



**Tax Reform Act of 2014**  
**Discussion Draft**  
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# **Tax Reform Act of 2014**

## **Discussion Draft**

### **Section-by-Section Summary**

#### **Section 1. Short Title; Etc.**

This section provides: (1) a short title for the discussion draft, the “Tax Reform Act of 2014”; (2) that when the discussion draft amends or repeals a particular section or other provision, such amendment or repeal generally should be considered as referring to sections or provisions of the Internal Revenue Code of 1986; and (3) a table of contents.

## **Title I – Tax Reform for Individuals**

### **Subtitle A – Individual Income Tax Rate Reform**

#### **Secs. 1001-1003. Simplification of individual income tax rates; Deduction for adjusted net capital gain; Conforming amendments related to simplification of individual income tax rates.**

**Current law:** Under current law, a taxpayer generally determines his regular tax liability by applying the tax rate schedules (or the tax tables) to his 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. For 2014, there are seven regular individual income tax brackets of 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent, and 39.6 percent. In addition, there are five categories of filing status: single, head of household, married filing jointly (and surviving spouses), married filing separately, and estates and trusts. For married individuals filing jointly, the upper bounds of the 10- and 15-percent brackets are exactly double the upper bounds that apply to single individuals, to prevent a marriage penalty from applying at these income levels. The income levels for each bracket threshold are indexed annually based on increases in the Consumer Price Index (CPI).

A separate rate schedule applies to adjusted net capital gain and qualified dividends, with rates of 0 percent, 15 percent, and 20 percent. Additional rates of 25 percent and 28 percent apply to unrecaptured section 1250 gain and 28-percent rate gain (collectibles gain and section 1202 gain), respectively. Special rules (i.e., the so-called “kiddie tax”) apply to certain unearned income of children, taxing a portion of such income at the parents’ tax bracket.

**Provision:** Under the provision, the current seven tax brackets would be consolidated and simplified into three brackets: 10 percent, 25 percent, and 35 percent. Generally, the new 10-percent bracket would replace the current 10- and 15-percent brackets; the new 25-percent bracket would replace the current 25-, 28-, 33-, and 35-percent brackets; and the new 35-percent bracket would replace the current 39.6-percent bracket. While the current 25-percent bracket

begins at \$72,500 (2013 dollars) for joint filers (half that amount for single filers), the new 25-percent bracket would begin at \$71,200 (2013 dollars) for joint filers (half that amount for single filers). The new 35-percent bracket would begin at the same income levels as the current 39.6-percent bracket (e.g., \$400,000 for single filers and \$450,000 for joint filers in 2013). Beginning in tax year 2015, these income levels would be indexed for chained CPI instead of CPI, a slightly different measure of inflation.

The 35-percent bracket would not apply to qualified domestic manufacturing income (QDMI), meaning that such income would be subject to a maximum statutory rate of 25 percent. QDMI generally would be net income attributable to domestic manufacturing gross receipts. Domestic manufacturing gross receipts would include gross receipts derived from (1) any lease, rental, license, sale, exchange, or other disposition of tangible personal property that is manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States, or (2) construction of real property in the United States as part of the active conduct of a construction trade or business. Income that either is net earnings from self-employment or results from an adjustment under Code section 481 (for changes in accounting methods) would not qualify as QDMI. Puerto Rico would be considered “domestic” for these purposes, and other rules similar to those under current-law Code section 199 would apply. Finally, the exemption of QDMI from the 35-percent bracket would be phased in over three years, with only one-third of QDMI being excluded from the top bracket in tax year 2015, and two-thirds being excluded in 2016.

In addition, certain tax preferences could only be taken against the 25-percent bracket, but not the 35-percent bracket. These tax preferences would include: the standard deduction; all itemized deductions except the deduction for charitable contributions; the foreign earned income exclusion (including the exclusions for income from Puerto Rico and U.S. possessions); tax-exempt interest; employer contributions to health, accident, and defined contribution retirement plans to the extent excluded from gross income; the deduction for health premiums of the self-employed; the deduction for contributions to Health Savings Accounts; and the portion of Social Security benefits excluded from gross income.

The 25-percent cap that would apply to both the maximum rate imposed on QDMI and the rate against which certain tax preferences may be taken would be administered by imposing the difference between the 25-percent bracket and the 35-percent bracket (i.e., 10 percentage points) on modified adjusted gross income (MAGI) rather than taxable income. MAGI would equal adjusted gross income, plus the above-the-line deductions and exclusions listed above, minus QDMI and charitable contributions.

For high-income taxpayers, the provision would phase out the tax benefit of the 10-percent bracket, measured as the difference between what the taxpayer pays and what the taxpayer would have paid had the first dollar of taxable income been subject to the 25-percent bracket. This tax benefit is phased out at a rate of \$5 of tax savings for every \$100 of modified adjusted gross income in excess of \$250,000 (single filers) or \$300,000 (joint filers). These thresholds are adjusted for chained CPI in tax years after 2013.

The special rate structure for net capital gain would be repealed. Instead, non-corporate taxpayers could claim an above-the-line deduction equal to 40 percent of adjusted net capital gain. Adjusted net capital gain would equal the sum of net capital gain and qualified dividends, reduced by net collectibles gain.

The provision would be effective for tax years beginning after 2014.

**Considerations:**

- Overall, the changes to the individual rate structure would create a simpler, fairer, and flatter Federal income tax.
- Most economists consider chained CPI to represent a more accurate measure of inflation than CPI.
- Qualifying for head of household filing status requires a taxpayer to comply with a complicated set of rules, and comparable relief for single individuals with dependents could be provided through simpler changes to certain deductions and credits.
- The modified tax preference for long-term capital gains and dividends would result in such income being taxed at 60 percent of the taxpayer's marginal rate. Thus, for example, taxpayers in the 35-percent bracket would pay an effective rate of 21 percent on adjusted net capital gain. Combining this with the additional 3.8 percent tax imposed on such income by Code section 1411 yields a top effective rate of 24.8 percent, slightly lower than the top effective rate under current law, which is 25 percent.
- The 40-percent deduction for adjusted net capital gain would greatly simplify the calculation of the tax preference for such income relative to current law, and is similar to how the tax preference was structured prior to enactment of the Tax Reform Act of 1986.
- Excluding qualified domestic manufacturing income from the 35-percent bracket would ensure that small businesses and pass-through entities (such as S corporations and partnerships) engaged in such activity are taxed at a rate no higher than 25 percent, achieving parity with C corporations under the discussion draft.

**JCT estimate:** According to JCT, the provisions, along with sections 3132 and 3139 of the discussion draft, would reduce revenues by \$498.7 billion over 2014-2023, and increase outlays by \$0.4 billion over 2014-2023.

## **Subtitle B – Simplification of Tax Benefits for Families**

**Considerations for Subtitle B:**

- The Code currently includes six basic family tax benefits, each with its own rules, eligibility criteria, and calculations.
- Three – the basic standard deduction, additional standard deduction, and personal exemption for taxpayer and spouse – are intended to shield a minimum level of income from Federal income taxation, with the level depending on whether the taxpayer is single or married.
- The other three – personal exemptions for children and dependents, the child tax credit, and head of household filing status – are intended to deliver additional tax benefits to households with children and dependents.

- Consolidating these six benefits into three simpler benefits – a larger standard deduction, an additional deduction for single parents, and an enhanced child and dependent tax credit – would achieve the same policy and distributional goals as current law while making the Code much simpler for low- and middle-income families.

### **Sec. 1101. Standard deduction.**

**Current law:** Under current law, an individual reduces adjusted gross income (AGI) by any personal exemption deductions and either (1) the applicable standard deduction or (2) his itemized deductions to determine taxable income. The basic standard deduction varies depending upon a taxpayer's filing status. For 2013, the amount of the standard deduction was \$6,100 for single individuals and married individuals filing separate returns, \$8,950 for heads of households, and \$12,200 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. The amounts of the basic and additional standard deductions are indexed annually for inflation (CPI). In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions.

**Provision:** Under the provision, the basic and additional standard deductions would be consolidated into a single standard deduction of \$22,000 for joint filers (and surviving spouses) and \$11,000 for other individual filers. Single filers with at least one qualifying child could claim an additional deduction of \$5,500, regardless of whether or not they itemize deductions. These amounts would be adjusted annually from tax year 2013 based on changes in the chained CPI.

The standard deduction – or in the case of itemizers, an equivalent amount of itemized deductions – would phase out by \$20 for every \$100 by which modified adjusted gross income (MAGI) exceeds \$517,500 for joint filers and \$358,750 for single filers. The additional deduction for single filers with a qualifying child would phase out by one dollar for every dollar by which AGI exceeds \$30,000. The phase-out threshold amounts also are adjusted for inflation based on 2013 dollars.

The provision would be effective for tax years beginning after 2014.

#### **Considerations:**

- The increase in the standard deduction would achieve substantial simplification by reducing the number of taxpayers who choose to itemize their deductions – from roughly one-third under current law to only 5 percent under the discussion draft (in 2015).
- While the provision eliminates the additional standard deduction for the elderly and blind, the increase in the standard deduction more than compensates these taxpayers for this simplification.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$578.3 billion over 2014-2023, and increase outlays by \$87.9 billion over 2014-2023.



## **Sec. 1102. Increase and expansion of child tax credit.**

**Current law:** Under current 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. The aggregate amount of child credits that may be claimed is phased out by \$50 for each \$1,000 of MAGI over \$75,000 for single filers and \$110,000 for joint filers. Neither the \$1,000 credit amount nor the MAGI thresholds are indexed for inflation. The taxpayer must submit a valid taxpayer identification number (TIN) for each child for whom the credit is claimed.

To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit, or ACTC) equal to 15 percent of earned income in excess of \$3,000 for tax years beginning before 2018, or \$10,000 thereafter, indexed for changes in the CPI since calendar year 2000. The taxpayer is not required to have a Social Security number (SSN) to claim the refundable portion of the credit, and (unlike with the EITC) taxpayers claiming the foreign earned income exclusion may qualify for the refundable portion of the credit.

**Provision:** Under the provision, the child credit would be increased to \$1,500 and would be allowed for qualifying children under the age of 18. A reduced credit of \$500 would be allowed for non-child dependents. Both the \$1,500 and \$500 credit amounts would be indexed annually for changes in the chained CPI. The credit would be refundable to the extent of 25 percent of the taxpayer's earned income (earned income in excess of \$3,000 before 2018). The credit would not begin to phase out until MAGI exceeds \$413,750 for single filers and \$627,500 for joint filers (indexed for inflation, using 2013 dollars).

To reduce waste, fraud, and abuse, a taxpayer would be required to provide his SSN, but not an SSN for the child or dependent, to claim the refundable portion of the credit. The IRS would be granted math error authority to adjust the returns of taxpayers failing to satisfy the identification requirements. The refundable portion of the credit would be disallowed for taxpayers claiming the foreign earned income exclusion.

The provision would be effective for tax years beginning after 2014.

### **Considerations:**

- The cost of raising children increases every year, but the current law child tax credit fails to recognize this because it is not indexed for inflation.
- Consolidating the personal exemption for children and dependents and the child tax credit into a single tax credit achieves simplification while better targeting relief to low- and middle-income families.
- Increasing the phase-out level dramatically would reward more families with children and would simplify the Code for middle class families currently forced to perform a phase-out computation.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$277.9 billion over 2014-2023, and increase outlays by \$276.1 billion over 2014-2023.

### **Sec. 1103. Modification of earned income tax credit.**

**Current law:** Under current law, a refundable earned income tax credit (EITC) is available to low-income workers who satisfy certain requirements. The amount of the EITC varies depending upon the taxpayer's earned income and whether the taxpayer has zero, one, two, or more than two qualifying children. In 2013, the maximum EITC (regardless of filing status) was \$6,044 for taxpayers with more than two qualifying children, \$5,372 for taxpayers with two qualifying children, \$3,250 for taxpayers with one qualifying child, and \$487 for taxpayers with no qualifying children. For tax year 2013, the credit amount begins to phase out at an income level of \$17,530 (\$7,970 for taxpayers with no qualifying children). The phase-out percentages are 15.98 percent for taxpayers with one qualifying child, 17.68 percent for two or more qualifying children, and 7.65 percent for no qualifying children.

**Provision:** Under the provision, the EITC would be modified so that it would refund employment-related taxes (i.e., payroll taxes and self-employment taxes) paid by or with respect to the individual. The employee's share of payroll taxes would be offset by a credit against such taxes, while the employer's share would be rebated through a refundable income tax credit. Only taxpayers with at least one qualifying child could qualify for the credit against the employer's share of payroll taxes. For taxpayers without a qualifying child, the maximum credit amount would be \$200 for joint filers (\$100 for other filers). For taxpayers with one qualifying child, the maximum credit would be \$2,400. For taxpayers with more than one qualifying child, the maximum credit would be \$4,000 in the case of a joint return and \$3,000 in other cases. These credit amounts would be indexed for chained CPI based on 2013 dollars.

A special rule would apply to tax years 2015, 2016, and 2017 that would make the credit equal to 200 percent of the taxpayer's payroll taxes (both employee and employer shares). In addition, taxpayers with one qualifying child could claim a maximum credit of \$3,000 (rather than \$2,400), and taxpayers with two or more qualifying children could claim a maximum credit of \$4,000, regardless of filing status.

The credit would phase out as AGI exceeds certain levels. For taxpayers with qualifying children, the credit would begin phasing out at \$20,000 for single filers and \$27,000 for joint filers. For taxpayers without qualifying children, the credit would begin phasing out at \$8,000 for single filers and \$13,000 for joint filers. These thresholds would be indexed to chained CPI, based on 2013 dollars. The phase-out percentages would be 19 percent for filers with one or more qualifying children and 7.65 percent for no qualifying children.

Finally, the provision would require the Treasury Department to report to Congress, within 180 days of the date of enactment, recommendations for providing advance payments of the EITC (1) as promptly as feasible, and (2) with minimal administrative burden imposed on employers and the IRS.

The provision would be effective for tax years beginning after 2014.

**Considerations:**

- Exempting a portion of wages from payroll tax would represent a tax cut, whereas the current EITC constitutes government spending.
- The Treasury Inspector General for Tax Administration (TIGTA) recently estimated that up to 25 percent of EITC payments are improper (including fraudulent claims), costing the Federal government up to \$132 billion over the last 10 years.
- The EITC calculation is highly complex, and TIGTA has estimated that as many as 22 percent of eligible taxpayers fail to claim it.
- Simply allowing low-income taxpayers a rebate of their payroll taxes is both much simpler and more transparent than current law, with the potential for fraud reduced by the direct link to payroll taxes withheld on a taxpayer's Form W-2.
- Allowing a larger maximum credit for joint filers than for other filers helps to reduce the marriage penalty embedded in the current EITC.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$160.8 billion over 2014-2023, and reduce outlays by \$378.0 billion over 2014-2023.

**Sec. 1104. Repeal of deduction for personal exemptions.**

**Current law:** Under current law, a taxpayer generally may claim personal exemptions for the taxpayer, the taxpayer's spouse, and any dependents. For 2013, taxpayers may deduct \$3,900 for each personal exemption. This amount is indexed annually for inflation (CPI). Additionally, the personal exemption phase-out (PEP) reduces a taxpayer's personal exemptions by 2 percent for each \$2,500 (\$1,250 for married filing separately) by which the taxpayer's AGI exceeds \$250,000 (single), \$275,000 (head-of-household), \$300,000 (married filing jointly), and \$150,000 (married filing separately). These threshold amounts apply to tax year 2013 and also are indexed for inflation.

**Provision:** Under the provision, the deduction for personal exemptions would be repealed. The provision would be effective for tax years beginning after 2014.

**Considerations:**

- The personal exemption for the taxpayer and taxpayer's spouse would be consolidated into a larger standard deduction.
- The personal exemption for children and dependents would be consolidated into an expanded child and dependent tax credit.

**JCT estimate:** According to JCT, the provision would increase revenues by \$859.1 billion over 2014-2023, and reduce outlays by \$128.1 billion over 2014-2023.

## Subtitle C – Simplification of Education Incentives

### Considerations for Subtitle C:

- Under current law, there are 15 different tax benefits relating to education that often overlap with one another.
- The current-law education tax benefits are so complicated that they are ineffective because many taxpayers cannot determine the tax benefits for which they are eligible.
- The IRS publication on tax benefits for education is almost 90 pages long.
- Streamlining education tax benefits would enable taxpayers to understand better the tax benefits for which they qualify.
- The provisions would help to simplify considerably the tax benefits relating to education.

### **Sec. 1201. American opportunity tax credit.**

**Current law:** Under current law, the American Opportunity Tax Credit (AOTC) replaces the pre-existing Hope Scholarship Credit (HSC) through the end of 2017. The AOTC provides a 100-percent tax credit for the first \$2,000 of certain higher education expenses and a 25-percent tax credit for the next \$2,000 of such expenses, for a maximum credit of \$2,500. The expenses that are eligible for the AOTC include tuition, fees and course materials. Up to 40 percent of the AOTC is refundable. The AOTC is available for up to four years of post-secondary education in a degree or certificate program, and generally phases out between modified adjusted gross income (MAGI) of \$160,000 and \$180,000 for joint filers and \$80,000 and \$90,000 for other filers.

After 2017, the AOTC expires and taxpayers may claim the HSC instead. Generally, the HSC is less generous than the AOTC in that it: (1) provides a credit of 100 percent of the first \$1,000 in expenses and 50 percent of the next \$1,000 in expenses; (2) applies only to tuition and fees; (3) is available only for two years of post-secondary education; (4) phases out at MAGI of \$80,000 to \$100,000 (joint filers) and \$40,000 to \$50,000 (other filers); and (5) is not refundable. (Under the HSC, all dollar amounts are indexed for inflation using 2000 as the base year.) As an alternative to the AOTC or the HSC, taxpayers may instead elect the Lifetime Learning Credit (LLC) for 20 percent of up to \$10,000 of qualified education expenses for post-secondary education. There is no limit on the number of years the LLC may be claimed for each student. For 2014, the LLC generally phases out for taxpayers with MAGI between \$54,000 and \$64,000 (\$108,000 and \$128,000 for joint filers). These income phase-outs are adjusted for inflation.

Prior to 2014, an individual also could claim an above-the-line deduction for qualified tuition and related expenses incurred. The maximum amount of the deduction was \$4,000 for taxpayers whose adjusted gross income (AGI) did not exceed \$65,000 (\$130,000 in the case of a joint return), and \$2,000 for taxpayers whose AGI did not exceed \$80,000 (\$160,000 in the case of a joint return).

Pell Grants generally may be used for a wider array of expenses than the AOTC or the HSC. However, Pell Grants must be first used against the expenses that are also covered by the AOTC or the HSC. These ordering rules have led to taxpayer confusion.

Certain educational institutions are also subject to Federal tax reporting requirements regarding tuition and related expenses that may be satisfied by providing either the amounts billed or the amounts paid.

**Provision:** Under the provision, the four existing higher education tax benefits described above – AOTC, HSC, LLC, and the tuition deduction – would be consolidated into a permanent, reformed AOTC. The new AOTC, like the current, temporary AOTC, would provide a 100-percent tax credit for the first \$2,000 of certain higher education expenses and a 25-percent tax credit for the next \$2,000 of such expenses. Also like the current AOTC, it would be available for up to four years of higher education, and eligible expenses would include tuition, fees and course materials. The provision would provide greater refundability, with the first \$1,500 of the credit being refundable. The credit would generally phase out for MAGI between \$86,000 and \$126,000 for joint filers and \$43,000 and \$63,000 for other filers. The credit amounts and phase-out ranges would be indexed for inflation starting in 2018. The HSC, LLC, and tuition deduction would be repealed.

The provision would deem Pell Grants to be applied first against expenses not covered by the AOTC. Thus, qualified tuition and related expenses that may be used for calculating the AOTC would be reduced by Pell Grants only to the extent the Pell Grants exceed the non-AOTC covered costs of college attendance.

To reduce credit overpayments, educational institutions subject to current reporting requirements would be required to report amounts paid rather than amounts billed.

The provision would be effective for tax years beginning after 2014.

**Consideration:** The provision would help to simplify the tax benefits relating to education by consolidating four similar, but not identical, tax benefits – AOTC, HSC, and LLC, and the deduction for qualified tuition and related expenses – into a single, easy-to-understand tax credit.

**JCT estimate:** According to JCT, the provision, along with section 1202 of the discussion draft, would increase revenues by \$29.4 billion over 2014-2023 and would increase outlays by \$38.1 billion over 2014-2023.

