues threshold for U.S. -owned passenger airlines for taxable years beginning after 2018, applying the cost-of-living adjustment determined under section 1(h)(3), substituting “2017” for “2016.” The indexed amount is rounded to the nearest multiple of \$1,000,000.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2017.

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<sup>1244</sup> Both the Department of Transportation, at <https://www.transportation.gov/policy/aviation-policy/airline-quarterly-financial-review>, in its Airline Quarterly Financial Review, and the Federal Aviation Administration at <https://www.transportation.gov/policy/aviation-policy/airline-quarterly-financial-review>, in its aerospace fiscal forecasts, use a threshold of annual operating revenues to differentiate among airlines, with revenues in excess of \$1,000,000,000 used to identify the major airlines.

## **E. Revenue Dependent Proposals**

### **1. Revenue dependent proposals (secs. 15001-15007 of the bill and new sec. 59A, sec. 172(a)(2), sec. 174, new sec. 250, sec. 274, and new sec. 6050Z of the Code)**

#### **Present Law**

##### **Provisions that modify or eliminate provisions in the bill**

For present law related to section 15001 of the bill, see the description of present law for section 13302 of the bill, which modifies the deduction for net operating losses.

For present law related to section 15002 of the bill, see the description of present law for section 13304 of the bill, which limits the deduction by employers of expenses for certain fringe benefits.

For present law related to sections 15003 and 15004, see the description of present law for Subtitle D of the bill.

For present law related to section 15005, see the description of present law for section 13206 of the bill, which amends section 174 to require taxpayers to capitalize and amortize specified research or experimental expenditures (including software development) ratably over a five-year period (or a 15-year period in the case of foreign research) for amounts paid or incurred in taxable years beginning after December 31, 2025.

##### **Reporting and penalty provisions**

Present law imposes a variety of information reporting requirements on participants in certain transactions.<sup>1245</sup> These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such income tax returns are correct and complete. Failure to comply with a reporting requirement may result in the imposition of a penalty.<sup>1246</sup>

##### **Revenue requirement**

There is no provision in the Code that depends on whether cumulative aggregate on-budget Federal revenue from all sources, during a certain period of time, reaches a particular threshold.

#### **Reasons for Change**

The Committee believes that the bill will generate economic growth that will increase the amount of Federal tax revenue collected. If the increase in Federal receipts attributable to

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<sup>1245</sup> Secs. 6031 through 6060.

<sup>1246</sup> See, *e.g.*, sec. 6652.

economic growth is substantial, the Committee would like to return a portion of that increase to taxpayers in the form of additional tax relief. In particular, the Committee believes that additional tax relief is warranted if the amount of on-budget revenue raised by the Federal government from all sources for the period beginning October 1, 2017, and ending on September 30, 2026, is at least \$900,000,000,000 more than what is projected under current law (as modified by the bill) and current convention of projecting under an assumption that macroeconomic variables such as gross domestic product and employment remain fixed at the values they are projected to reach under current law.

The Committee also believes that certain provisions of the Code, including provisions added by the bill, require additional reporting to ensure compliance.

### **Explanation of Provision**

#### **Provisions that modify or eliminate provisions in the bill**

If a certain revenue requirement is met, five modifications are made to the bill for taxable years beginning after December 31, 2025.

1. The limitation on net operating loss deductions, contained in section 13302 of the bill, is increased to 90 percent.
2. The denial of the deduction for expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer, contained in section 13304 of the bill, is eliminated.
3. The deduction for foreign-derived intangible income and global intangible low-taxed income, contained in section 14202 of the bill and new section, is maintained at 37.5 percent for foreign-derived intangible income and 50 percent for global intangible low-taxed income.
4. The amount of regular tax liability used for purposes of computing the base erosion minimum tax amount, contained in section 14401 of the bill and new section 59A, continues to not be reduced by the amount of section 41 research credit claimed. The 10-percent tax rate applied to modified taxable income (as defined in section 14401 of the bill and new section 59A) used for purposes of computing the base erosion minimum tax amount is maintained.
5. The requirement, contained in section 13206 of the bill, that taxpayers capitalize and amortize specified research or experimental expenditures (including software development expenditures) ratably over a five-year period (or a 15-year period in the case of foreign research) for amounts paid or incurred in taxable years beginning after December 31, 2025, is eliminated, and section 174, as in effect before amendment by section 13206 of the bill, is reinstated.

The revenue requirement is met if cumulative aggregate on-budget Federal revenue from all sources for the period beginning on October 1, 2017, and ending on September 30, 2026, as

determined by the Secretary of the Treasury based on amounts reported in the Financial Report of the United States Government, exceeds \$27,487,000,000,000 by \$900,000,000,000 or more.

### **Reporting and penalty provisions**

Section 15006 of the bill (and new section 6050Z) establishes certain reporting requirements. These reporting requirements are effective for taxable years beginning after December 31, 2024, and continue to be required regardless of whether the revenue requirement is met.

1. Any taxpayer who makes research and experimental expenditures (within the meaning of section 174) during a taxable year is required to make a return, according to forms and regulations prescribed by the Secretary, setting forth the aggregate amount of such expenditures.
2. Any taxpayer who makes a payment to a foreign person who is a related party (as such term is defined in section 14401 of the bill and new section 59A) of the taxpayer during the taxable year is required to make a return, according to forms and regulations prescribed by the Secretary, setting forth (1) the amount of such payments by type and separately stated and (2) any amount paid that results in a reduction of gross receipts to the taxpayer (*e.g.*, cost of goods sold).
3. Any taxpayer who has foreign-derived intangible income (as defined in section 14202 of the bill and new section 250) for a taxable year is required to make a return, according to the forms and regulations prescribed by the Secretary, setting forth (1) the aggregate amount of such income, (2) the amount of foreign-derived deduction eligible income (as defined in section 14202 of the bill and new section 250), and (3) a certification that any foreign-derived deduction eligible income does not relate to the sale of products for any use, consumption, or disposition within the United States.

Unless it is shown that such failure is due to reasonable cause, if there is any failure to make a return required under this provision containing the information required by this provision on the date described therefor (including any extension of time for filing), the person failing to file the return is required to pay (on notice and demand by the Secretary and in the same manner as tax) an amount equal to \$1,000 for each day during which the failure continues (with the total amount per return not to exceed \$250,000).

### **Effective Date**

The provisions that modify or repeal other provisions of the bill are effective for taxable years beginning after December 31, 2025, if the revenue requirement is met.

The reporting requirements are effective for taxable years beginning after December 31, 2024.