### **Sec. 1202. Expansion of Pell Grant exclusion from gross income.**

**Current law:** Under current law, qualified scholarship amounts, such as Pell Grants, received by a degree candidate at a qualifying educational organization are generally excluded from gross income. However, such scholarship amounts are only excluded if used for qualified tuition and related expenses, a category that does not include room and board.

**Provision:** Under the provision, all Pell Grants would be excluded from income regardless of how they are used. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for section 1201 of the discussion draft.

**Sec. 1203. Repeal of exclusion of income from United States savings bonds used to pay higher education tuition and fees.**

**Current law:** Under current law, interest on United States savings bonds is excluded from income if used to pay qualified higher education expenses. Only taxpayers with MAGI below certain (inflation-adjusted) levels qualify for the exclusion. For 2014, the exclusion phases out between \$113,950 and \$143,950 for joint returns and between \$76,700 and \$91,000 for other returns.

**Provision:** The provision would repeal the exclusion for interest on United States savings bonds used to pay qualified higher education expenses. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

**Sec. 1204. Repeal of deduction for interest on education loans.**

**Current law:** Under current law, an individual may claim an above-the-line deduction for interest payments on qualified education loans for qualified higher education expenses of the taxpayer, the taxpayer's spouse, or dependents. The maximum amount of the deduction is \$2,500. Only taxpayers with MAGI below certain inflation-adjusted amounts qualify for the exclusion. For 2014, the exclusion phases out between \$130,000 and \$160,000 for joint returns and between \$65,000 and \$80,000 for other returns.

**Provision:** The provision would repeal the deduction for interest on education loans. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$13.0 billion over 2014-2023.

**Sec. 1205. Repeal of deduction for qualified tuition and related expenses.**

**Current law:** Under current law, an individual could claim an above-the-line deduction for qualified tuition and related expenses incurred in tax years beginning before 2014. The maximum amount of the deduction was \$4,000 for taxpayers whose adjusted gross income (AGI) did not exceed \$65,000 (\$130,000 in the case of a joint return), and \$2,000 for taxpayers whose AGI did not exceed \$80,000 (\$160,000 in the case of a joint return).

**Provision:** The provision would repeal the deduction for qualified tuition and related expenses. The provision would be effective for tax years beginning after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 1206. No new contributions to Coverdell education savings accounts.**

**Current law:** Under current law, Coverdell education savings accounts, which are established for the purpose of paying qualified education expenses of a named beneficiary, are exempt from tax. Contributions are not deductible and may not exceed \$2,000 per beneficiary annually, and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for contributors with modified adjusted gross income between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return). Distributions from a Coverdell account are excludable from the gross income of the beneficiary if used to pay for qualified education expenses. Qualified education expenses include qualified higher education expenses and qualified elementary and secondary school expenses for attendance in kindergarten through grade 12.

**Provision:** The provision would prohibit new contributions to Coverdell education savings accounts after 2014 (except rollover contributions), but would allow tax-free rollovers from Coverdell accounts into section 529 plans. The provision would be effective for contributions made and distributions after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.2 billion over 2014-2023.

**Sec. 1207. Repeal of exclusion for discharge of student loan indebtedness.**

**Current law:** Under current law, discharge of indebtedness generally constitutes taxable income. However, an exception applies to student loans that are forgiven because the former students work for a period of time in certain professions or for certain classes of employers. The exception also applies to loan repayments as part of the National Health Services Corps Loan Repayment Program and loan repayments or forgiveness under certain State loan repayment programs intended to provide for increased health care services in certain areas.

**Provision:** Under the provision, the exclusion for discharge of student loan indebtedness would be repealed. The provision would be effective for amounts discharged after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.1 billion over 2014-2023.

### **Sec. 1208. Repeal of exclusion for qualified tuition reductions.**

**Current law:** Under current law, qualified tuition reductions provided by educational institutions to their employees, spouses, or dependents are excluded from income. The exclusion may be provided in the form of either reduced tuition or cash. The reduction must be part of a program that does not discriminate in favor of highly compensated employees and may not apply to graduate programs (except for a graduate student who is teaching or a research assistant).

**Provision:** Under the provision, the exclusion for qualified tuition reduction programs would be repealed. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$2.5 billion over 2014-2023.

### **Sec. 1209. Repeal of exclusion for education assistance programs.**

**Current law:** Under current law, employer-provided education assistance is excluded from income. The exclusion is limited to \$5,250 per year and applies to both graduate and undergraduate courses. The education assistance must be part of a written plan of the employer that does not discriminate in favor of highly compensated employees.

**Provision:** Under the provision, the exclusion for education assistance programs would be repealed. Employer-provided education assistance may still be excluded as a working condition fringe benefit, however, if it is related to the employee's performance of his job duties for the employer. The provision would be effective for amounts paid or incurred after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$10.5 billion over 2014-2023.

### **Sec. 1210. Repeal of exception to 10-percent penalty for higher education expenses.**

**Current law:** Under current law, an additional 10-percent tax generally is imposed on distributions from retirement plans and Individual Retirement Accounts (IRAs) occurring before the account holder reaches age 59½. This 10-percent tax is in addition to any income tax that may be due on the distribution. There are several exceptions to the early withdrawal penalty, including early distributions to pay for higher education expenses.

**Provision:** Under the provision, the exception to the additional 10-percent tax for early distributions used to pay for higher education expenses would be repealed. The provision would be effective for distributions after 2014.

**Consideration:** This provision would help Americans achieve greater retirement security by encouraging taxpayers not to make withdrawals from their accounts before retirement.



**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for section 1605 of the discussion draft.

## **Subtitle D – Repeal of Certain Credits for Individuals**

### **Sec. 1301. Repeal of dependent care credit.**

**Current law:** Under current law, a taxpayer may claim a non-refundable credit for a portion of the taxpayer's employment-related expenses for household services and the care of qualifying individuals. The credit takes into account up to \$3,000 of such expenses for households with one qualifying individual, and \$6,000 for two qualifying individuals. Taxpayers whose adjusted gross income is \$15,000 or less may claim a credit of 35 percent of expenses. The credit rate phases down to 20 percent as adjusted gross income increases from \$15,000 to \$43,000 (meaning that taxpayers with incomes exceeding \$43,000 may claim a maximum credit of \$600).

**Provision:** Under the provision, the dependent care credit would be repealed. The provision would be effective for tax years beginning after 2014.

#### **Considerations:**

- The dependent care credit is complex and overlaps with other tax provisions that provide tax benefits for families.
- Consolidating redundant and complex family tax benefits, such as the dependent care credit, into an increased child credit and standard deduction would result in significant simplification.

**JCT estimate:** According to JCT, the provision would increase revenues by \$20.0 billion over 2014-2023, and would reduce outlays by \$6.0 billion over 2014-2023.

### **Sec. 1302. Repeal of credit for adoption expenses.**

**Current law:** Under current law, a taxpayer may claim an adoption tax credit of \$13,190 per eligible child for 2014 (both special needs and non-special needs adoptions). These benefits are phased-out for taxpayers with modified adjusted gross income (MAGI) between \$197,880 and \$237,880 for 2014. The amount of the credit and the income phase-outs are indexed for inflation. For a non-special needs adoption, the credit amount is limited to actual adoption expenses. The credit is not refundable, but unused amounts may be carried forward for five years.

**Provision:** Under the provision, the adoption credit would be repealed. The provision would be effective for amounts paid or incurred after 2014 for non-special needs adoptions. For special needs adoptions, amounts deemed to have been paid for purposes of the credit shall be treated as paid on the date the adoption was finalized.

**Considerations:**

- The adoption credit can be complex and overlaps with other tax provisions that provide tax benefits for families.
- Consolidating redundant and complex family tax benefits, such as the adoption credit, into an increased child credit and standard deduction would result in significant simplification.

**JCT estimate:** According to JCT, the provision would increase revenues by \$4.7 billion over 2014-2023.

**Sec. 1303. Repeal of credit for nonbusiness energy property.**

**Current law:** Under current law, a taxpayer could claim a credit of 10 percent of expenditures for energy-efficient improvements to the building envelope (e.g., windows, doors, skylights, and roofs) of principal residences and credits of fixed dollar amounts ranging from \$50 to \$300 for energy-efficient property including furnaces, boilers, biomass stoves, heat pumps, water heaters, central air conditioners and circulating fans, for property placed in service before 2014. The credit was subject to a lifetime cap of \$500. The credit expired at the end of 2013.

**Provision:** Under the provision, the credit for nonbusiness energy property would be repealed. The provision would be effective for property placed in service after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 1304. Repeal of credit for residential energy efficient property.**

**Current law:** Under current law, a taxpayer may claim a credit for the purchase of qualified solar electric property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit is equal to 30 percent of qualifying expenditures. There also is a 30-percent credit for the purchase of qualified geothermal heat pump property, qualified small wind energy property, and qualified fuel cell power plants. The credit applies to property placed in service prior to 2017.

**Provision:** Under the provision, the credit for residential energy efficient property would be repealed. The provision would be effective for property placed in service after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$2.3 billion over 2014-2023.

**Sec. 1305. Repeal of credit for qualified electric vehicles.**

**Current law:** Under current law, a taxpayer could claim a 10-percent credit for the cost of a qualified plug-in electric-drive motor vehicle that is either a low-speed vehicle, motorcycle, or

three-wheeled vehicle prior to 2012. Two- or three-wheeled vehicles must have a battery capacity of at least 2.5 kilowatt-hours. Other vehicles must have a battery capacity of at least 4 kilowatt-hours. The maximum credit for such vehicles was \$2,500. The credit was available for vehicles acquired after February 17, 2009, and before January 1, 2012.

**Provision:** Under the provision, the credit for qualified electric vehicles would be repealed. The provision would be effective for vehicles acquired after 2011.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2013.

#### **Sec. 1306. Repeal of alternative motor vehicle credit.**

**Current law:** Under current law, a taxpayer may claim a credit for each new qualified fuel cell vehicle, hybrid vehicle, advanced lean burn technology vehicle, and alternative fuel vehicle placed in service by the taxpayer during the tax year. The credit amount varies depending upon the type of technology used, the weight class of the vehicle, the amount by which the vehicle exceeds certain fuel economy standards, and, for some vehicles, the estimated lifetime fuel savings. The credit generally is available for vehicles purchased after 2005, but terminates after 2009, 2010, or 2014, depending on the type of vehicle.

**Provision:** Under the provision, the credit for qualified fuel cell motor vehicles would be repealed. The provision would be effective for property purchased after 2014.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

#### **Sec. 1307. Repeal of alternative fuel vehicle refueling property credit.**

**Current law:** Under current law, a taxpayer may claim a 30-percent credit for the cost of installing qualified clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer. The credit may not exceed \$30,000 per tax year per location in the case of a trade or business, and \$1,000 per tax year per location in the case of a principal residence.

**Provision:** Under the provision, the alternative motor vehicle credit would be repealed. The provision would be effective for property placed in service after 2014.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

#### **Sec. 1308. Repeal of credit for new qualified plug-in electric drive motor vehicles.**

**Current law:** Under current law, a taxpayer may claim a credit for each qualified plug-in electric-drive motor vehicle placed in service. A qualified plug-in electric-drive motor vehicle is a motor vehicle that has at least four wheels, is manufactured for use on public roads, meets

certain emissions standards (except for certain heavy vehicles), draws propulsion using a traction battery with at least four kilowatt hours of capacity, and is capable of being recharged from an external source of electricity.

For plug-in electric drive vehicles acquired after 2009, the maximum credit is capped at \$7,500 regardless of vehicle weight. In addition, after that date, no credit is available for low speed plug-in vehicles or for plug-in vehicles weighing 14,000 pounds or more.

After 2009, the 250,000 total plug-in vehicle limitation is replaced with a 200,000 plug-in vehicles per manufacturer limitation. Under the new limitation, the credit phases out over four calendar quarters beginning in the second calendar quarter following the quarter in which the manufacturer limit is reached. A limited \$2,500 credit was available for certain 2- and 3-wheel vehicles through the end of 2013.

**Provision:** Under the provision, the credit for new qualified plug-in drive vehicles would be repealed. The provision would be effective for vehicles acquired after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$5.0 billion over 2014-2023.

#### **Sec. 1309. Repeal of credit for health insurance costs of eligible individuals.**

**Current law:** Under current law, certain individuals could claim a refundable health coverage tax credit (HCTC) equal to 72.5 percent of the cost of certain types of health coverage purchased prior to 2014. In general, the HCTC was available to individuals who received certain unemployment assistance due to trade-related events (i.e., Trade Adjustment Assistance), as well as individuals over age 55 who received pension benefits from the Pension Benefit Guaranty Corporation. The credit was available for certain employer-based insurance, State-based insurance and, in some cases, insurance purchased in the individual market. The credit expired for coverage months beginning after 2013.

**Provision:** Under the provision, the HCTC would be repealed. The provision would be effective for months beginning after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

#### **Sec. 1310. Repeal of first-time homebuyer credit.**

**Current law:** Under current law, a first-time homebuyer could claim a refundable tax credit of up to 10 percent of the purchase price of a principal residence in the United States for residences purchased on or after April 9, 2008, and before May 1, 2010 (or June 30, 2011, for taxpayers on qualified official extended duty outside of the United States). The credit amount was limited to \$8,000 (\$4,000 for married individuals filing a separate return). The credit phased out for taxpayers with MAGI of \$125,000 (\$225,000 for married taxpayers filing a joint return).

**Provision:** Under the provision, the first-time homebuyer credit would be repealed. The provision would be effective for residences purchased after June 30, 2011.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

## **Subtitle E – Deductions, Exclusions, and Certain Other Provisions**

Note: The JCT revenue estimate for the discussion draft reports only the combined, aggregate revenue effect of a number of separate provisions making changes to certain itemized deductions. The specific provisions for which JCT reports only this aggregate revenue effect are as follows:

- Sec. 1402. Mortgage interest;
- Sec. 1403. Charitable contributions;
- Sec. 1404. Denial of deduction for expenses attributable to the trade or business of being an employee;
- Sec. 1405. Repeal of deduction for taxes not paid or accrued in a trade or business;
- Sec. 1406. Repeal of deduction for personal casualty losses;
- Sec. 1408. Repeal of deduction for tax preparation expenses;
- Sec. 1409. Repeal of deduction for medical expenses;
- Sec. 1414. Repeal of 2-percent floor on miscellaneous itemized deductions; and
- Sec. 1415. Repeal of overall limitation on itemized deductions.

According to JCT, these provisions, taken together, would increase revenues by \$853.7 billion over 2014-2023, and reduce outlays by \$4.7 billion over 2014-2023.

### **Sec. 1401. Exclusion of gain from sale of a principal residence.**

**Current law:** Under current law, a taxpayer may exclude from gross income up to \$500,000 for joint filers (\$250,000 for other filers) of gain on the sale of a principal residence. The property generally must have been owned and used as the taxpayer's principal residence for two out of the previous five years. A taxpayer may only use this exclusion once every two years.

**Provision:** Under the provision, a taxpayer would have to own and use a home as the taxpayer's principal residence for five out of the previous eight years to qualify for the exclusion. In addition, the taxpayer would only be able to use the exclusion once every five years. The exclusion would be phased out by one dollar for every dollar by which a taxpayer's modified adjusted gross income (MAGI) exceeds \$500,000 (\$250,000 for single filers). The provision would be effective for sales and exchanges after 2014.

#### **Considerations:**

- The provision would continue to protect middle-class homeowners who either do not have the documentation to establish basis in their home or who have experienced gains as a result of inflation over a long period of ownership. Meanwhile, speculators and so-

called “flippers” in the housing market would not be rewarded for their activity with tax-exempt income.

- The provision’s “five-out-of-eight year” rule existed prior to 1978, when Congress decided to reduce the necessary holding period. This provision would merely restore the holding period requirement to what it was prior to 1978.

**JCT estimate:** According to JCT, the provision would increase revenues by \$15.8 billion over 2014-2023.

### **Sec. 1402. Mortgage interest.**

**Current law:** Under current law, a taxpayer may claim an itemized deduction for mortgage interest paid with respect to a principal residence and one other residence of the taxpayer. Itemizers may deduct interest payments on up to \$1 million in acquisition indebtedness (for acquiring, constructing, or substantially improving a residence), and up to \$100,000 in home equity indebtedness. Under the alternative minimum tax (AMT), however, the deduction for home equity indebtedness is disallowed.

Premiums paid before 2014 on a private mortgage insurance contract issued after 2006 for acquisition indebtedness are generally deductible as qualified residence interest, but this deduction phases out for taxpayers with adjusted gross income exceeding \$100,000.

In addition, the discharge of up to \$2 million in mortgage debt with respect to a principal residence was not subject to tax if the discharge occurred before 2014 and was on account of a decline in the value of the residence or the financial condition of the borrower.

**Provision:** Under the provision, a taxpayer may continue to claim an itemized deduction for interest on acquisition indebtedness, but the \$1 million limitation would be reduced to \$500,000 in four annual increments, so that the limitation would be \$875,000 for debt incurred in 2015, \$750,000 for debt incurred in 2016, \$625,000 for debt incurred in 2017, and \$500,000 for debt incurred thereafter. Similar to the current-law AMT rule, interest on home equity indebtedness incurred after the effective date would not be deductible. The provision would generally be effective for interest paid on debt incurred after 2014. In the case of refinancings of debt incurred prior to 2018, the refinanced debt generally would be treated as incurred on the same date that the original debt was incurred for purposes of determining the limitation amount applicable to the refinanced debt.

The provision also would require that information reporting for mortgage interest also include the mortgage origination date and the amount of the outstanding principal on the mortgage as of the beginning of the calendar year. The information reporting provision would be effective for returns and statements for calendar years after 2014.

**Considerations:**

- The provision would preserve a substantial tax benefit for homeownership without affecting most taxpayers, who either do not itemize their deductions or who live in moderately priced housing markets.
- Because of other changes in the discussion draft, far fewer taxpayers would choose to itemize overall, with the remaining 95 percent of taxpayers finding they are better off by taxing advantage of the larger, simpler standard deduction instead. And, for those taxpayers who would continue to itemize, no existing mortgage would be affected by this provision, and 95 percent of future mortgages are also expected to be unaffected.
- By reducing the current-law \$1 million limitation, the provision would more effectively promote homeownership, rather than also promoting leveraged purchases of larger homes than taxpayers otherwise would acquire without the tax benefit.
- The provision would phase in the reduced limitation and only apply to new debt to avoid disrupting the housing market, which more broadly will benefit from comprehensive, pro-growth tax reform. Indeed, historical data show that the strength of the nation's housing market is tied more closely to the health of the overall economy than to any specific tax policies that may be in place. The best way to promote a thriving housing market is to improve the overall economy, which is precisely what comprehensive tax reform is designed to achieve.
- By creating a stronger economy, the discussion draft as a whole is estimated – based on calculations using data provided by the independent, non-partisan Joint Committee on Taxation – to increase the rate of growth in home values by up to 40 percent.

**JCT estimate:** For information about JCT's revenue estimate for this provision, see the note immediately following the heading for Subtitle E of Title I in this document.

**Sec. 1403. Charitable contributions.**

**Current law:** Under current law, a taxpayer may claim an itemized deduction for charitable contributions. To be eligible, a contribution must be made by the last day of the tax year for which a return is filed. Thus, for a calendar year taxpayer, a contribution must be made on or before December 31 to be included on a tax return for that tax year, which must be filed by April 15 of the following year.

A charitable contribution deduction is limited to a certain percentage of the individual's adjusted gross income (AGI). The AGI limitation varies depending on the type of property contributed and the type of exempt organization receiving the property. In general, cash contributed to public charities, private operating foundations, and certain non-operating private foundations may be deducted up to 50 percent of the donor's AGI. Contributions that do not qualify for the 50-percent limitation (e.g., contributions to private foundations) may be deducted up to the lesser of (1) 30 percent of AGI, or (2) the excess of the 50-percent-of-AGI limitation for the tax year over the amount of charitable contributions subject to the 30-percent limitation.

Capital gain (i.e., appreciated) property contributed to public charities, private operating foundations, and certain non-operating private foundations may be deducted up to 30 percent of

AGI. Capital gain property contributed to non-operating private foundations may be deducted up to the lesser of (1) 20 percent of AGI, or (2) the excess of the 30-percent-of-AGI limitation over the amount of property subject to the 30-percent limitation for contributions of capital gain property. In general, qualified conservation contributions (e.g., conservation easements) are subject to the 30-percent limitation. Under a temporary provision, however, qualified conservation contributions made in tax years beginning before 2014 may be deducted up to 50 percent of AGI, or up to 100 percent of AGI in the case of property used in agriculture or livestock production.

If an individual contributes more than the applicable AGI limits, the excess contribution generally may be carried over and deducted in the following five tax years, or 15 years in the case of qualified conservation contributions.

In general, taxpayers may deduct the fair market value of a charitable contribution. A variety of complex rules under current law, however, limit the amount of a charitable deduction to less than fair market value (e.g., the taxpayer's adjusted basis) based on the type of property and charitable organization receiving the contribution.

In general, a charitable deduction is disallowed to the extent a taxpayer receives a benefit in return. A special rule, however, permits taxpayers to deduct as a charitable contribution 80 percent of the value of a contribution made to an educational institution to secure the right to purchase tickets for seating at an athletic event in a stadium at that institution.

In general, the value of a deduction for intellectual property is limited to the property's adjusted basis. Under current law, however, the donor is allowed an additional deduction equal to a percentage of the income generated by the intellectual property over the 12 years following the contribution, even though that income is likely earned by a tax-exempt entity.

**Provision:** Under the provision, numerous changes would be made to the rules applicable to charitable contributions, all of which, unless otherwise indicated, would be effective for tax years after 2014.

*Extension of time to file:* Under the provision, individual taxpayers would be permitted to deduct charitable contributions made after the close of the tax year but before the due date of the return (April 15 for calendar year taxpayers) for the tax year covered by the return.

*AGI limitations:* Under the provision, the AGI limitations on deductible contributions would be substantially simplified. First, the 50-percent limitation for cash contributions and the 30-percent limitation for contributions of capital gain property to public charities and certain private foundations would be harmonized at a single limit of 40 percent. Second, the 30-percent contribution limit for cash contributions and the 20-percent limitation for contributions of capital gain property that apply to organizations not covered by the current 50-percent limitation rule would be harmonized at a single limit of 25 percent. Thus, contributions to this latter group of organizations would be allowed to the extent they do not exceed the lesser of (1) 25 percent of AGI or (2) the excess of 40 percent of AGI for the tax year over the amount of charitable contributions subject to the 25-percent limitation.



*Two-percent floor:* Under the provision, an individual's charitable contributions could be deducted only to the extent they exceed 2 percent of the individual's AGI. The reduction would apply to charitable contributions in the following order: first, to contributions subject to the 25-percent of AGI limitation; second, to qualified conservation contributions; and third, to contributions subject to the 40-percent limitation.

*Value of deduction generally limited to adjusted basis:* Under the provision, the rules for determining the value of the deduction for contributions of property (e.g., fair market value or adjusted basis) would be substantially simplified. The amount of any charitable deduction generally would be equal to the adjusted basis of the contributed property. For the following types of property, however, the deduction would be based on the fair market value of the property less any ordinary gain that would have been realized if the property had been sold by the taxpayer at its fair market value:

- (1) tangible property related to the purpose of the donee exempt organization;
- (2) any qualified conservation contribution;
- (3) any qualified inventory contribution;
- (4) any qualified research property; and
- (5) publicly traded stock.

In addition, in the case of inventory contributed solely for the care of the ill, needy, or infants, the provision would preserve the current law rule that provides a higher valuation for the charitable deduction.

*Qualified conservation contributions:* Under the provision, the special, temporary rules for conservation easements, including the rules for farmers or ranchers, would be made permanent. The general rule would provide that deductions for conservation easements would be limited to 40 percent of AGI. Farmers and ranchers would still be allowed a charitable deduction up to 100 percent of AGI for property used in agricultural or livestock production. The provision also would clarify that no deduction is permitted for land reasonably expected to be used as a golf course. This portion of the provision would be effective for tax years after 2013.

*College athletic event seating rights:* Under the provision, the special rule that provides a charitable deduction of 80 percent of the amount paid for the right to purchase tickets for athletic events would be repealed.

*Income from intellectual property:* Under the provision, income from intellectual property contributed to a charitable organization would no longer be allowed as an additional contribution by the donor. The deduction for the contribution of the intellectual property would be retained.

### **Considerations:**

- Because a taxpayer must itemize to claim a charitable deduction, only about 25 percent of Americans benefit from the current charitable contribution rules. While other changes in the discussion draft would result in fewer taxpayers choosing to itemize overall – as the remaining 95 percent would take advantage of the larger, simpler standard deduction

instead – the changes to the charitable contribution rules would continue to provide significant tax incentives for those who would continue to itemize.

- The provision recognizes that Americans typically contribute to churches, community organizations and other public charities out of generosity, not for a tax benefit, which only higher income individuals generally claim under current law. The provision would continue to provide a tax incentive for individuals who want to make large contributions to public charities.
- Moreover, historical data show that the total amount of charitable giving is tied more closely to the health of the overall economy than to any specific tax policies that may be in place. The best way to promote charitable giving to the organizations doing so much good in communities across the country is to improve the overall economy, which is precisely what comprehensive tax reform is designed to achieve.
- As noted below, several aspects of the provision would encourage charitable giving in important ways, and by creating a stronger economy, the discussion draft as a whole is estimated – based on calculations using data provided by the independent, non-partisan Joint Committee on Taxation – to increase charitable giving by up to \$2.2 billion per year.
- Enabling individuals to take charitable deductions in a particular tax year through the due date for that return (typically April 15 of the following year) is expected to increase charitable giving, since many taxpayers will decide to give more generously at the time they are actually preparing and finalizing their returns.
- The provision also would continue to provide an incentive for contributions of conservation easements for the benefit of our communities and the environment.
- The provision would simplify the complex rules and limitations with respect to charitable contributions to make the tax law easier to understand and to help taxpayers better comply with the rules.

**JCT estimate:** For information about JCT’s revenue estimate for this provision, see the note immediately following the heading for Subtitle E of Title I in this document.

#### **Sec. 1404. Denial of deduction for expenses attributable to the trade or business of being an employee.**

**Current law:** Under current law, a taxpayer generally may claim a deduction for trade and business expenses, regardless of whether the taxpayer itemizes deductions or take the standard deduction. Taxpayers generally may claim expenses relating to the trade or business of being an employee only if they itemize deductions. Certain expenses attributable to the trade or business of being an employee, however, are allowed as above-the-line deductions, including reimbursed expenses included in the employee’s income, certain expenses of performing artists, certain expenses of State and local government officials, certain expenses of elementary and secondary school teachers (for tax years beginning after 2001 and before 2014), and certain expenses of members of reserve components of the United States military.

**Provision:** Under the provision, a taxpayer would not be allowed an itemized deduction for expenses attributable to the trade or business of performing services as an employee. In addition,

the only above-the-line deductions allowed for expenses attributable to the trade or business of being an employee would be those for reimbursed expenses and certain expenses of members of reserve components of the United States military. The provision would be effective for tax years beginning after 2014.

**Considerations:**

- In conjunction with an increased standard deduction and lower overall tax rates, the provision would simplify the tax laws for taxpayers who currently claim deductions for employee business expenses.
- Keeping records of these expenses is often very burdensome for taxpayers, and this current-law deduction also poses administrative and enforcement challenges for the IRS.

**JCT estimate:** For information about JCT's revenue estimate for this provision, see the note immediately following the heading for Subtitle E of Title I in this document.

**Sec. 1405. Repeal of deduction for taxes not paid or accrued in a trade or business.**

**Current law:** Under current law, an individual may claim an itemized deduction for State and local government income and property taxes paid. In lieu of the itemized deduction for State and local income taxes, individuals may claim, for tax years beginning before 2014, an itemized deduction for State and local government sales taxes.

**Provision:** Under the provision, individuals would only be allowed a deduction for State and local taxes paid or accrued in carrying on a trade or business or producing income. The provision would be effective for tax years beginning after December 31, 2014.

**Considerations:**

- In conjunction with an increased standard deduction and lower overall tax rates, the provision would simplify the tax laws for taxpayers who currently claim itemized deductions for non-business State and local taxes.
- The provision would eliminate a tax benefit that effectively subsidizes higher State and local taxes and increased spending at the State and local level.

**JCT estimate:** For information about JCT's revenue estimate for this provision, see the note immediately following the heading for Subtitle E of Title I in this document.

**Sec. 1406. Repeal of deduction for personal casualty losses.**

**Current law:** Under current law, an individual may claim an itemized deduction for personal casualty losses (i.e., losses not connected with a trade or business or entered into for profit), including property losses arising from fire, storm, shipwreck, or other casualty, or from theft.

**Provision:** Under the provision, the deduction for personal casualty losses would be repealed. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** For information about JCT's revenue estimate for this provision, see the note immediately following the heading for Subtitle E of Title I in this document.

**Sec. 1407. Limitation on wagering losses.**

**Current law:** Under current law, a taxpayer may claim an itemized deduction for losses from gambling, but only to the extent of gambling winnings. However, taxpayers may claim other deductions connected to gambling that are deductible regardless of gambling winnings.

**Provision:** Under the provision, all deductions for expenses incurred in carrying out wagering transactions (not just gambling losses) would be limited to the extent of wagering winnings. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

**Sec. 1408. Repeal of deduction for tax preparation expenses.**

**Current law:** Under current law, an individual may claim an itemized deduction for tax preparation expenses.

**Provision:** Under the provision, an individual would not be allowed an itemized deduction for tax preparation expenses. The provision would be effective for tax years beginning after 2014

**JCT estimate:** For information about JCT's revenue estimate for this provision, see the note immediately following the heading for Subtitle E of Title I in this document.

**Sec. 1409. Repeal of deduction for medical expenses.**

**Current law:** Under current law, a taxpayer may claim an itemized deduction for out-of-pocket medical expenses of the taxpayer, a spouse, or a dependent. This deduction is allowed only to the extent the expenses exceed 10 percent of the taxpayer's adjusted gross income.

**Provision:** Under the provision, the itemized deduction for medical expenses would be repealed. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** For information about JCT's revenue estimate for this provision, see the note immediately following the heading for Subtitle E of Title I in this document.

**Sec. 1410. Repeal of disqualification of expenses for over-the-counter drugs under certain accounts and arrangements.**

**Current law:** Under prior law, expenses incurred for over-the-counter medicine could constitute qualified medical expenses for purposes of receiving tax-favored reimbursements from Health Savings Accounts, Archer MSAs, and Health Flexible Spending Arrangements (“health accounts”). Pursuant to section 9003 of the Patient Protection and Affordable Care Act, however, taxpayers now may not receive tax-free disbursements from health accounts to pay for medicine other than prescription medication and insulin.

**Provision:** Under the provision, the prohibition on using tax-free funds from health accounts to pay for over-the-counter drugs would be repealed, and expenses for such medication could again constitute qualified medical expenses. The provision would be effective for expenses incurred after 2014.

**Considerations:**

- The provision would reinstate the prior-law treatment of over-the-counter drugs as qualified expenses for purposes of health accounts, repealing the prohibition on the use of tax-free funds from such accounts enacted in the Affordable Care Act (ACA).
- The provision recognizes that diseases and other physical ailments often can be cured, mitigated, treated, or prevented through the use of over-the-counter drugs, rather than prescription drugs. Moreover, because over-the-counter medicines are often less expensive treatment options, repealing the ACA prohibition could help reduce overall health care spending.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$3.3 billion over 2014-2023.

**Sec. 1411. Repeal of deduction for alimony payments and corresponding inclusion in gross income.**

**Current law:** Under current law, alimony payments generally are an-above-the line deduction for the payor and included in the income of the payee. However, alimony payments are not deductible by the payor or includible in the income of the payee if designated as such by the divorce decree or separation agreement.

**Provision:** Under the provision, alimony payments would not be deductible by the payor or includible in the income of the payee. The provision would be effective for any divorce decree or separation agreement executed after 2014 and to any modification after 2014 of any such instrument executed before such date if expressly provided for by such modification.

**Considerations:**

- The provision would eliminate what is effectively a “divorce subsidy” under current law, in that a divorced couple can often achieve a better tax result for payments between them than a married couple can.

- The provision recognizes that the provision of spousal support as a consequence of a divorce or separation should have the same tax treatment as the provision of spousal support within the context of a married couple, as well as the provision of child support.

**JCT estimate:** According to JCT, the provision would increase revenues by \$5.5 billion over 2014-2023.

### **Sec. 1412. Repeal of deduction for moving expenses.**

**Current law:** Under current law, a taxpayer may claim a deduction for moving expenses incurred in connection with starting a new job, regardless of whether or not the taxpayer itemizes his deductions. To qualify, the new workplace generally must be at least 50 miles farther from the former residence than the former place of work or, if the taxpayer had no former workplace, at least 50 miles from the former residence.

**Provision:** Under the provision, the deduction for moving expenses would be repealed. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$8.0 billion over 2014-2023.

### **Sec. 1413. Termination of deduction and exclusions for contributions to medical savings accounts.**

**Current law:** Under current law, an individual may claim an above-the-line deduction for contributions to an Archer Medical Savings Account (MSA) and exclude from income employer contributions to an MSA. In general, Archer MSAs may be set up by an individual working for a small employer and who participates in the employer's high-deductible health plan. The total amount of monthly contributions to an Archer MSA may not exceed one-twelfth of 65 percent of the annual deductible for an individual with a self-only plan and one-twelfth of 75 percent of the annual deductible for an individual with family coverage. Distributions from the accounts used to pay qualified medical expenses are not taxable. Archer MSAs may not be established after 2005. Archer MSA balances may be rolled over on a tax-free basis to another Archer MSA or to a Health Savings Account (HSA).

**Provision:** Under the provision, no deduction would be allowed for contributions to an Archer MSA, and employer contributions to an Archer MSA would not be excluded from income. Existing Archer MSA balances, however, could continue to be rolled over on a tax-free basis to an HSA. The provision would be effective for tax years beginning after 2014.

#### **Considerations:**

- There is no manner in which Archer MSAs are more favorable than HSAs; thus, no taxpayer would see his ability to save for future health costs restricted.

- As a result, the provision merely simplifies the Code by consolidating two similar tax-favored accounts into a single account with more taxpayer-friendly rules (i.e., HSAs).

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

#### **Sec. 1414. Repeal of 2-percent floor on miscellaneous itemized deductions.**

**Current law:** Under current law, “miscellaneous” itemized deductions may only be claimed to the extent such deductions in the aggregate exceed 2 percent of adjusted gross income. The floor applies to all itemized deductions except for those relating to interest, taxes, casualty or theft losses, wagering losses, charitable contributions, medical expenses, impairment-related work expenses, the estate tax for income in respect of a decedent, personal property used in a short sale, computation of tax where the taxpayer restores a substantial amount held under claim of right, annuity payments that cease before the investment is recovered, amortizable bond premium, and cooperative housing corporations. The floor applies after the application of any other limits on such deductions.

**Provision:** Under the provision, the 2-percent floor on miscellaneous itemized deductions would be repealed. The provision would be effective for tax years after 2014.

**JCT estimate:** For information about JCT’s revenue estimate for this provision, see the note immediately following the heading for Subtitle E of Title I in this document.

#### **Sec. 1415. Repeal of overall limitation on itemized deductions.**

**Current law:** Under current law, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is limited for certain upper-income taxpayers (sometimes referred to as the “Pease limitation”). This limitation applies on top of any other limitations applicable to such deductions. Under the Pease limitation, the otherwise allowable total amount of itemized deductions is reduced by 3 percent of the amount by which the taxpayer’s adjusted gross income exceeds a threshold amount. For 2013, the threshold amount is (1) \$250,000 for single individuals, (2) \$300,000 for married couples filing joint returns and surviving spouses, (3) \$275,000 for heads of households, and (4) \$150,000 for married individuals filing a separate return. These amounts are indexed for inflation for tax years beginning after 2013. The Pease limitation does not reduce itemized deductions by more than 80 percent.

**Provision:** Under the provision, the overall limitation on itemized deductions would be repealed. The provision would be effective for tax years after 2014.

**Consideration:** The Pease limitation functions as a hidden increase in the top marginal rate for individuals – about 1.2 percent – and adds significant complexity.

**JCT estimate:** For information about JCT's revenue estimate for this provision, see the note immediately following the heading for Subtitle E of Title I in this document.

**Sec. 1416. Deduction for amortizable bond premium allowed in determining adjusted gross income.**

**Current law:** Under current law, the holder of a taxable debt instrument purchased at a premium (i.e., on which the holder paid more for the instrument than the principal payable at maturity) may amortize and deduct the premium over the term of the bond. However, bond premium amortization deductions may only be claimed as itemized deductions (although the deductions are not subject to the 2-percent floor generally applicable to itemized deductions).

**Provision:** Under the provision, bond premium amortization deductions would be allowed as above-the-line deductions (i.e., without regard to whether a taxpayer itemizes deductions). The provision would apply for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by less than \$50 million over 2014-2023.

**Sec. 1417. Repeal of exclusion, etc., for employee achievement awards.**

**Current law:** Under current law, employee achievement awards are excluded from employees' income. To qualify for the tax exclusion, an employee achievement award must be given in recognition of the employee's length of service or safety achievement at a ceremony that is a meaningful presentation. Furthermore, the conditions and circumstances cannot suggest a significant likelihood of the payment of disguised compensation. The employee is taxed to the extent that the cost (or value, if greater) of the award exceeds the employer's deduction for the award. The employer's deduction for employee achievement awards for any employee in any year cannot exceed \$1,600 for qualified plan awards, and \$400 otherwise. A qualified plan award is an employee achievement award that is part of an established written program of the employer, which does not discriminate in favor of highly compensated employees. In addition, the average award (not counting those of nominal value) may not exceed \$400.

**Provision:** The provision would repeal the exclusion for employee achievement awards, so that such awards would constitute taxable compensation to the recipient. The provision also would repeal the restrictions on employer deductions for such awards. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$3.4 billion over 2014-2023.



### **Sec. 1418. Clarification of special rule for certain governmental plans.**

**Current law:** Under current law, amounts received as reimbursement of medical expenses under an employer-provided accident or health insurance plan generally are excluded from an employee's gross income. An accident or health insurance plan, however, is disqualified if the plan permits amounts to be paid as medical benefits to a designated beneficiary, other than the employee's spouse or dependents. In such a case, all amounts paid as medical expense reimbursement are includible in the employee's gross income.

Similar rules apply to a governmental accident or health plan that is funded by a medical trust established in connection with a public retirement system and that either has been authorized by a State legislature or received a favorable IRS ruling providing that the trust's income is tax-exempt under Code section 115, which generally exempts States and municipalities from Federal income tax. A special rule provides that such a governmental accident or health plan will not be disqualified (and amounts paid as medical benefits will be excluded from the employee's gross income) if the plan permitted the payment of medical benefits to a deceased participant's beneficiaries (including non-spousal and non-dependent beneficiaries) on or before January 1, 2008. This special rule does not affect the tax treatment of amounts received by the beneficiary, which continue to be taxable. The special rule does not apply to accident or health plans of certain State or political subdivisions, including plans organized as voluntary employees' beneficiary associations (VEBAs) that are exempt from tax under Code section 501(c)(9).

**Provision:** Under the provision, the special rule would be extended to accident or health plans established in connection with a public retirement system or established by or on behalf of a State or political subdivision that either has been authorized by a State legislature or received a favorable ruling from the IRS that the trust's income is not includible in gross income under either Code section 115 or section 501(c)(9), and that on or before January 1, 2008, provided for payment of medical benefits to a deceased participant's beneficiary. The provision would be effective for payments after the date of enactment.

**JCT estimate:** According to JCT, the provision would reduce revenues by less than \$50 million over 2014-2023.

### **Sec. 1419. Limitation on exclusion for employer-provided housing.**

**Current law:** Under current law, housing and meals provided to an employee and the employee's spouse or dependents for the convenience of the employer are excluded from income if the meals are on the business premises of the employer and the employee is required to accept lodging on the premises of the employer as a condition of employment. In the case of educational institutions, the value of housing provided to their employees also is excluded to the extent the rent paid by the employee is at least the lesser of 5 percent of the lodging's appraised value or the average of the rent paid by individuals (other than employees or students of the educational institution) for comparable lodging provided by the educational institution.

**Provision:** Under the provision, the exclusion for housing provided for the convenience of the employer and for employees of educational institutions would be limited to \$50,000 (\$25,000 for a married individual filing a joint return). The exclusion also would be limited to one residence. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

### **Sec. 1420. Fringe benefits.**

**Current law:** Under current law, various fringe benefits provided by employers to employees are not included in employee income, including no-additional cost services and qualified transportation fringes. No-additional cost services include free air transportation to an employee, retired employee, or dependent, spouse or parent of an employee or retired employee, or widowed spouse of a deceased employee.

A qualified transportation fringe includes, for 2014, up to \$250 per month for qualified parking and up to \$130 for any transit pass provided by an employer to employees (with these amounts adjusted for inflation). The qualified transportation fringe also includes qualified bicycle commuting reimbursement of up to \$20 per month.

**Provision:** The provision would repeal the exclusion from income for air transportation provided as a no-additional cost service to the parent of an employee. For the qualified transportation fringe benefit, the provision would set the qualified transportation fringe excludable qualified parking amount at \$250 per month, and the excludable transit pass amount at \$130 per month. These amounts would no longer be adjusted for inflation. The provision would repeal the qualified bicycle commuting reimbursement. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$39.0 billion over 2014-2023.

### **Sec. 1421. Repeal of exclusion of net unrealized appreciation in employer securities.**

**Current law:** Under current law, distributions from tax-deferred retirement plans generally are subject to tax, including the value of any securities distributed. In the case of a lump-sum distribution of employer securities, however, any net unrealized appreciation in the securities is excluded from income, unless the individual elects to forgo the exclusion. A distributee's basis in distributed employer securities is the securities' fair market value, less the unrealized appreciation excluded from gross income, thus preserving any capital gain if the securities are later sold.

Employer securities include the securities issued by the employer or a parent or subsidiary of the employer. The “net unrealized appreciation” is the excess of the fair market value of the employer securities over the retirement plan’s cost of acquiring them.

**Provision:** Under the provision, the exclusion for net unrealized appreciation in distributed employer securities would be repealed. The distributee generally would have income in the amount of the value of the distributed securities. The provision would be effective for distributions after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.9 billion over 2014-2023.

### **Sec. 1422. Consistent basis reporting between estate and person acquiring property from decedent.**

**Current law:** Under current law, the basis of property acquired by a beneficiary from a decedent generally is the fair market value of the property on the date of the decedent’s death. Similarly, property included in a decedent’s gross estate for estate tax purposes generally also must be the fair market value on the date of death. However, while both provisions generally require that fair market value on the date of death be used, there is no requirement that the valuations be the same.

**Provision:** Under the provision, the basis of property acquired from a decedent may not exceed the fair market value of property as reported for estate for tax purposes. This provision would apply to property if inclusion of the property in the decedent’s estate results in additional estate tax liability or if an executor is required to file an estate tax return. The estate would be required to report the value of the property to the IRS and to the beneficiary receiving the property, and the estate would be subject to a penalty for failure to file such an information return. Any underpayment of tax due to the understatement of basis under this provision would be subject to a 20-percent accuracy-related penalty. The provision would be effective for transfers for which an estate tax return is filed after the date of enactment.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.6 billion over 2014-2023.

## **Subtitle F – Employment Tax Modifications**

### **Sec. 1501. Modifications of deduction for Social Security taxes in computing net earnings from self-employment.**

**Current law:** Under current law, a tax is imposed under the Self-Employment Contributions Act (SECA) on the self-employment income of an individual to help finance the Social Security and Medicare trust funds. Under the Social Security component, the rate of tax is 12.4 percent of the first \$117,000 (for 2014) of self-employment income, which is indexed for inflation. Under

the Medicare component, the rate is 2.9 percent, and the amount of self-employment income subject to the Medicare component is not capped. An additional 0.9-percent tax applies for individuals with self-employment income in excess of \$200,000 (single filers) or \$250,000 (married couples).

Under current law, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes. This deduction reflects the fact that under the Federal Insurance Contributions Act (FICA), a similar tax is imposed on an employee's wages, with the liability to pay the tax divided evenly between employer and employee. The deduction is intended to provide parity between FICA and SECA taxes because an employer may deduct, as a business expense, its share of FICA taxes paid. The SECA deduction, however, is larger than the amount needed to make SECA taxes the economic equivalent of FICA taxes because the calculation does not properly reflect the fact that net earnings from self-employment are inclusive of SECA taxes. In addition, the calculation does not take into account the fact that wages above the Social Security wage base (i.e., \$117,000 for 2014) are subject to tax only at the hospital insurance rate of 2.9 percent.

**Provision:** Under the provision, the deduction with respect to net earnings from self-employment would be modified to make SECA taxes economically equivalent to FICA taxes. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$5.1 billion over 2014-2023.

### **Sec. 1502. Determination of net earnings from self-employment.**

**Current law:** Under current law, for SECA tax purposes, net earnings from self-employment – upon which the calculation of self-employment income and the SECA tax are based – means the gross income derived by an individual from any trade or business carried on by the individual, less the allowable deductions. Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or losses from the sale or exchange of a capital asset, and certain other property.

Application of the SECA tax can depend on the form of business entity through which the taxpayer operates. For an individual who is a general partner in a partnership, net earnings from self-employment generally include the partner's distributive share of income or loss from any trade or business carried on by the partnership (excluding specified types of income described above). A limited partner's distributive share of partnership income or loss, however, is excluded from SECA. This exclusion does not apply to guaranteed payments for services actually rendered by the limited partner. The IRS takes the position that owners of a limited liability company, which is taxed as a partnership, are treated as general partners for SECA tax purposes.

In contrast, an S corporation shareholder who is an employee of the S corporation is subject to FICA taxes on wages, but is not subject to SECA on S corporation distributions. The question of

how much of the shareholder's distributive share should constitute wages turns on the definition of reasonable compensation, which has been the subject of much controversy and case law.

**Provision:** Under the provision, the SECA tax would be clarified to apply to general and limited partners of a partnership (including limited liability companies) as well as to shareholders of an S corporation to the extent of their distributive share of the entity's income or loss (subject to the exclusions for certain types of income described above under current law). In determining net earnings from self-employment, partners and S corporation shareholders would be allowed a new deduction designed to approximate the return on invested capital. The effect of the deduction would be that partners and S corporation shareholders who materially participate in the trade or business of the partnership or S corporation would treat 70 percent of their combined compensation and distributive share of the entity's income as net earnings from self-employment (and thus subject to FICA or SECA, as applicable) and the remaining 30 percent as earnings on invested capital not subject to SECA. For partners and S corporation shareholders who do not materially participate in the trade or business (i.e., passive investors), the effect of the deduction would be that no amount would be treated as net earnings from self-employment. The provision would be effective for tax years beginning after 2014.

**Considerations:**

- Under current law, self-employment taxes are not applied consistently to owners of different types of business entities. An S corporation shareholder, a general partner, and a limited partner are all subject to different rules. Additionally, many LLC owners take the position that they are limited partners and exempted from SECA when they are more properly treated as general partners who are subject to SECA. The disparate application of SECA leads to confusion, poor compliance, and significant opportunities for abuse of the rules, all of which result in similarly situated business owners being treated in substantially different ways. The provision creates a straightforward rule that treats all owners of pass-through businesses equally.
- The provision's distinction between net earnings from self-employment and other income not subject to SECA reflects the fact that over the last several decades, the portion of Gross Domestic Product (GDP) attributable to labor has remained remarkably constant at approximately 70 percent, while the portion of GDP attributable to capital has held steady at roughly 30 percent. The 30-percent deduction recognizes that a portion of the distributive share of a partnership, LLC or S corporation represents earnings on invested capital.
- The material participation standard is a familiar standard that has been used to enforce the passive loss rules since their enactment in 1986.

**JCT estimate:** According to JCT, the provision would increase revenues by \$15.3 billion over 2014-2023.

**Sec. 1503. Repeal of exemption from FICA taxes for certain foreign workers.**

**Current law:** Under current law, certain foreign workers from the Bahamas, Jamaica, and the other British West Indies (or any possession of such country) are exempt from the FICA tax

provided they are lawfully admitted to the United States on a temporary basis to perform agricultural services. A similar exemption applies to certain foreign students and their families present in the United States on a temporary basis for educational purposes and to foreign participants in international cultural exchange programs in the United States.

**Provision:** Under the provision, the exceptions for foreign agricultural workers, foreign students, and foreign participants in international cultural exchange programs would be repealed. Thus, earnings by such foreign individuals while in the United States would be subject to FICA on the same basis as other employees in the United States. The provision would be effective for remuneration received for services performed after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$7.7 billion over 2014-2023.

#### **Sec. 1504. Repeal of exemption from FICA taxes for certain students.**

**Current law:** Under current law, an exemption from FICA is provided in the case of certain services performed by a student employed by a school, college, or university, provided that the student is enrolled and regularly attending classes at the school, college, or university. The exception also applies to students who perform certain domestic services in a college club, fraternity or sorority.

**Provision:** Under the provision, the FICA exception for students would be limited to the student's earnings that are less than the amount needed to receive a quarter of Social Security coverage for the year (\$1,200 for 2014). The provision would be effective for remuneration received for services performed after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$13.0 billion over 2014-2023.

#### **Sec. 1505. Override of Treasury guidance providing that certain employer-provided supplemental unemployment benefits are not subject to employment taxes.**

**Current law:** Under current law, certain supplemental unemployment benefit payments (e.g., severance pay) are treated as wages for purposes of income tax withholding. The IRS has issued administrative guidance concluding that severance pay meeting certain requirements is exempt from payroll tax withholding under the Federal Insurance Contribution Act (FICA), Federal Unemployment Tax Act (FUTA), and the Railroad Retirement Tax Act (RRTA). The courts have issued conflicting rulings concerning the extent to which severance benefit payments not covered by the IRS administrative guidance are similarly exempt from withholding under FICA, FUTA, and RRTA.

**Provision:** Under the provision, the IRS guidance exempting certain supplemental unemployment benefit payments from payroll tax withholding would be overridden and the

general tax treatment of severance benefit payments would be clarified, so that all such payments would be subject to income and payroll taxes (i.e., FICA, FUTA and RRTA). The provision would be effective for amounts paid after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.9 billion over 2014-2023.

### **Sec. 1506. Certified professional employer organizations.**

**Current law:** Under current law, employers are responsible for withholding and payment of certain employment taxes with respect to their employees. In some cases, employers contract with professional employer organizations (PEOs) for human-resource services, such as managing employee payroll and employment taxes. Despite such arrangements, the contractual agreement between the employer and the PEO does not release the employer from responsibility for all taxes due with respect to its employees if the PEO fails to withhold or remit the taxes or otherwise comply with related reporting requirements.

**Provision:** Under the provision, if an employer becomes a customer of a certified PEO under a contract for employment-tax services with respect to the customer's work site employees, the certified PEO, and not the customer, would be treated as the employer of such work site employees for Federal employment tax purposes. Thus, the customer would be released from liability for employment taxes. To qualify, at least 85 percent of individuals performing services for the customer at the work site (subject to exceptions for certain workers, such as temporary or part-time workers) would have to be covered by a PEO services contract. The services contract would be required to provide that the certified PEO is responsible for wages, employee benefits (if any), and employment taxes regardless of whether the customer pays the certified PEO for such services.

For a PEO to be certified by the IRS, the business must satisfy various requirements intended to ensure that the PEO properly remits wages and employment taxes. Under these requirements, the PEO must satisfy applicable reporting obligations, submit audited financial statements and quarterly auditing reports, and post a bond against the PEO's failure to satisfy its employment tax withholding and payment obligations. The bond would be posted on April 1 and be equal to the greater of 5 percent of employment taxes for the previous calendar year (but not to exceed \$1 million) or \$50,000. A special rule would reduce the bond to \$50,000 during the first three years of a PEO's operations, provided the PEO's employment tax liability for the calendar year does not exceed \$5 million. The provision would apply only for purposes of employment taxes under Chapter 25 of the Code and would not create any inference with respect to who is an employee or employer for any other provision of law.

The provision would be effective for wages for services performed on or after January 1 of the first calendar year beginning more than 12 months after date of enactment (e.g., January 1, 2016, assuming the date of enactment is during calendar year 2014), and the IRS would be required to establish the PEO certification program no later than six months prior to such date.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

## **Subtitle G – Pensions and Retirement**

### **Part 1 – Individual Retirement Plans**

#### **Secs. 1601-1603. Elimination of income limits on contributions to Roth IRAs; No new contributions to traditional IRAs; Inflation adjustment for Roth IRA contributions.**

**Current law:** Under current law, taxpayers may contribute to traditional Individual Retirement Accounts (IRAs) up to \$5,500 for 2014, with an additional \$1,000 catch-up contribution permitted for those at least 50 years old. These contribution limits are indexed for inflation. Contributions to a traditional IRA are deductible, earnings are not taxed currently, and distributions are included in income. Taxpayers may also make non-deductible IRA contributions with after-tax dollars, and earnings on amounts invested in the IRA are not currently taxed, but distributions (less previously taxed contributions) are subject to tax. Additionally, taxpayers may contribute up to the same limits to Roth IRAs but with after-tax contributions. Earnings and distributions from Roth IRAs are excluded from income. The \$5,500 and \$1,000 annual limits apply in the aggregate to the three types of IRAs.

Taxpayers covered by employer-sponsored retirement plans may not contribute to a traditional IRA if they are married filing separately, or if they exceed certain income levels. In 2014, the phase-out range for participation in a traditional IRA is \$60,000 to \$70,000 for singles and heads of households, \$96,000 to \$116,000 for joint returns for a spouse who is covered by an employer-sponsored plan, and \$181,000 to \$191,000 for the spouse who is not covered. Taxpayers not covered by an employer-sponsored plan may contribute to a traditional IRA regardless of income. There are no income limits on eligibility to contribute to non-deductible traditional IRAs. For Roth IRAs, eligibility does not depend on participation in an employer plan, but the contribution limit phases out over a range of \$114,000 to \$129,000 for singles and \$181,000 to \$191,000 for joint returns.) These amounts are indexed for inflation.

**Provision:** Under the provisions, the income eligibility limits for contributing to Roth IRAs would be eliminated and new contributions to traditional IRAs and non-deductible traditional IRAs would be prohibited. The inflation adjustment of the annual limit on Roth IRA contributions also would be suspended until tax year 2024, at which time inflation indexing would recommence based off of the frozen level. The provisions would be effective for tax years beginning after 2014.

#### **Considerations:**

- These provisions would help Americans achieve greater retirement security by effectively increasing the amounts they have available at retirement. Most people saving in traditional IRAs do not consider the taxes that will be due upon distribution, and mistakenly assume that their entire account balance will be available to them upon



retirement. In contrast, the entire balance in a Roth account is distributed free of tax and is available for retirement needs.

- These provisions would help Americans save for retirement by simplifying their options. The multitude of types of IRAs, with their different income limits and other varying requirements (such as minimum distribution rules), results in many Americans simply not saving because of the complexity. Streamlining the choices would encourage more Americans to save.
- When interest rates are relatively low, as they have been for the last several years, freezing the inflation adjustment would have little or no effect on the annual Roth IRA contribution limitations. For example, the maximum Roth IRA contribution of \$5,500 is the same for 2013 and 2014.

**JCT estimate:** According to JCT, the provisions would increase revenues by \$14.8 billion over 2014-2023, and would reduce outlays by \$1.9 billion over 2014-2023.

#### **Sec. 1604. Repeal of special rule permitting recharacterization of Roth IRA contributions as traditional IRA contributions.**

**Current law:** Under current law, an individual may re-characterize a contribution to a traditional IRA as a contribution to a Roth IRA (and vice versa). An individual may also re-characterize a conversion of a traditional IRA to a Roth IRA. The deadline for re-characterization generally is October 15 of the year following the contribution or conversion. When a re-characterization occurs, the individual is treated for tax purposes as having made the original contribution to the second account or not having made the conversion. The re-characterization must include any net earnings related to the contribution.

**Provision:** Under the provision, the rule allowing re-characterization of Roth IRA contributions or conversions would be repealed. Note that under other provisions of the discussion draft, no new contributions to traditional IRAs would be permitted. The provision would be effective for tax years beginning after 2014.

**Consideration:** This provision would prevent a taxpayer from gaming the system by converting to a Roth IRA, investing in an extremely aggressive fashion and benefiting from any gains (which are never subject to tax), but retroactively reversing the conversion if the taxpayer suffers a loss to avoid taxes on some or all of the converted amount.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.4 billion over 2014-2023.

#### **Sec. 1605. Repeal of exception to 10-percent penalty for first home purchases.**

**Current law:** Under current law, an additional 10-percent tax generally is imposed on distributions from retirement plans and Individual Retirement Accounts (IRAs) occurring before the account holder reaches age 59½. This 10-percent tax is in addition to any income tax that

may be due on the distribution. There are several exceptions to the early withdrawal penalty, including early distributions of up to \$10,000 to pay for first-time homebuyer expenses.

**Provision:** Under the provision, the exception to the additional 10-percent tax for early distributions used to pay for first-time homebuyer expenses would be repealed. The provision would be effective for distributions after 2014.

**Consideration:** The provision would help Americans achieve greater retirement security by encouraging taxpayers not to make withdrawals from their accounts before retirement.

**JCT estimate:** According to JCT, the provision, along with section 1210 of the discussion draft, would increase revenues by \$0.3 billion over 2014-2023.

## **Part 2 – Employer-Provided Plans**

### **Secs. 1611-1612. Termination for new SEPs; Termination for new SIMPLE 401(k)s.**

**Current law:** Under current law, certain employers may offer a Simplified Employee Pension (SEP) IRA, which generally may only accept employer contributions. (Certain grandfathered SEPs, called SARSEPs, also may accept employee contributions.) The maximum contribution to a SEP is the lesser of the overall limit for contributions to a defined-contribution plan (\$52,000 for 2014, indexed for inflation) or 25 percent of the employee's compensation. Employers must make contributions on behalf of all employees, which generally must be the same percentage of compensation for all employees.

For employers with no more than 100 employees, the Savings Incentive Match Plan for Employees (SIMPLE) option allows sponsoring employers to set up a SIMPLE 401(k) plan or a SIMPLE IRA. Under the SIMPLE 401(k) plan, the employer generally may satisfy the nondiscrimination rules by matching contributions up to 2 percent of compensation or non-elective contributions equal to 3 percent of compensation. A SIMPLE 401(k) must allow each eligible employee to participate through salary reduction contributions equal to a specified percentage of compensation up to \$12,000 for 2014 (indexed for inflation). Individuals who are at least 50 years old may contribute annually up to another \$2,500 (indexed for inflation). Under the SIMPLE IRA, sponsoring employers generally must follow similar contribution requirements, and the employee contribution annual limits are the same, but with individual IRA accounts established for the participating employees.

**Provision:** Under the provisions, employers would not be permitted to establish new SEPs or SIMPLE 401(k) plans after 2014. Employers would be permitted to continue making contributions to existing SEPs and SIMPLE 401(k) plans. SIMPLE IRAs would continue to be available. The SEP provision would be effective for tax years beginning after 2014, and the SIMPLE 401(k) provision would be effective for plan years beginning after 2014.

**Considerations:**

- The multitude of confusing plans and accounts from which employers must choose if they want to set up a tax-qualified plan to help employees save for retirement serves to dissuade many employers from establishing any workplace retirement plan.
- Today, SIMPLE IRAs and 401(k) plans are the most popular defined-contribution options selected by businesses starting new retirement plans. SEPs and SIMPLE 401(k) plans lack many of the flexibilities of these other plan options and are not as commonly selected.
- The provision reduces the complexity of choices facing employers looking to start a retirement plan, encouraging employers to make a workplace retirement plan available to more Americans.

**JCT estimate:** According to JCT, the provisions would increase revenues by \$0.6 billion over 2014-2023.

**Sec. 1613. Rules related to designated Roth contributions.**

**Current law:** Under current law, 401(k) plans may offer either traditional accounts alone or both traditional and Roth accounts. Contributions to a traditional 401(k) account are not included in the employee's income and earnings are not currently taxed, while distributions are treated as taxable income. Contributions to a 401(k) Roth account are made out of the employee's after-tax income. Earnings in a Roth account are not taxable currently, and distributions generally are not taxable if the employee meets certain holding period and age requirements. If a 401(k) plan has a Roth option, the employee (but not the employer) may contribute to the Roth account, the traditional account, or both. Employer contributions to a 401(k) plan for employees with Roth accounts must be made into separate traditional accounts for the employee for whom the contribution is made. For these purposes, 403(b) plans and 457(b) plans are treated like 401(k) plans.

**Provision:** Under the provision, employees would generally be able to contribute up to half the maximum annual elective deferral amount (including catch-up contributions for employees at least 50 years old, if applicable) into a traditional account. (For 2014, the maximum annual elective deferral amount is \$17,500, and the maximum catch-up amount is \$5,500 (for a total of \$23,000 for such employees)). Any contributions in excess of half of these limits – \$8,750 and \$11,500, respectively – would be to a Roth account. Employees could contribute up to the entire annual elective deferral amount into a Roth account if they wish. Plans would generally be required to offer Roth accounts. Employer contributions would continue to be made to traditional accounts.

The provision would not apply to employers with 100 or fewer employees. In addition, employers may choose to have Roth accounts in a SIMPLE IRA, and if an employer with a SIMPLE IRA elects to limit traditional employee contributions to half the annual contribution limits, the employee contribution limits to such SIMPLE IRA would be increased to the contribution limits for a 401(k) plan. For purposes of this provision, 403(b) plans and 457(b) plans would be treated like 401(k) plans. The provision would generally be effective for plan

years and tax years beginning after 2014. The SIMPLE IRA portion of the provision would be effective for tax years and calendar years beginning after 2014.

**Considerations:**

- The provision would help Americans achieve greater retirement security by effectively increasing the amounts they have available at retirement. Many people saving in traditional 401(k) plans do not consider the taxes that will be due upon distribution, and assume that their entire account balance will be available to them upon retirement. In contrast, the entire balance in a Roth account is distributed free of tax, and is available for retirement needs.
- Only approximately 17 percent of those making contributions to 401(k) plans in a given year contribute more than 50 percent of the maximum amount and thus would be affected by the provision. This amounts to only approximately 5 percent of the civilian workforce.

**JCT estimate:** According to JCT, the provision would increase revenues by \$143.7 billion over 2014-2023.

**Sec. 1614. Modifications of required distribution rules for pension plans.**

**Current law:** Under current law, owners of traditional IRAs and employees in employer-sponsored retirement plans (both defined contribution and defined benefit plans) are subject to required minimum distribution (RMD) rules, which generally require the IRA owner (other than Roth IRAs) or employee (if he has retired, except for a 5-percent owner) to take minimum distributions beginning at age 70½ or pay a 50-percent excise tax on the amount of such distributions. Special rules apply when the IRA owner (including a Roth IRA owner) or employee dies before the entire account balance has been withdrawn. If the death occurs on or after the required beginning date for RMDs, the remaining amount must be distributed to the beneficiaries at least as rapidly as distributed to the decedent as of the date of death (but over the life expectancy of any designated beneficiary, if longer). Absent a designated beneficiary, the distribution period is the remaining life expectancy of the IRA owner or employee at the time of death. If an IRA owner or employee dies before the required beginning date and any part of the benefit is payable to a designated beneficiary, distributions generally must begin within one year of death and are spread over the life expectancy of the designated beneficiary. If the IRA owner or employee dies before the required beginning date and there is no designated beneficiary, the entire remaining account balance generally must be distributed to the estate by the end of the fifth year following the death.

**Provision:** Under the provision, if an employee becomes a 5-percent owner after age 70½ but before retiring, the required beginning date for RMDs would be April 1 of the following year. With respect to IRAs and employer-sponsored retirement plans that exist when the IRA owner or employee dies distributions would be required within five years (regardless of whether the IRA owner or employee dies before or after RMDs have begun). An exception would apply if the beneficiary is a spouse, is disabled, chronically ill, not more than 10 years younger than the deceased, or is a child, and would permits distributions to begin within one year of death and be

spread over the life expectancy of the beneficiary. However, if that beneficiary dies or a child beneficiary turns 21, the general five-year-distribution rule would apply upon such occurrence.

The provision regarding RMDs after the death of an IRA owner or employee generally would be effective for distributions with respect to IRA owners or employees who die after 2014. The provisions would not apply to certain qualified annuities that are binding annuity contracts in effect on the date of enactment and at all times thereafter. The provision changing RMDs for 5-percent owners generally would become effective for employees becoming 5-percent owners with respect to plan years ending in calendar years beginning before, on, or after the date of enactment – except that the provision would not result in a required beginning date earlier than April 1, 2015.

**Considerations:**

- The provision would simplify the current complex required minimum distribution rules and reduce the compliance burdens on seniors and beneficiaries of IRAs and other retirement plans.
- The provision would also address the issue in current law that permits deferral of tax on retirement savings not only until the account owner's retirement, but also well past the owner's life if the beneficiary chooses to spread the RMDs over his life expectancy.
- The provision also safeguards the ability of individuals to provide resources for spouses, minor children, and others with special needs through beneficiary designations on retirement accounts.
- The modifications in the provision would not affect the ability or incentive for Americans to save for retirement.

**JCT estimate:** According to JCT, the provision would increase revenues by \$3.5 billion over 2014-2023.

**Sec. 1615. Reduction in minimum age for allowable in-service distributions.**

**Current law:** Under current law, defined-contribution plans generally are not permitted to allow in-service distributions (i.e., distributions while an employee is still working for the employer) attributable to tax-deferred contributions if the employee is less than 59½ years old. For State and local government defined-contribution plans, and for all defined-benefit plans, the restriction on in-service distributions applies if the employee is less than age 62.

**Provision:** Under the provision, all defined-benefit plans as well as State and local government defined-contribution plans would be permitted to make in-service distributions beginning at age 59½. The provision would be effective for distributions made after 2014.

**Considerations:**

- The provision would encourage Americans to continue working or working part-time instead of retiring early in order to access retirement savings at age 59½. Under current law, many employees choose to retire instead of continuing to work because they cannot otherwise access their retirement accounts.

- The provision would provide uniformity across various plan types, allowing all plans to offer in-service distributions at age 59½ instead of having different ages for different types of plans. The varying rules under current law have no apparent justification.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.2 billion over 2014-2023.

### **Sec. 1616. Modification of rules governing hardship distributions.**

**Current law:** Under current law, defined-contribution plans are generally not permitted to allow in-service distributions (distributions while an employee is still working for the employer) attributable to elective deferrals if the employee is less than 59½ years old. One exception is for hardship distributions, which plans have the option of offering participants, but only if the plan follows guidelines such as that any distribution be necessary for an immediate and heavy financial need of the employee. Treasury regulations require that plans not allow employees taking hardship distributions to make contributions to the plan for six months after the distribution.

**Provision:** Under the provision, the IRS would be required within one year of the date of enactment to change its guidance to allow employees taking hardship distributions to continue making contributions to the plan. The provision would be effective for plan years beginning after 2014.

#### **Considerations:**

- The provision would help Americans save for retirement by making common-sense reforms to remove harsh rules that often trap individuals and families going through difficult financial circumstances.
- The provision would overturn Treasury regulations requiring individuals to stop making contributions to their retirement plans in order to take hardship distributions, which often results in such individuals failing to resume retirement savings in the future.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

### **Sec. 1617. Extended rollover period for the rollover of plan loan offset amounts in certain cases.**

**Current law:** Under current law, defined-contribution plans are permitted (but not required) to allow plan loans. If the employee fails to abide by the applicable rules, the loan is treated as a taxable distribution that may also be subject to the 10-percent penalty for early withdrawals. If a plan terminates or an employee's employment terminates while a plan loan is outstanding, the employee has 60 days to contribute the loan balance to an individual retirement account (IRA), or the loan is treated as a distribution.

**Provision:** Under the provision, employees whose plan terminates or who separate from employment while they have plan loans outstanding would have until the due date for filing their tax return for that year to contribute the loan balance to an IRA in order to avoid the loan being taxed as a distribution. The provision would apply to tax years beginning after 2014.

**Considerations:**

- The provision would help Americans save for retirement by making common-sense reforms to remove harsh rules that often trap individuals and families going through difficult financial circumstances.
- The provision would overturn the current rule requiring individuals who lose their jobs to roll over any outstanding retirement plan loans to an IRA within 60 days or be subject to taxes and penalties on the loan amount.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

**Sec. 1618. Coordination of contribution limitations for 403(b) plans and governmental 457(b) plans.**

**Current law:** Under current law, 401(k) plans generally may allow employees to make elective deferrals of up to \$17,500 for 2014 and an additional \$5,500 catch-up contribution for those who are at least 50 years old. Total employer and employee contributions may not exceed \$52,000 for 2014. Contributions generally may not exceed employee compensation and may only be made by active employees. These amounts are indexed for inflation.

Certain employees with more than 15 years of service who are participants in 403(b) plans may make an additional contribution of up to \$3,000 per year. Entities sponsoring 403(b) plans (typically tax-exempt organizations) also may make non-elective employer contributions of up to \$52,000 in 2014 (indexed for inflation) for up to five years after the employee has separated from service. Similarly, a church may contribute a maximum of \$10,000 per year, even if the participant has no taxable compensation, up to a lifetime limit of \$40,000 per participant. For foreign missionaries with \$17,000 or less in adjusted gross income, a church may contribute up to \$3,000 per year (even in the absence of U.S. taxable compensation).

Participants in 457 plans sponsored by State and local governments are allowed to make additional contributions of up to \$35,000 for 2014 (indexed for inflation) for the three years prior to normal retirement age. State and local government employees may participate in both a 457 plan and either a 403(b) plan or a 401(k) plan in which case the employee may make the maximum allowable annual contributions to each of the plans.

**Provision:** Under the provision, all defined-contribution plans would be subject to the annual contribution limits currently applicable to 401(k) plans and would not have additional limits for different classes of employees at certain types of employers. The provision would apply to plan years and tax years beginning after 2014.

**Consideration:** The provision would simplify the Code by treating employees the same regardless of whether they work for private, non-profit or public employers.

**JCT estimate:** According to JCT, the provisions would increase revenues by \$0.9 billion over 2014-2023.

**Sec. 1619. Application of 10-percent early distribution tax to governmental 457 plans.**

**Current law:** Under current law, early distributions from employer-sponsored retirement plans and IRAs are generally subject to an additional tax of 10 percent. This additional tax does not apply to early distributions from 457 plans sponsored by State and local governments.

**Provision:** Under the provision, participants in governmental 457 plans would be subject to the 10-percent additional tax on early distributions. The provision would be effective for withdrawals after February 26, 2014.

**Consideration:** The provision would simplify the Code by treating employees the same regardless of whether they work for private, non-profit or public employers.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.6 billion over 2014-2023.

**Secs. 1620-1624. Inflation adjustments for qualified plan benefit and contribution limitations; Inflation adjustments for qualified plan elective deferral limitations; Inflation adjustments for SIMPLE retirement accounts; Inflation adjustments for catch-up contributions for certain employer plans; Inflation adjustments for governmental and tax-exempt organization plans.**

**Current law:** Under current law, the myriad retirement plan alternatives generally have contributions limits that are indexed for inflation. For 2014, the maximum benefit under a tax-qualified defined benefit plan is an annual payment equal to the lesser of an employee's average compensation for the three highest compensation years or \$210,000. For 401(k), 403(b), and 457 plans (as well as grandfathered SARSEPs), the maximum annual elective deferral by employees is \$17,500 (not counting catch-up contributions for employees at least 50 years old). The maximum combined contribution by employer and employee to a defined contribution plan (as well as SEPs) in 2014 is \$52,000. SIMPLE IRA and SIMPLE 401(k) plans sponsored by small businesses are subject to a maximum annual contribution of \$12,000 (not counting catch-up contributions for employees at least 50 years old) for 2014.

Employees in certain retirement plans who are at least 50 years old may make additional catch-up contributions beyond the otherwise applicable annual contribution limits. For 401(k), 403(b), and 457 plans, the maximum annual catch-up contribution is \$5,500 for 2014. For SIMPLE IRAs and SIMPLE 401(k) plans, the maximum annual catch-up contribution is \$2,500 for 2014.



**Provision:** Under the provisions, the inflation adjustments for the maximum benefit under a defined benefit plan, the maximum combined contribution by an employer and employee to a defined contribution plan, the maximum elective deferrals with respect to each type of SEP, SIMPLE IRA, and defined contribution plan (i.e., 401(k), 403(b), and 457(b)), and catch-up contributions would be suspended until 2024, at which time inflation indexing would recommence based off of the frozen level. The provisions generally would be effective after 2014. More specifically, the inflation adjustments for qualified plan benefit and contribution limitations would be effective for years ending with or within a calendar year beginning after 2014; the inflation adjustments for qualified plan elective deferral limitations would be effective for plan years and tax years beginning after 2014; the inflation adjustments for SIMPLE retirement accounts would be effective for calendar years beginning after 2014; and the inflation adjustments for catch-up contributions for certain employer plans and for governmental and tax-exempt organization plans would be effective for tax years beginning after 2014.

**Consideration:** When interest rates are relatively low, as they have been for the last several years, these provisions would have little or no effect on the annual contribution limitations. For example, the maximum employee contribution levels of \$12,000 for SIMPLE IRAs and \$17,500 for 401(k) plans were the same in 2013 and 2014.

**JCT estimate:** According to JCT, the provisions would increase revenues by \$63.4 billion over 2014-2023.

## **Subtitle H – Certain Provisions Related to Members of Indian Tribes**

### **Secs. 1701-1703. Indian general welfare benefits; Tribal Advisory Committee; Other relief for Indian tribes.**

**Current law:** Under current law, taxpayers must generally include all items of income in computing gross income. IRS guidance has established a general welfare exclusion under which payments made to individuals by governmental entities pursuant to legislatively provided social benefit programs for the promotion of the general welfare are not included in the recipient's gross income. To qualify under the general welfare exclusion, payments must not be lavish or extravagant, they must be made under a government program based on need, and such payments may not constitute compensation. Under proposed IRS guidance, the IRS will conclusively presume that payments from Indian tribes to tribal members and their spouses and dependents will qualify under the general welfare exclusion if certain requirements are met. Specifically, the payments must be made pursuant to a specific Indian tribal government program with written guidelines, be available to any tribal member meeting those guidelines, not discriminate in favor of the tribe's governing body members, not be compensation for services, and not be extravagant. Taxpayers may rely on the proposed rule until additional guidance is published. Additionally, taxpayers may rely on the proposed rules retroactively to file for refunds for any open tax years.

**Provision:** Under the provisions, the proposed IRS guidance specifically applying the general welfare exclusion to Indian tribes and payments received by tribal members, their spouses and

children generally would be codified. The provisions also would require the IRS to establish a Tribal Advisory Committee to advise the IRS on matters relating to taxation of tribal members including training and education for IRS agents dealing with tribal members. Additionally, the provisions would provide the IRS with discretion to waive any interest and penalties under the Code for any tribe or tribal member with regard to the general welfare exclusion. The provision codifying the IRS guidance concerning the general welfare exclusion would be effective for tax years for which the period of limitations is open as of the date of enactment, and taxpayers would have one additional year from the date of enactment to file for a refund with respect to any such open tax year.

**JCT estimate:** According to JCT, the provisions would have negligible revenue effect over 2014-2023.

## **Title II – Alternative Minimum Tax Repeal**

### **Sec. 2001. Repeal of alternative minimum tax.**

**Current law:** Under current law, taxpayers must compute their income for purposes of both the regular income tax and the alternative minimum tax (AMT), and their tax liability is equal to the greater of their regular income tax liability or AMT liability. In computing the AMT, only alternative minimum taxable income (AMTI) above an AMT exemption amount is taken into account, but AMTI represents a broader base of income than regular taxable income. For example, personal exemptions, the standard deduction, and certain itemized deductions (such as the deduction for State and local taxes) are not allowed in calculating AMTI. In addition, many business tax preferences that are allowed for regular taxable income are not allowed in determining AMTI, including accelerated depreciation. Corporations and, in some cases, non-corporate taxpayers receive a credit for AMT paid, which they may carry forward and claim against regular tax liability in future tax years (to the extent such liability exceeds AMT in a particular year), and which never expire.

For individuals, estates, and trusts, the AMT has a 26-percent bracket and a 28-percent bracket, but capital gains and dividends are taxed under the AMT at the highest rate that such items are taxed under the regular income tax. The 26-percent tax rate applies to the first \$182,500 of AMTI (half that amount for married couples filing separately), and the 28-percent rate applies to AMTI in excess of that amount. For 2014, the AMT exemption amounts for non-corporate taxpayers are \$52,800 for single filers, \$82,100 for joint filers, \$41,050 for married individuals filing separately, and \$23,500 for estates and trusts. The AMT exemption amounts begin phasing out at a 25-percent rate at \$156,500 for joint returns, \$117,300 for singles, and \$78,250 for married individuals filing separately and trusts and estates. These amounts are indexed for inflation.

The corporate AMT rate is 20 percent, and the exemption amount is \$40,000, though corporations with average gross receipts of less than \$7.5 million for the preceding three tax years are exempt from the AMT. The exemption amount for corporations phases out at a 25-percent rate starting at \$150,000.

**Provision:** Under the provision, the AMT would be repealed. If a taxpayer has AMT credit carryforwards, the taxpayer would be able to claim a refund of 50 percent of the remaining credits (to the extent the credits exceed regular tax for the year) in tax years beginning in 2016, 2017, and 2018. Taxpayers would be able to claim a refund of all remaining credits in the tax year beginning in 2019. The provision would generally be effective for tax years beginning after 2014.

#### **Considerations:**

- 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 current Code.
- According to JCT, the AMT affected about 4 million American families in 2013, and that this number will rise to more than 6 million American families in 2023 under current law.

- Families subject to the AMT face an average tax increase of approximately \$7,300, based on recent IRS Statistics of Income (SOI) data.
- The AMT is particularly burdensome for small businesses, which 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 hire, expand, and give raises to workers.
- In its 2001 tax simplification report, JCT concluded that the AMT “no longer serves the purposes for which it was intended,” and recommended its repeal.

**JCT estimate:** According to JCT, the repeal of the individual AMT would reduce revenues by \$1,331.8 billion over 2014-2023, and the repeal of the corporate AMT would reduce revenues by \$110.2 billion over 2014-2023.

## Title III – Business Tax Reform

### Subtitle A – Tax Rates

#### **Sec. 3001. 25-percent corporate tax rate.**

**Current law:** Under current law, a corporation’s regular income tax liability generally is determined by applying the following tax rate schedule to its taxable income:

<u>Taxable income:</u>	<u>Tax rate:</u>
\$0-\$50,000	15 percent
\$50,001-\$75,000	25 percent
\$75,001-\$10,000,000	34 percent
Over \$10,000,000	35 percent

The 15- and 25-percent rates are phased out for corporations with taxable income between \$100,000 and \$335,000. As a result, a corporation with taxable income between \$335,000 and \$10,000,000 effectively is subject to a flat tax rate of 34 percent. Similarly, the 34-percent rate is gradually phased out for corporations with taxable income between \$15,000,000 and \$18,333,333, such that a corporation with taxable income of \$18,333,333 or more effectively is subject to a flat rate of 35 percent.

Personal service corporations are not entitled to use the graduated corporate rates below the 35-percent rate. A personal service corporation is a corporation the principal activity of which is the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and such services are substantially performed by the employee-owners.

**Provision:** Under the provision, the corporate tax rate would be a flat 25-percent rate beginning in 2019. A transition rule would set the rate for taxable income up to \$75,000 to 25 percent beginning in 2015, with the rate on income above that level phased down to 25 percent as follows:

<u>For tax years beginning during calendar year:</u>	<u>Tax rate:</u>
2015	33 percent
2016	31 percent
2017	29 percent
2018	27 percent
2019 and later	25 percent

The special rule applicable to personal services corporations would be repealed. The provision would be effective for tax years beginning after 2014.

**Considerations:**

- Today, U.S. corporations are subject to the highest combined Federal-State tax rate in the industrialized world, which puts American multinational companies at a significant competitive disadvantage against their global competitors.
- Lowering the corporate rate from 35 percent to 25 percent not only would increase America's ability to compete internationally, but also would ensure that American corporations have more resources here in the United States to invest, hire and grow their businesses.
- According to information compiled by the RATE Coalition, reducing the corporate rate to 25 percent would add 581,000 jobs annually and increase GDP growth by 1-2 percent.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$680.3 billion over 2014-2023.

**Subtitle B – Reform of Business-related Exclusions and Deductions****Sec. 3101. Revision of treatment of contributions to capital.**

**Current law:** Under current law, the gross income of a corporation generally does not include contributions to its capital (i.e., transfers of money or property to the corporation by a non-shareholder such as a government entity). In addition, a corporation does not recognize gain or loss on the receipt of money or property in exchange for stock of the corporation, nor does it recognize gain or loss with respect to any lapse or acquisition of an option to buy or sell its stock.

**Provision:** Under the provision, the gross income of a corporation would include contributions to its capital (including any premiums received by the corporation with respect to an option written by the corporation to sell its stock), to the extent the amount of money and fair market value of property contributed to the corporation exceeds the fair market value of any stock that is issued in exchange for such money or property. Similar rules would apply to contributions to the capital of any non-corporate entity, such as a partnership. Under section 3423 of the discussion draft, however, the tax liability of a corporation would not take into account income, gains, losses, or deductions with regard to a derivative that relates to the corporation's stock, except for income received with regard to certain forward contracts that relate to the corporation's stock. The provision would be effective for contributions made, and transactions entered into, after the date of enactment.

**Consideration:** This provision would remove a Federal tax subsidy for State and local governments to offer incentives and concessions to business that locate operations within their jurisdiction (usually in lieu of locating operations in a different State or locality). In conjunction with section 3423 of the discussion draft, the provision also would eliminate current-law loopholes for corporations that engage in transactions involving their own stock.

**JCT estimate:** According to JCT, the provision would increase revenues by \$8.8 billion over 2014-2023.

### **Sec. 3102. Repeal of deduction for local lobbying expenses.**

**Current law:** Under current law, businesses generally may deduct ordinary and necessary expenses paid or incurred in connection with carrying on any trade or business. An exception to the general rule, however, disallows deductions for lobbying and political expenditures with respect to legislation and candidates for office, except for lobbying expenses with respect to legislation before local or Indian tribal government bodies.

**Provision:** Under the provision, deductions for lobbying expenses with respect to legislation before local government bodies (including Indian tribal governments) would be disallowed. The provision would be effective for amounts paid or incurred after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.6 billion over 2014-2023.

### **Sec. 3103. Expenditures for repairs in connection with casualty losses.**

**Current law:** Under current law, a taxpayer that is engaged in a trade or business generally may deduct any property loss sustained during the tax year (e.g., as a result of a natural disaster) that is not compensated by insurance or otherwise. A taxpayer's loss is limited to the adjusted basis of the property, and adjusted basis is reduced if a casualty loss is deducted. Taxpayers engaged in a trade or business also may deduct amounts paid or incurred to maintain property, including repairs for damage as a result of a natural disaster. If the repairs rise to the level of a permanent improvement or betterment made to increase the value of the property (rather than just to maintain the property), the costs must be capitalized in the basis and recovered over the depreciable life of the property. Some taxpayers have taken the position that both the casualty-loss deduction and the deduction for amounts paid or incurred for repairs may be claimed with respect to the same property damaged in a natural disaster.

**Provision:** Under the provision, taxpayers could elect either to claim a casualty loss for damaged property (with a corresponding decrease to the property's basis) or to deduct the repair of such property, but not both. The provision would be effective for losses sustained after 2014.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

### **Sec. 3104. Reform of accelerated cost recovery system.**

**Current law:** Under current law, a taxpayer may recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction with respect to tangible property for a tax year is determined under the modified accelerated cost recovery system (MACRS). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods.

The MACRS recovery periods applicable to most tangible personal property range from three to 25 years. In general, the recovery periods for real property are 39 years for non-residential real property and 27.5 years for residential rental property. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the tax year in which the straight-line method would provide a larger deduction. However, in certain circumstances – such as with respect to corporate taxpayers subject to the alternative minimum tax (AMT) – property must be depreciated under the alternative depreciation system (ADS), which requires longer recovery periods and the use of the straight-line depreciation method. The primary source of IRS guidance for class lives is Revenue Procedure 87-56, 1987-2 C.B. 674, which has not been updated since its release in 1987 (as the result of a statutory prohibition enacted by Congress).

Special depreciation provisions enacted in recent years have also accelerated cost recovery for certain assets. For example, in general, property with a recovery period of less than 20 years placed in service from 2008 through 2013 is eligible for bonus depreciation of either 50 percent or 100 percent, depending on the year. In addition, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property placed in service before 2014 were eligible for an accelerated recovery period of 15 years.

**Provision:** Under the provision, MACRS recovery periods and methods would be repealed and rules substantially similar to the ADS rules would apply to depreciable property. Thus, in general, class lives would match more closely the true economic useful life of assets, and depreciation deductions would be determined under the straight-line method. In addition, a taxpayer could elect to take an additional depreciation deduction to account for the effects of inflation on depreciable personal property, calculated by multiplying the year-end adjusted basis in the property (determined without regard to inflation deductions) by the chained CPI rate for the year.

The provision also would repeal the following special depreciation provisions: bonus depreciation, the special recovery periods for Indian reservation property, the special allowance for second generation biofuel plant property, the special allowance for certain reuse and recycling property, and the special allowance for qualified disaster assistance property. In addition, the special depreciation provisions for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property would be repealed. The provision would require the Treasury Department, in consultation with the Bureau of Economic Analysis, to develop a new schedule of economic depreciation, and submit a report to Congress containing the new schedule and other recommendations by December 31, 2017. The provision would be effective for property placed in service after 2016. Thus, current law would apply to property placed in service during 2014, 2015 and 2016.

#### **Considerations:**

- Public companies already must use the straight-line method for purposes of financial statements, and switching to this slower depreciation method does not affect the earnings statements they provide to investors and the Securities and Exchange Commission (SEC). Thus, because most public companies prioritize financial statement earnings, they generally support trading accelerated depreciation for a lower tax rate.



- The provision eliminates numerous special depreciation provisions, simplifying the Code and providing uniform rules for all businesses.
- The longer ADS class lives more accurately reflect the actual economic life of assets.
- In addition, the provision requires the Treasury Department to reexamine the class lives of depreciable assets, focusing on the economic life of the assets, and revise IRS guidance. Such an update has not been published since 1987, and the nature of asset classes has changed dramatically in the last 26 years.

**JCT estimate:** According to JCT, the provision would increase revenues by \$269.5 billion over 2014-2023.

### **Sec. 3105. Repeal of amortization of pollution control facilities.**

**Current law:** Under current law, a taxpayer may elect to recover the cost of a certified pollution control facility over a period of 60 months (84 months in the case of certain atmospheric pollution control facilities used in connection with a power plant or other property that is primarily coal-fired) rather than through annual depreciation deductions based on the useful life of the property. A corporate taxpayer must reduce the amount of basis otherwise eligible for the 60-month recovery by 20 percent.

**Provision:** Under the provision, the special election for amortization of pollution control facilities would be repealed. Accordingly, such facilities would be subject to the general depreciation rules, with the cost recovery of pollution control facilities generally based on the class life of the underlying property (e.g., the building to which the pollution control facility is attached would have a 40-year life). The provision would be effective for facilities placed in service after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$7.9 billion over 2014-2023.

### **Sec. 3106. Net operating loss deduction.**

**Current law:** Under current law, a net operating loss (NOL) generally is the amount by which a taxpayer's current-year business deductions exceed its current-year gross income. NOLs may not be deducted in the year generated, but may be carried back two years and carried forward 20 years to offset taxable income in such years. The AMT rules provide that a taxpayer's NOL deduction may not reduce the taxpayer's alternative minimum taxable income by more than 90 percent.

Different rules apply with respect to NOLs arising in certain circumstances. A special five-year carryback applies to NOLs arising from a farming loss, losses arising from certain bad debts of commercial banks, and certain amounts related to the Hurricane Katrina and the Gulf Opportunity Zone before 2010. Special rules also apply to specified liability losses (ten-year carryback) and excess interest losses (no carryback to any year preceding a corporate equity

reduction transaction). Additionally, a special rule applied to losses incurred in 2008 and 2009 (up to a five-year carryback) and a special rule applied to certain electric utility companies with respect to NOLs arising in 2003 through 2005 (five-year carryback).

**Provision:** Under the provision, C corporations could deduct an NOL carryover or carryback only to the extent of 90 percent of the corporation's taxable income (determined without regard to the NOL deduction) – conforming to the current-law AMT rule. The provision also would repeal the special carryback rules for specified liability losses, bad debts losses of commercial banks, excess interest losses relating to corporate equity reduction transactions, and certain farming losses. Additionally, the provision would repeal the expired special rules regarding losses incurred in 2008 and 2009, losses of certain electric utility companies, and losses related to the Hurricane Katrina and the Gulf Opportunity Zone. The provision generally would be effective for tax years beginning after 2014 and losses incurred after 2014 and carried back to prior years.

**JCT estimate:** According to JCT, the provision would increase revenues by \$70.5 billion over 2014-2023.

#### **Sec. 3107. Circulation expenditures.**

**Current law:** Under current law, expenditures that produce benefits in future tax years to a taxpayer's business or income-producing activities generally are capitalized and recovered over time through depreciation, amortization, or depletion deductions. A special rule, however, allows taxpayers to deduct immediately expenditures to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical. Under the AMT, however, circulation expenditures must be capitalized and amortized over 36 months.

**Provision:** Under the provision, taxpayers would recover the cost of circulation expenditures by capitalizing and amortizing such costs over 36 months – conforming to the current-law AMT rule. The provision would be effective for amounts paid or incurred in tax years beginning after 2015, with a three-year phase-in period in which 75 percent of circulation expenditures would be deductible in 2016 (25 percent amortized), 50 percent would be deductible in 2017 (50 percent amortized), and 25 percent deductible in 2018 (75 percent amortized).

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.6 billion over 2014-2023.

#### **Sec. 3108. Amortization of research and experimental expenditures.**

**Current law:** Under current law, business expenditures associated with the development and creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life. As an exception to this general rule, taxpayers may elect to deduct currently certain research or experimentation (R&E) expenditures paid or

incurred in connection with a trade or business. Such deductions must be reduced by the amount of the taxpayer's research tax credit.

**Provision:** Under the provision, all R&E expenditures would be amortized over a five-year period beginning with the midpoint of the tax year in which the expenditure is paid or incurred. The five-year period would continue even in the event any property with respect to which amortization deductions were made is retired or abandoned. Expenditures incurred for the development of software would be treated as R&E expenditures.

The provision would be effective for amounts paid or incurred in tax years beginning after 2014, but would be phased in slowly over several years. For tax years beginning in 2015, a taxpayer could expense 60 percent and amortize 40 percent over two years; for tax years beginning in 2016 and 2017, a taxpayer could expense 40 percent and amortize 60 percent over three years; and for tax years beginning in 2018, 2019, and 2020, a taxpayer could expense 20 percent and amortize 80 percent over four years. When adding together, the percentage that is permitted to be expensed in any particular year and the amortized percentages from prior years that are also available as a deduction in that particular year, the effect of this formula is to permit a deduction of at least 80 percent of the amount that is deductible under current law (assuming constant levels of annual investment). Alternatively, a taxpayer may elect to apply the five-year amortization rule to all R&E expenditures immediately.

**Considerations:**

- In general, the cost of assets that have a useful life beyond the tax year must be recovered over the useful life of the asset. The provision recognizes that research and experimentation has a useful life beyond the tax year in which the expenses are incurred.
- In particular, the tangible and intangible property created through research and experimentation provide value to a business beyond a single tax year.

**JCT estimate:** According to JCT, the provision would increase revenues by \$192.6 billion over 2014-2023.

**Sec. 3109. Repeal of deductions for soil and water conservation expenditures and endangered species recovery expenditures.**

**Current law:** Under current law, a taxpayer engaged in the business of farming may deduct immediately, rather than recover over time through annual depreciation deductions, costs paid or incurred during the tax year for the purpose of soil or water conservation in respect of land used in farming, for the prevention of erosion of land used in farming, or for endangered species recovery. Such expenditures are allowed as a deduction, not to exceed 25 percent of the gross income derived from farming during the tax year, with any excess amount carried over to a succeeding year subject to the same percentage limitations.

**Provision:** Under the provision, the special deduction for soil and water conservation and for the prevention of erosion in land used in farming and endangered species recovery would be

repealed. Accordingly, such costs would be capitalized in the basis of the underlying property. The provision would be effective for amounts paid or incurred after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.8 billion over 2014-2023.

### **Sec. 3110. Amortization of certain advertising expenses.**

**Current law:** Under current law, a deduction is allowed for ordinary and necessary expenses paid or incurred in carrying on any trade or business. However, expenditures that create a long-term benefit generally must be capitalized and recovered through depreciation or amortization, rather than deducted currently. Although advertising expenditures are not addressed specifically in the Code, the IRS generally allows taxpayers to treat advertising expenditures as an ordinary and necessary business expense. In addition, a special regulatory exception applies to amounts paid to develop a package design. This includes the design of shapes, colors, words, pictures, lettering, and other elements on a given product package or the design of a container to hold a given product. Even though such design cost may have a useful life beyond the current tax year, current regulations permit taxpayers to deduct such costs in the year incurred.

**Provision:** Under the provision, 50 percent of certain advertising expenses would be currently deductible and 50 percent would be amortized ratably over a ten-year period. This rule would phase in for tax years beginning before 2018 as follows: for tax years beginning in 2015, 80 percent of advertising costs would be deductible and 20 percent amortized; in 2016, 70 percent of advertising costs would be deductible and 30 percent amortized; and in 2017, 60 percent of advertising costs would be deductible and 40 percent amortized. The provision would also permit taxpayers to expense the first \$1,000,000 of advertising expenditures. However, the \$1,000,000 would be reduced to the extent a taxpayer's advertising costs exceed \$1,500,000, and completely phased out once advertising costs exceed \$2,000,000. All of these thresholds would be adjusted for inflation.

Advertising expenses would include any amount paid or incurred for development, production, or placement (including any form of transmission, broadcast, publication, display, or distribution) of any communication to the general public intended to promote the taxpayer's trade or business (including any service, facility, or product provided pursuant to such trade or business). In addition, advertising expenses would include wages paid to employees primarily engaged in activities related to advertising and the direct supervision of employees engaged in such activities. Advertising expenses, however, would not include: depreciable property, amortizable section 197 intangibles, discounts, certain communications on the taxpayer's property, the creation of logos (and trade names), marketing research, business meals, and qualified sponsorship payments.

Under the provision, no deduction of unamortized expenses would be allowed if any property with respect to which amortizable advertising expenses are paid or incurred is retired or abandoned during the 10-year amortization period.

Under the provision, the regulatory exception permitting the immediate deduction of packaging-design costs would be repealed, and such costs would be capitalized into the cost of producing the packaging and recovered as the packaging (and products the packaging contains) are sold.

The provision would be effective for amounts paid or incurred in tax years beginning after 2014.

**Considerations:**

- In general, the cost of assets that have a useful life beyond the tax year must be recovered over the useful life of the asset. The provision recognizes that a portion of advertising has a useful life beyond the tax year in which the expenses are incurred because a portion of advertising creates long-lived intangible assets such as brand awareness and customer loyalty, the benefits of which inure to the company for many years after the taxpayer incurs the expense.
- The Supreme Court has noted that “a taxpayer’s realization of benefits beyond the year in which [an] expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.”

**JCT estimate:** According to JCT, the provision would increase revenues by \$169.0 billion over 2014-2023.

**Sec. 3111. Expensing certain depreciable business assets for small business.**

**Current law:** Under current law, a taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Under Code section 179, a taxpayer may deduct immediately (“expense”) the cost of investments in property, equipment, and computer software rather than depreciating such costs over the recovery period of such property under the Code. For 2008 and 2009, taxpayers could expense up to \$250,000 of qualifying property, reduced proportionately to the extent that the taxpayer placed in service more than \$800,000 of qualifying property. From 2010 through 2013, the expensing limitation was \$500,000 and phase-out threshold was \$2 million. For tax years after 2013, the expensing limitation under Code section 179 drops to \$25,000, and the phase-out begins once investments exceed \$200,000. Computer software and certain types of real property (qualifying leasehold improvements, investments in restaurant property, and improvements to retail property) were eligible for expensing if placed in service before 2014. However, the amount of real property that could be expensed was limited to \$250,000. Investments in air conditioning and heating units do not qualify for expensing.

**Provision:** Under the provision, Code section 179 expensing would be made permanent at the 2008-2009 levels. Taxpayers would be able to expense up to \$250,000 of investments in new equipment and property per year, with the deduction phased out for investments exceeding \$800,000 (with both amounts indexed for inflation). The provision would also would also restore and make permanent rules allowing computer software and certain investments in real property to qualify for section 179 expensing. In addition, the provision would allow investments in air conditioning and heating units to qualify for section 179 expensing. The provision would be effective for tax years beginning after 2013.

**Considerations:**

- Starting in 2014, the expensing levels are now \$25,000 and \$200,000, respectively, a significant reduction from the 2013 levels for small businesses and farms that have struggled through the economic challenges of the past six years to build their businesses and hire new employees.
- By making permanent the current-law provisions allowing computer software and certain investments in real property to qualify for section 179 expensing, this provision would significantly expand the pool of eligible assets.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$54.9 billion over 2014-2023.

**Sec. 3112. Repeal of election to expense certain refineries.**

**Current law:** Under current law, a taxpayer could elect to expense 50 percent of the cost of any qualified property used for processing liquid fuel from crude oil or qualified fuels prior to 2014. The remaining 50 percent was recovered under normal depreciation rules. Qualified refinery property included assets located in the United States and used in the refining of liquid fuels. The expensing election expired for property placed in service after 2013.

**Provision:** Under the provision, the deduction would be repealed. The provision would be effective for property placed in service after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3113. Repeal of deduction for energy efficient commercial buildings.**

**Current law:** Under current law, a taxpayer could claim a deduction with respect to certain energy-efficient commercial building property expenditures incurred prior to 2014. The deduction was limited to an amount equal to \$1.80 per square foot of the property for which such expenditures were made. The deduction was allowed in the year in which the property was placed in service. The deduction expired at the end of 2013.

**Provision:** Under the provision, the deduction would be repealed. The provision would be effective for property placed in service after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3114. Repeal of election to expense advanced mine safety equipment.**

**Current law:** Under current law, a taxpayer could deduct immediately, rather than recover through annual depreciation deductions, 50 percent of the cost of any qualified advanced mine

safety equipment property that was placed in service before 2014. The deduction expired at the end of 2013.

**Provision:** Under the provision, the special rule for immediately deducting 50 percent of the cost of advanced mine safety equipment would be repealed. The provision would be effective for property placed in service after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 3115. Repeal of deduction for expenditures by farmers for fertilizer, etc.**

**Current law:** Under current law, a taxpayer engaged in the business of farming may elect to deduct immediately expenditures for fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming.

**Provision:** Under the provision, the special rule for deducting expenditures for fertilizer and other farming-related materials would be repealed. The provision would be effective for expenses paid or incurred in tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$3.4 billion over 2014-2023.

### **Sec. 3116. Repeal of special treatment of certain qualified film and television productions.**

**Current law:** Under current law, a taxpayer could elect to deduct immediately the cost of a qualifying film and television production (up to a maximum deduction of \$15 million), commencing prior to 2014, rather than capitalizing and recovering the costs through depreciation deductions generally in relation to the forecasted income from the production. The threshold was increased to \$20 million if a significant amount of the production expenditures were incurred in certain low-income, distressed or isolated areas in the United States.

**Provision:** Under the provision, the special rule allowing an immediate deduction of qualifying film and television production costs would be repealed. The provision would be effective for productions commencing after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 3117. Repeal of special rules for recoveries of damages of antitrust violations, etc.**

**Current law:** Under current law, a taxpayer who recovers damages from certain antitrust violations, patent infringements, or breaches of contract or fiduciary duty and includes the damages in income, may claim a special deduction intended to offset any losses relating to such antitrust violation, etc. that did not result in a tax benefit to the taxpayer. This rule, enacted in

1969, addressed cases in which a taxpayer did not have sufficient income to offset the losses resulting from the antitrust violation in the year the loss occurred or could not carryover such losses to the year in which the litigation damages were recovered due to the limitations on net operating loss carryovers (NOLs), which varied between five and seven years until 1981. Under current law, NOLs may be carried forward for 20 years.

**Provision:** Under the provision, the special deduction for antitrust violations would be repealed. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

### **Sec. 3118. Treatment of reforestation expenditures.**

**Current law:** Under current law, costs incurred to improve property used in a trade or business generally must be capitalized and recovered through depreciation deductions over the useful life of the property. A taxpayer, however, may elect to amortize reforestation expenditures over 84 months (i.e., seven years). In addition, a taxpayer may also elect to deduct up to \$10,000 of certain reforestation expenditures that otherwise would be capitalized. To the extent that reforestation expenditures exceed the \$10,000 limit, a taxpayer may elect to amortize the remaining expenditures over 84 months. The special rule applies to property in the United States that generally contains any type of trees in significant commercial quantities and that is held by the taxpayer for planting, cultivating, caring for and cutting of trees for sale or use in the commercial production of timber products.

**Provision:** Under the provision, the election to deduct up to \$10,000 for reforestation expenditures would be repealed. For purposes of the 84-month amortization election, the provision would limit the definition of qualifying timber property to U.S. property that (1) contains evergreen trees in commercial quantities that are reasonably expected to be cut down after they are more than six years old, and (2) is held for the planting, cultivating, caring for, and cutting of such trees for ornamental purposes. The provision would be effective for expenditures paid or incurred in tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.4 billion over 2014-2023.

### **Sec. 3119. 20-year amortization of goodwill and certain other intangibles.**

**Current law:** Under current law, when a taxpayer acquires intangible assets held in connection with a trade or business, any value properly attributable to such intangible assets is amortizable on a straight-line basis over 15 years. For these purposes, intangible assets generally include: goodwill; going-concern value; workforce in place; business books and records; any patent, copyright, formula, process, design, pattern, know-how, or similar item; any franchise, trademark or trade name; customer- and supplier-based intangibles; any license, permit, or other rights



granted by governmental units; and any other similar item. Certain assets are excluded from the rule, such as mortgage servicing rights, which are amortizable over nine years.

**Provision:** Under the provision, the amortization period for acquired intangible assets would be extended to 20 years. The provision also would treat mortgage servicing rights as intangible assets subject to amortization over 20 years. The provision would be effective for property acquired after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$13.0 billion over 2014-2023.

### **Sec. 3120. Treatment of environmental remediation costs.**

**Current law:** Under current law, taxpayers generally must capitalize amounts paid or incurred for permanent improvements or betterments made to increase the value of any property used in carrying on any trade or business. Thus, environmental remediation costs relating to the abatement or control of hazardous substances at a qualified contaminated site are capitalized into the cost of the land and recovered only when the land is sold. Prior to 2012, taxpayers could elect to treat environmental expenditures as deductible in the year paid.

**Provision:** Under the provision, environmental remediation costs would be recovered ratably over 40 years beginning with the midpoint of the tax year in which the expenditures are paid or incurred. The provision would be effective for expenditures paid or incurred after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by less than \$50 million over 2014-2023.

### **Sec. 3121. Repeal of expensing of qualified disaster expenses.**

**Current law:** Under current law, taxpayers generally must capitalize amounts paid or incurred to acquire property or for permanent improvements or betterments made to increase the value of any property used in carrying on any trade or business. A special rule permitted taxpayers to deduct qualified disaster expenses in 2008 and 2009 relating to Hurricane Katrina and the Gulf Opportunity Zone.

**Provision:** Under the provision, the special rule for expensing certain disaster expenses would be repealed as obsolete. The provision would be effective for amounts paid or incurred after 2014.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 3122. Phaseout and repeal of deduction for income attributable to domestic production activities.**

**Current law:** Under current law, taxpayers may claim a deduction equal to 9 percent (6 percent in the case of certain oil and gas activities) of the lesser of the taxpayer's qualified production activities income or the taxpayer's taxable income for the tax year. The deduction is limited to 50 percent of the W-2 wages paid by the taxpayer during the calendar year. Qualified production activities income is equal to domestic production gross receipts less the cost of goods sold and expenses properly allocable to such receipts. Qualifying receipts are derived from property that was manufactured, produced, grown, or extracted within the United States; qualified film productions; production of electricity, natural gas, or potable water; construction activities performed in the United States; and certain engineering or architectural services. Qualifying receipts do not include gross receipts derived from the sale of food or beverages prepared at a retail establishment; the transmission or distribution of electricity, gas, and potable water; or the disposition of land.

**Provision:** Under the provision, the deduction for domestic production activities would be phased out, with the deduction reduced to 6 percent for tax years beginning in 2015 and 3 percent for tax years beginning in 2016. The deduction would be repealed for tax years beginning after 2016.

**JCT estimate:** According to JCT, the provision would increase revenues by \$115.8 billion over 2014-2023.

### **Sec. 3123. Unification of deduction for organizational expenditures.**

**Current law:** Under current law, new businesses may deduct up to \$5,000 of start-up expenses (i.e., costs incurred prior to the commencement of the business' operation). The deduction phases out to the extent that start-up expenses exceed \$50,000. Start-up expenses that do not qualify for the deduction may be amortized over 15 years. Partnerships and C corporations also may deduct up to \$5,000 of organizational expenses (i.e., expenses relating to the commencement of the business). The additional deduction phases out to the extent organizational expenses exceed \$50,000, with excess expenses amortized over a 15-year period.

**Provision:** Under the provision, the various existing provisions for start-up and organizational expenses would be combined into a single provision applicable to all businesses. The provision would allow a taxpayer to deduct up to \$10,000 in start-up and organizational costs, with a phase-out beginning at \$60,000. The additional deduction for organizational expenses incurred by a partnership or C corporation would be repealed. Expenses above the new increased limit would continue to be deductible over the 15-year period following the start of the business. The provision would be effective for expenses paid or incurred in tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$0.6 billion over 2014-2023.

## **Sec. 3124. Prevention of arbitrage of deductible interest expense and tax-exempt interest income.**

**Current law:** Under current law, taxpayers may not deduct interest on indebtedness incurred to purchase or carry obligations if the interest income from the obligations is exempt from tax (tax-exempt obligations). The rule is intended to prevent taxpayers from engaging in tax arbitrage by deducting interest on indebtedness used to purchase tax-exempt obligations. There are two methods for determining the amount of the disallowance: The first method, which applies to all taxpayers other than financial institutions or dealers in tax-exempt obligations, asks whether a taxpayer's borrowing can be traced to its holding of tax-exempt obligations and disallows an interest deduction for that portion used to purchase the tax-exempt obligations. The second method, which applies to financial institutions and dealers in exempt obligations, disallows interest deductions based on the percentage of the taxpayer's assets comprised of tax-exempt obligations. Under the second method, a special rule excludes certain qualified small issuer tax-exempt obligations from the pro rata disallowance rule; instead, 20 percent of the interest allocable to such obligations is disallowed.

Under current law, individuals may not deduct investment interest in excess of net investment income. Investment interest generally is the interest paid or accrued on indebtedness with respect to property held for investment, excluding home-mortgage interest. Property considered held for investment currently does not include property that generates tax-exempt interest. Disallowed investment interest deductions may be carried over to the succeeding tax year.

**Provision:** Under the provision, C corporations, including financial institutions and dealers in tax-exempt obligations, would be required to use the same interest-disallowance method. Thus, the interest deduction of any taxpayer would be disallowed based on the percentage of the taxpayer's assets comprised of tax-exempt obligations. The special rule under present law for qualified small issuer tax-exempt obligations also would be repealed.

The provision also would permanently disallow the investment-interest deduction of a taxpayer (other than a corporation or financial institution) by the amount of tax-exempt interest received. Any remaining interest deduction would still be limited to the taxpayer's net investment income.

The provision relating to the interest-disallowance method would be effective for tax years ending after and obligations issued after February 26, 2014. The provision relating to the investment-interest deduction would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.6 billion over 2014-2023.

## **Sec. 3125. Prevention of transfer of certain losses from tax indifferent parties.**

**Current law:** Under current law, a deduction is generally disallowed for a loss on the sale or exchange of property to certain related parties or controlled partnerships. If a loss has been disallowed in such a case, the transferee generally may reduce any gain later recognized on a

disposition of the asset by the amount of loss disallowed to the transferor. In effect, this rule has the effect of shifting the benefit of the loss from the transferor to the transferee. Special rules apply in the case of transfers of property within a controlled group of businesses.

**Provision:** Under the provision, the related-party loss rules would be modified to prevent losses from being shifted from a tax-indifferent party (e.g., a foreign person not subject to U.S. tax) to another party in whose hands any gain or loss with respect to the property would be subject to U.S. tax. The provision would be effective for sales and exchanges after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.7 billion over 2014-2023.

### **Sec. 3126. Entertainment, etc. expenses.**

**Current law:** Under current law, no deduction is allowed for expenses relating to entertainment, amusement or recreation activities, or facilities (including membership dues with respect to such activities or facilities), unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business, in which case the taxpayer may deduct up to 50 percent of expenses relating to meals and entertainment. An item is considered directly related if it is associated with a substantial and bona fide business discussion.

A taxpayer also may deduct the cost of certain fringe benefits provided to employees (e.g., employee discounts, working condition and transportation fringe benefits), even though such benefits are excluded from the employee's income under Code section 132. Additionally, a taxpayer may deduct expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and wages to an employee (or includible in gross income of a recipient who is not an employee).

A taxpayer may deduct certain reimbursed expenses, including reimbursement arrangements in which an employer reimburses the expenses incurred by employees of a subcontractor, provided such expenses are properly substantiated and not treated as income to the employee.

**Provision:** Under the provision, no deduction would be allowed for entertainment, amusement or recreation activities, facilities or membership dues relating to such activities or other social purposes. In addition, no deduction would be allowed for transportation fringe benefits or for amenities provided to an employee that are primarily personal in nature and that involve property or services not directly related to the employer's trade or business, except to the extent that such benefits are treated as taxable compensation to an employee (or includible in gross income of a recipient who is not an employee). The 50-percent limitation under current law also would apply only to expenses for food or beverages and to qualifying business meals under the provision, with no deduction allowed for other entertainment expenses. Furthermore, no deduction would be allowed for reimbursed entertainment expenses paid as part of a reimbursement arrangement that involves a tax-indifferent party such as a foreign person or an entity exempt from tax. The provision would be effective for amounts paid or incurred after 2014.

**Considerations:**

- It is difficult for the IRS to determine whether entertainment expenses are directly related to a trade or business, creating uncertainty for taxpayers as well as the potential for significant abuse.
- The provision aligns the treatment of transportation fringe benefits and amenities provided to an employee that are primarily personal in nature and not directly related to a trade or business with other similar tax items.

**JCT estimate:** According to JCT, the provision would increase revenues by \$14.7 billion over 2014-2023.

**Sec. 3127. Repeal of limitation on corporate acquisition indebtedness.**

**Current law:** Under current law, a corporation's interest deduction may be limited if it issues debt as consideration for the acquisition of stock in another corporation or for the acquisition of assets of another corporation. However, there are several exceptions to this general rule.

**Provision:** Under the provision, the interest-limitation rule for debt issued with respect to corporate acquisitions would be repealed. The provision would be effective for interest paid or incurred with respect to indebtedness incurred after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$0.1 billion over 2014-2023.

**Sec. 3128. Denial of deductions and credits for expenditures in illegal businesses.**

**Current law:** Under current law, no deduction or credit is allowed for an amount paid or incurred in carrying on a trade or business if the activities of the business consist of trafficking in controlled substances that are prohibited by Federal law or the State law in which the business is conducted. Current law, however, does not generally deny deductions or credits to illegal businesses, generally, however.

**Provision:** Under the provision, the rule denying deductions and credits would be expanded to include any trade or business if carrying out such business is a felony under Federal law or the law of any State in which the business is conducted. The provision would be effective for amounts paid or incurred after the date of enactment in tax years ending after the date of enactment.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

### **Sec. 3129. Limitation on deduction for FDIC premiums.**

**Current law:** Under current law, amounts paid by insured depository institutions pursuant to an assessment by the Federal Deposit Insurance Corporation (FDIC) to support the Deposit Insurance Fund (DIF) are currently deductible as a trade or business expense.

**Provision:** Under the provision, a percentage of such assessments would be non-deductible for institutions with total consolidated assets in excess of \$10 billion. The percentage of non-deductible assessments would be equal to the ratio that total consolidated assets in excess of \$10 billion bears to \$40 billion, so that assessments would be completely non-deductible for institutions with total consolidated assets in excess of \$50 billion. The provision would be effective for tax years beginning after 2014.

**Consideration:** The provision corrects for the fact that, when the FDIC determines the amount of assessments that are necessary to maintain an adequate balance in the DIF, it does so on a pre-tax 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.

**JCT estimate:** According to JCT, the provision would increase revenues by \$12.2 billion over 2014-2023.

### **Sec. 3130. Repeal of percentage depletion.**

**Current law:** Under current law, depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset is being expended to produce income. Under the percentage-depletion method, a percentage, varying from 5 percent to 22 percent (generally 15 percent for certain oil and gas properties), of the taxpayer's gross income from a producing property is allowed as a deduction in each tax year. The deduction generally may not exceed 50 percent (100 percent in the case of certain oil and gas properties) of the net income from the property in any year (the "net-income limitation"). Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income for the year. Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

**Provision:** Under the provision, the percentage-depletion method would be repealed. The provision would be effective for tax years beginning after 2014.

**Consideration:** All taxpayers are allowed a depreciation deduction for their assets that are being used to produce income. However, only extractive industries are allowed to recover more than their investment. The provision would create parity among all businesses with respect to recovering costs.

**JCT estimate:** According to JCT, the provision would increase revenues by \$5.3 billion over 2014-2023.

**Sec. 3131. Repeal of passive activity exception for working interests in oil and gas property.**

**Current law:** Under current law, the passive loss rules limit deductions and credits from passive trade or business activities. 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 subsequent years. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person. Pursuant to a special rule, a passive activity does not include a working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest. Thus, losses and credits from such interests may be used to offset other income of the taxpayer without limitation under the passive loss rule. This special rule applies without regard to whether the taxpayer materially participates in the activity.

**Provision:** Under the provision, the passive activity exception for working interests in oil and gas property would be repealed. The provision would be effective for tax years beginning after 2014.

**Consideration:** Generally, individual taxpayers are not allowed to deduct passive losses against their active or wage income under current law. However, a special rule exists for taxpayers that have an interest in oil and gas property. The provision creates parity among all taxpayers by removing this special exception.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

**Sec. 3132. Repeal of special rules for gain or loss on timber, coal, or domestic iron ore.**

**Current law:** Under current law, a taxpayer may elect to treat the cutting of timber for sale or use in the taxpayer's business as a sale or exchange of such timber cut during the year. A taxpayer that makes the election converts part of the ordinary gain resulting from the sale of the timber into capital gain. To elect this treatment, a taxpayer must have owned the timber or held a contract right to cut the timber for more than a year. Under the election, gain equal to the difference between the adjusted basis of the timber and the fair market value as of the first day of the tax year in which it was cut is treated as capital gain. Any additional gain attributable to the difference between the fair market value of the timber on the first day of the tax year and the proceeds from the sale of products produced from the timber cut (less ordinary and necessary business expenses) is ordinary. A similar election is permitted for the disposal of timber or coal or iron ore mined in the United States held for more than one year before the disposal.

**Provision:** Under the provision, gain from timber cut by an owner and used in its trade or business, and from the disposal of timber or coal or domestic iron ore held for more than one year before the disposal, would no longer be treated as capital gain. Thus, all gain in these circumstances would be treated as ordinary income. This provision generally would be effective for tax years beginning after 2014.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for sections 1001-1003 of the discussion draft.

### **Sec. 3133. Repeal of like-kind exchanges.**

**Current law:** Under current law, an exchange of property, like a sale, generally is a taxable transaction. A special rule provides that no gain or loss is recognized to the extent that property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like-kind that also is held for productive use in a trade or business or for investment. The taxpayer receives a basis in the new property equal to the taxpayer's adjusted basis in the exchanged property. The like-kind exchange rule applies to a wide range of property from real estate to tangible personal property. It does not apply, however, to exchanges of stock in trade or other property held primarily for sale, stocks, bonds, partnership interests, certificates of trust or beneficial interest, other securities or evidences of indebtedness or interest, or to certain exchanges involving livestock or involving foreign property. A like-kind exchange does not require that the properties be exchanged simultaneously – as long as the property to be received in the exchange is identified within 45 days and ultimately received within 180 days of the sale of the originally property, gain is deferred.

**Provision:** Under the provision, the special rule allowing deferral of gain on like-kind exchanges would be repealed. The provision would be effective for transfers after 2014. However, a like-kind exchange would be permitted if a written binding contract is entered into on or before December 31, 2014, and the exchange under the contract is completed before January 1, 2017.

#### **Considerations:**

- The like-kind exchange rules currently allow taxpayers to defer tax on the built-in gains in property by exchanging it for similar property. With multiple exchanges, gains essentially may be deferred for decades, and ultimately escape taxation entirely if the property's basis is stepped up to its fair market value upon the death of the owner.
- The current rules have no precise definition of "like-kind," which often leads to controversy with the IRS and provides significant opportunities for abuse.

**JCT estimate:** According to JCT, the provision would increase revenues by \$40.9 billion over 2014-2023.



**Sec. 3134. Restriction on trade or business property treated as similar or related in service to involuntarily converted property in disaster areas.**

**Current law:** Under current law, gain or loss realized from the sale or other disposition of property generally must be recognized at the time of the sale or other disposition. However, a special exception applies to certain involuntary or compulsory conversions of property (e.g., the property's destruction is due to a natural disaster, theft, seizure, requisition or condemnation) and generally permits such property to be replaced within two years with property that is similar or related in service or use to the property converted without recognizing taxable gain. If the trade or business is located in a Federally declared disaster area, any tangible property held for productive use in the trade or business is treated as similar or related in service or use. Thus, a taxpayer could replace lost inventory with a building, and no gain would be recognized.

**Provision:** Under the provision, tangible business property that is involuntarily converted in a Federally declared disaster area would qualify for deferral of gain recognition only if the depreciation class life of replacement property does not exceed that of the converted property. The provision would be effective for disasters declared after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

**Sec. 3135. Repeal of rollover of publicly traded securities gain into specialized small business investment companies.**

**Current law:** Under current law, gain or loss generally is recognized on any sale, exchange, or other disposition of property. A special rule permits an individual or corporation to roll over without recognition of income any capital gain realized on the sale of publicly traded securities when the proceeds are used to purchase common stock or a partnership interest in a specialized small business investment corporation (SSBIC) within 60 days of the sale of the securities. SSBICs are a special type of investment fund licensed by the U.S. Small Business Administration until 1996 when the program was repealed (though certain existing SSBICs were grandfathered). The amount of gain that a taxpayer may roll over in a tax year is limited to the lesser of (1) \$50,000 (\$250,000 for corporations) or (2) \$500,000 (\$1,000,000 for corporations) reduced by the gain previously excluded under the provision.

**Provision:** Under the provision, the special rule permitting gains on publicly traded securities to be rolled over to an SSBIC would be repealed. The provision would be effective for sales after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.3 billion over 2014-2023.

### **Sec. 3136. Termination of special rules for gain from certain small business stock.**

**Current law:** Under current law, a taxpayer (other than a corporation) may exclude 50 percent of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. For stock acquired in 2009 through 2013, the exclusion is 75 percent or 100 percent, depending on the timing of the acquisition. The amount of gain eligible for the exclusion with respect to the stock of any qualifying domestic C corporation is the greater of ten times the taxpayer's basis in the stock or \$10 million (reduced by the amount of gain eligible for exclusion in prior years). To qualify, the small business must have aggregate gross assets of \$50 million or less when the stock is issued and meet certain active trade or business requirements. A taxpayer may elect to roll over gain from the sale of qualified small business stock held more than six months when other qualified small business stock is purchased during the 60-day period beginning on the date of sale.

**Provision:** Under the provision, the exclusion of gain from the sale of certain small business stock would be repealed. The provision would be effective for gains with respect to stock issued after the date of enactment. For rollover of gains, the provision would not apply to sales of qualifying small business stock acquired before the date of enactment.

#### **Considerations:**

- Current law provides this narrow benefit only to investors in small businesses organized as C corporations with tradable stock, thereby favoring investors in those types of businesses over investors in small businesses organized as S corporations, partnerships, or LLCs. Accordingly, the provision repealing this narrow tax benefit would not apply to small businesses organized as pass-through entities.
- The current-law benefit would be repealed in favor of broad-based tax rate reductions, which will help all types of small businesses as well as the individuals who invest in them.

**JCT estimate:** According to JCT, the provision would increase revenues by \$4.8 billion over 2014-2023.

### **Sec. 3137. Certain self-created property not treated as a capital asset.**

**Current law:** Under current law, a self-created patent, invention, model or design (whether or not patented), or secret formula or process is treated as a capital asset. However, the following self-created property is not treated as a capital asset: copyrights; literary, musical or artistic compositions; and letters or memoranda. Any gain or loss recognized as a result of the sale, exchange, or other disposition of such property is generally ordinary in character. The creator of musical compositions or copyrights in musical works, however, may elect to treat such property as a capital asset.

**Provision:** Under the provision, gain or loss from the disposition of a self-created patent, invention, model or design (whether or not patented), or secret formula or process would be ordinary in character. This would be consistent with the treatment of copyrights under current

law. In addition, the election to treat musical works as a capital asset would be repealed. The provision would be effective for sales, exchanges, and other dispositions of such property after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.6 billion over 2014-2023.

### **Sec. 3138. Repeal of special rule for sale or exchange of patents.**

**Current law:** Under current law, an individual who creates a patent and an unrelated individual who acquires a patent from its creator prior to the actual commercial use of the patent may treat any gains on the transfer of the patent as long-term capital gains. To qualify, a transfer must be of substantially all the rights to the patent (or an undivided interest therein) and cannot be by gift, inheritance or devise.

**Provision:** Under the provision, the special rule treating the transfer of a patent prior to its commercial exploitation as long-term capital gain would be repealed. The provision would be effective for transfers after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.2 billion over 2014-2023.

### **Sec. 3139. Depreciation recapture on gain from disposition of certain depreciable realty.**

**Current law:** Under current law, the disposition of most property used in a business on which depreciation deductions were taken results in gain or loss that is treated as ordinary or capital depending on whether there is a net gain or a net loss. A net loss may be deducted fully against ordinary income. A net gain generally results in long-term capital gain treatment, subject to the depreciation recapture rules. The depreciation recapture rules require taxpayers to recognize ordinary income in an amount equal to all or a portion of the gain realized as a result of the basis reduction attributable to accumulated depreciation deductions. For depreciable real property (e.g., buildings or structural components of buildings) held for more than one year, gain is treated as ordinary income, rather than capital gain to the extent that the accelerated depreciation taken with respect to the property exceeds the amount of depreciation that would have been taken had the straight-line method been used. For depreciable real property held for one year or less, all of the depreciation is recaptured. For corporations, the recaptured amount treated as ordinary income generally is increased by an amount equal to 20 percent of all of the depreciation deductions taken with respect to the asset.

**Provision:** Under the provision, the recapture rules with respect to depreciable real property are revised to limit the amount treated as ordinary income to the lesser of: (1) the difference between the accelerated depreciation and straight-line depreciation attributable to periods before 2015, plus the total amount of depreciation attributable to periods after 2014, or (2) the excess of

the amount realized over the adjusted basis. The provision would be effective for dispositions after 2014.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for sections 1001-1003 of the discussion draft.

#### **Sec. 3140. Common deduction conforming amendments.**

**Current law:** Not applicable.

**Provision:** Under the provision, a number of conforming changes that are common to various sections in Subtitle B of Title III of the discussion draft would be made. These sections revise or repeal business-related exclusions and deductions. The provision generally would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Subtitle C – Reform of Business Credits**

#### **Sec. 3201. Repeal of credit for alcohol, etc., used as fuel.**

**Current law:** Under current law, a taxpayer could claim per-gallon incentives relating to alcohol (including ethanol) and cellulosic biofuels. The ethanol credit expired at the end of 2011. For alcohol other than ethanol, the amount of the credit was 60 cents per gallon, and for ethanol, the credit was 45 cents per gallon, with an extra 10 cents per gallon available for small ethanol producers.

The cellulosic biofuel producer credit was a nonrefundable income tax credit for each gallon of qualified cellulosic fuel produced during the tax year. The amount of the credit per gallon is \$1.01. The credit expired at the end of 2013.

**Provision:** Under the provision, these fuel tax credits would be repealed. The provision would be effective for fuels sold or used after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

#### **Sec. 3202. Repeal of credit for biodiesel and renewable diesel used as fuel.**

**Current law:** Under current law, the biodiesel fuels credit was the sum of three credits: (1) the biodiesel fuel-mixture credit, (2) the biodiesel credit, and (3) the small agri-biodiesel producer credit. Prior to 2014, a taxpayer could claim a credit of \$1.00 per gallon for producing a biodiesel fuel mixture, biodiesel and renewable diesel. The agri-biodiesel credit was a 10-cents-per-gallon credit for up to 15 million gallons of agri-biodiesel produced by small producers,

defined generally as persons whose agri-biodiesel production capacity did not exceed 60 million gallons per year. The credits expired at the end of 2013.

**Provision:** Under the provision, these fuel tax credits would be repealed. The provision would be effective for fuels sold or used after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 3203. Research credit modified and made permanent.**

**Current law:** Under current law, a taxpayer could claim a credit for qualified, U.S.-based research expenses prior to 2014. The research credit had three components, and in general, the credit was available for incremental increases in qualified research. First, a taxpayer could claim a credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a tax year exceeded its base amount for that year. An alternative simplified research credit (ASC) could be claimed in lieu of the basic credit. The ASC was equal to 14 percent of the qualified research expenses for the tax year that exceeded 50 percent of the average qualified research expenses for the three tax years preceding the tax year for which the credit was being determined. Under the ASC, if a taxpayer did not have any qualified research expenses in any of the three preceding tax years, the taxpayer could claim a research credit equal to 6 percent of qualified expenses incurred in the current year.

Second, a taxpayer also could claim a 20-percent credit for amounts paid (including grants or contributions) over a base amount to universities and certain non-profit scientific research organizations for basic research. Third, a 20-percent credit could be claimed for all expenses (without regard to a base amount) paid to an energy-research consortium for research conducted for the taxpayer. The research credit is not available for qualified expenses paid or incurred after 2013.

A taxpayer's qualified research expenses included: (1) in-house expenses for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent (higher in certain cases) of amounts paid or incurred to certain other entities for qualified research conducted on the taxpayer's behalf (contract research expenses).

To be eligible for the credit, qualified research must have been: (1) undertaken for the purpose of discovering information that was technological in nature; (2) the application of which was intended to be useful in the development of a new or improved business component; and (3) substantially all the activities of which constituted elements of a process of experimentation for the functional aspects, performance, reliability, or quality of a business component. In general, computer software developed by a taxpayer primarily for internal use was not qualified research. However, computer software was qualified research if for use in an activity that constituted qualified research, or in a production process that met the requirements for qualified research.

In addition, deductions otherwise allowed a taxpayer (for example for research and development expenses under Code section 174) were reduced by the amount of the taxpayer's research credit

for the tax year. Alternatively, a taxpayer could elect to claim a reduced research credit in lieu of reducing deductions otherwise allowed.

**Provision:** Under the provision, a modified research credit would be made permanent. The research credit would equal: (1) 15 percent of the qualified research expenses for the tax year that exceed 50 percent of the average qualified research expenses for the three tax years preceding the tax year for which the credit is determined (thus making the ASC permanent), plus (2) 15 percent of the basic research payments for the tax year that exceed 50 percent of the average basic research payments for the three tax years preceding the tax year for which the credit is determined. The provision would retain the rule under the ASC that allows a taxpayer to claim a reduced research credit if the taxpayer has no qualified research expenses in any one of the three preceding tax years. The general 20-percent credit would be repealed, as well as the 20-percent credit for amounts paid for basic research and the 20-percent credit for amounts paid to an energy research consortium.

Under the provision, amounts paid for supplies or with respect to computer software would no longer qualify as qualified research expenses. In addition, the special rule allowing 75 percent of amounts paid to a qualified research consortium and 100 percent of amounts paid to eligible small businesses, universities, and Federal laboratories to qualify as contract research expenses would be repealed (though such amounts still would qualify as contract research expenses subject to the 65-percent inclusion rule).

In addition, the provision would repeal the election to claim a reduced research credit in lieu of reducing deductions otherwise allowed.

The provision would be effective for tax years beginning after 2013, and for amounts paid and incurred after 2013.

**Considerations:**

- For too long, the research credit has been a temporary measure, even expiring in some years, resulting in significant uncertainty for innovators and reducing the effectiveness of the credit as an incentive. With a permanent research credit, business would have greater certainty when committing to investments in research and development.
- Making the ASC the only method for calculating the credit would ease administrative burdens for taxpayers and the IRS. Doing so would eliminate substantial amounts of recordkeeping, documentation issues, and controversy connected with the historical base-period credit. For example, using only the ASC would eliminate the need to document gross receipts, a key component to the historic base-period credit, and a source of controversy with the IRS.
- Other changes, such as removing the cost of supplies from the credit calculation, would reduce controversy with the IRS.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$34.1 billion over 2014-2023.

### **Sec. 3204. Low-income housing tax credit.**

**Current law:** Under current law, owners of certain residential rental property may claim a low-income housing tax credit (LIHTC) over a ten-year period for the cost of rental housing occupied by qualifying low-income tenants. However, rental housing must remain qualified low-income housing for a 15-year compliance period, beginning with the first year of the credit period (even though the credit period is only ten years). The amount of the credit for any tax year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The applicable percentage is adjusted monthly by the IRS so that the ten annual installments of the credit have a present value of either 70 percent or 30 percent of the total qualified basis. With certain exceptions, the qualified basis for any tax year equals the eligible basis of the building dedicated to low-income housing, based generally on the number of units or floor space of such units in the building.

In general, buildings subject to the 70-percent rule should yield a 9-percent credit, and buildings subject to the 30-percent rule should yield a 4-percent credit, although the credit amounts depend on the applicable interest rate used for discounting the building's basis for the particular tax year. A temporary provision under current law provided an applicable percentage of 9 percent with respect to the 70-percent rule for newly constructed non-Federally subsidized buildings placed in service before 2014.

Housing that qualifies for the 9-percent credit must be either newly constructed or substantially rehabilitated, and may not be Federally subsidized (including through tax-exempt bond financing). A new building generally is considered Federally subsidized if it also receives tax-exempt bond financing. The 4-percent credit is available, in general, for Federally subsidized buildings and existing housing.

To claim the credit, the owner of a qualified building must receive a housing credit allocation from the State or local housing credit agency. A State's available credit allocation has four components: (1) the State's unused housing amount, if any, from the prior calendar year; (2) the credit amount for the current year; (3) any credits returned to the State during the calendar year from previous allocations; and (4) the State's share, if any, of the national pool of unused credits from other States that failed to use them. Only States that allocated their entire credit authority for the preceding calendar year are eligible for a share of the national pool. For calendar year 2013, each State's credit authority was \$2.25 per resident, with a minimum annual cap of \$2,590,000 for certain small population States. These amounts are indexed for inflation. Certain buildings that also receive financing with proceeds of tax-exempt bonds do not require an allocation to qualify for the LIHTC.

Generally, buildings located in two types of high-cost areas – qualified census tracts and difficult development areas – are eligible for an enhanced credit, under which the applicable basis of the property is increased from 100 percent to 130 percent. In addition, a building designated by a State housing credit agency may qualify if the enhanced credit is required for such building to be financially feasible.

Property subject to the credit generally must continue to be a low-income housing project for a compliance period of 15 years, beginning on the first day of the first tax year in which the credit is claimed. The penalty for any building failing to remain qualified is the recapture of the accelerated portion of the credit, with interest, for all prior years. Generally, a change in ownership of a building is a recapture event, subject to an exception if it can reasonably be expected that the building will continue to be operated as qualified low-income housing for the remainder of the compliance period.

Current law includes a number of other eligibility criteria for the LIHTC. While the residential units in a qualified low-income housing project must be available for use by the general public (e.g., the owner complies with certain housing non-discrimination policies and does not restrict occupancy based on membership in a social organization or employment by specific employers), a project may impose occupancy restrictions or preferences that favor tenants: (1) with special needs; (2) who are members of specified group under a Federal program or State program or policy that supports housing for such a specified group; or (3) who are involved in artistic and literary activities. Additionally, each State must develop a plan for allocating credits, and certain selection criteria must be considered when evaluating projects for credit allocations. The criteria are: (1) project location; (2) housing needs characteristics; (3) project characteristics (including whether the project uses existing housing as part of a community revitalization plan); (4) sponsor characteristics; (5) tenant populations with special needs; (6) tenant populations of individuals with children; (7) projects intended for eventual tenant ownership; (8) the energy efficiency of the project; and (9) the historic nature of the project. The State allocation plan must give preference to housing projects that serve the lowest-income tenants, that are obligated to serve qualified tenants for the longest periods, and that are located in qualified census tracts and the development of which contributes to a concerted community revitalization plan.

**Provision:** Under the provision, the LIHTC would be modified in several ways.

*Allocation of basis:* Under the provision, State and local housing authorities would allocate qualified basis, rather than credit amounts. The annual amount of allocable basis for each State would be equal to \$31.20 multiplied by the State's population, with a minimum annual amount of \$36,300,000. The annual amount would continue to include unused basis allocations from the prior year plus basis allocations returned to the State during the calendar year from previous allocations. The national pool of unused credits, however, would be eliminated.

*Credit period:* Under the provision, the credit period would be extended from 10 years to 15 years to match the current 15-year compliance period. Because the credit period would be aligned with the compliance period, the recapture rules also would be repealed as no longer necessary to ensure that the building continues to be a low-income housing project for the duration of the tax benefit.

*Credit amount:* Under the provision, the 4-percent credit would be repealed. The 9-percent credit for newly constructed property and substantial rehabilitations would be retained. In addition, Federally funded grants would not be taken into account in determining the eligible basis of a building for purposes of the credit. As a result, the credit would apply to private funding of low-income housing and not provide an additional subsidy for Federal funding of



such projects. The amount of the credit would continue to equal the qualified basis in the qualified low-income building multiplied by the applicable percentage. Under the provision, the IRS would determine the applicable percentage generally for the month that the building is placed in service, which would be equal to the percentage that would yield over a 15-year period a credit amount that would have a present value equal to 70 percent of the qualified basis of the building.

*Other changes:* Under the provision, several other rules would be modified. First, the increased basis rule for high-cost and difficult development areas would be repealed. Second, the general-public-use requirement would be revised to eliminate the special occupancy preference for members of specific groups under certain Federal or State programs and the special preference for individuals involved in artistic and literary activities. Instead, occupancy preferences would only be permitted for individuals with special needs and for veterans. Third, the provision would repeal the requirement that States include in their low-income-housing selection criteria the energy efficiency of the project and the historic nature of the project.

The provision would be effective for State basis amounts and allocations of such amounts determined for calendar years after 2014. A transition rule would translate credit allocations prior to 2015 into equivalent amounts of eligible basis for purposes of determining new allocations of basis after 2014.

#### **Considerations:**

- The LIHTC provides an important private-sector alternative to Federally financed and operated housing for low-income individuals (e.g., Section 8 housing).
- According to the non-partisan Joint Committee on Taxation (JCT), the provision would increase the amount of LIHTC-financed projects by more than 5 percent in 2015 (from \$9.3 billion to \$9.8 billion), while reducing the cost to taxpayers.
- By modernizing the credit, the provision would provide a more transparent benefit by permitting States to allocate the basis that supports low-income housing units.
- The provision also would align the credit period with the current 15-year compliance period to ensure that the housing project continues to meet its low-income purpose for the duration of the tax benefit.
- The provision would simplify the current credit, which is the longest section of the Code today, by streamlining many complex provisions and eliminating several special rules.

**JCT estimate:** According to JCT, the provision would increase revenues by \$10.7 billion over 2014-2023.

#### **Sec. 3205. Repeal of enhanced oil recovery credit.**

**Current law:** Under current law, taxpayers may claim a credit equal to 15 percent of enhanced oil recovery (EOR) costs. The EOR credit is ratably reduced over a \$6 phase-out range when the reference price for domestic crude oil exceeds \$28 per barrel (adjusted for inflation after 1991). The EOR credit currently is phased-out based on the current price of a barrel of oil.

**Provision:** Under the provision, the enhanced oil recovery credit would be repealed. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3206. Phaseout and repeal of credit for electricity produced from certain renewable resources.**

**Current law:** Under current law, a taxpayer may claim a credit (the production tax credit or PTC) is allowed for the production of electricity from qualified energy resources. Qualified energy resources are comprised of wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. To be eligible for the PTC, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person. The base amount of the PTC is 1.5 cents (indexed annually for inflation) per kilowatt-hour of electricity produced. The amount of the credit is generally 2.3 cents per kilowatt-hour for 2013. A taxpayer generally may claim a credit every year during a 10-year period for projects that begin construction before 2014.

**Provision:** Under the provision, the inflation adjustment would be repealed, effective for electricity and refined coal produced or sold after 2014. Therefore, taxpayers' credit amount would revert to 1.5 cents per kilowatt-hour for the remaining portion of the 10-year period. The entire production tax credit would be repealed, effective for electricity and refined coal produced and sold after 2024.

**Consideration:** Businesses in the wind industry have represented to the Committee that the industry could survive with a credit worth 60 percent of the current credit, implying that the credit provides a windfall that does not serve the intended policy.

**JCT estimate:** According to JCT, the provision would increase revenues by \$9.6 billion over 2014-2023.

**Sec. 3207. Repeal of Indian employment credit.**

**Current law:** Under current law, a taxpayer could claim a credit equal to 20 percent of qualifying wages and health insurance costs (up to \$20,000, for a maximum credit amount of \$4,000) paid prior to 2014 to enrolled members of an Indian tribe (or spouses) living on or near an Indian reservation for services performed on a reservation. The credit was limited to employees earning wages of \$45,000 or less. The credit expired for tax years beginning after 2013.

**Provision:** Under the provision, the Indian employment credit would be repealed. The provision would be effective for tax years beginning after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3208. Repeal of credit for portion of employer Social Security taxes paid with respect to employee cash tips.**

**Current law:** Under current law, an employer may claim an income tax credit equal to its share of FICA taxes attributable to tips received from customers in connection with the provision of food or beverages if tipping is customary. The credit is available only to the extent such tips exceed the amount of tips that the employer uses to meet the minimum wage requirements for the employee under the Fair Labor Standards Act. An employer may not claim a deduction for any amount taken into account in determining the credit.

**Provision:** Under the provision, the tip credit would be repealed. The provision would be effective for tips received for services performed after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$10.1 billion over 2014-2023.

**Sec. 3209. Repeal of credit for clinical testing expenses for certain drugs for rare diseases or conditions.**

**Current law:** Under current law, a taxpayer may claim a credit equal to 50 percent of qualified clinical testing expenses incurred in testing certain drugs for rare diseases or conditions, often referred to as “orphan drugs.” Expenses taken into account for purposes of the orphan drug credit do not qualify for the general research credit.

**Provision:** Under the provision, the tax credit for orphan drugs would be repealed. The provision would be effective for amounts paid or incurred in tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$9.1 billion over 2014-2023.

**Sec. 3210. Repeal of credit for small employer pension plan startup costs.**

**Current law:** Under current law, a taxpayer may claim a credit to help offset the start-up costs associated with a small employer pension plan. The credit is only available for the first three years of the plan and is limited to the lesser of \$500 per year or 50 percent of the start-up costs for a qualified plan under Code section 401(a), an annuity plan under Code section 403(a), a Simplified Employee Pension (SEP) plan, or a SIMPLE retirement plan.

**Provision:** Under the provision, the credit for small employer pension plan start-up costs would be repealed. The provision would be effective for costs paid or incurred after 2014 with respect to qualified employer plans first effective after such date.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

**Sec. 3211. Repeal of employer-provided child care credit.**

**Current law:** Under current law, an employer may claim a credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child-care resource and referral services. The credit is limited to \$150,000 per tax year.

**Provision:** Under the provision, the credit for employer-provided child care would be repealed. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.2 billion over 2014-2023.

**Sec. 3212. Repeal of railroad track maintenance credit.**

**Current law:** Under current law, an eligible taxpayer could claim a credit equal to 50 percent of qualified railroad track maintenance expenditures paid or incurred in a tax year prior to 2014. The credit generally was limited to \$3,500 multiplied by the number of miles of railroad track owned or leased by the eligible taxpayer as of the close of its tax year. The credit expired at the end of 2013.

**Provision:** Under the provision, the railroad track maintenance credit would be repealed. The provision would be effective for tax years beginning after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3213. Repeal of credit for production of low sulfur diesel fuel.**

**Current law:** Under current law, a small business refiner may claim, with respect to expenses paid or incurred before 2010, a credit of 5 cents per gallon for each gallon of low sulfur diesel fuel produced during the tax year. The total production credit claimed by the taxpayer was limited to 25 percent of the qualified costs incurred to come into compliance with the EPA diesel fuel requirements. The credit for low sulfur diesel fuel expired at the end of 2009.

**Provision:** Under the provision, the credit would be repealed. The provision would be effective for expenses paid or incurred in tax years after 2014.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3214. Repeal of credit for producing oil and gas from marginal wells.**

**Current law:** Under current law, producers may claim a \$3-per-barrel credit (adjusted for inflation) for the production of crude oil and a 50-cents-per-1,000-cubic-foot credit (also adjusted for inflation) for the production of qualified natural gas. In both cases, the credit is available only for domestic production. The credit is not available for production if the reference price of oil exceeds \$18 (\$2 for natural gas). The credit is reduced proportionately for reference prices between \$15 and \$18 (\$1.67 and \$2 for natural gas). Currently, the credit is phased out completely based on the current price of a barrel of oil.

**Provision:** Under the provision, the credit would be repealed. The provision would be effective for tax years after 2014.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3215. Repeal of credit for production from advanced nuclear power facilities.**

**Current law:** Under current law, a taxpayer producing electricity at a qualifying advanced nuclear power facility may claim a credit equal to 1.8 cents per kilowatt-hour of electricity produced for the eight-year period starting when the facility is placed in service.

**Provision:** Under the provision, the credit would be repealed. The provision would be effective for electricity produced and sold after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.6 billion over 2014-2023.

**Sec. 3216. Repeal of credit for producing fuel from a nonconventional source.**

**Current law:** Under current law, a taxpayer producing coke and coke gas in the United States at qualified facilities and sold to unrelated parties could claim a credit equal to \$3 (generally adjusted for inflation) per Btu oil barrel equivalent. The credit for fuel from a non-conventional source expired at the end of 2009.

**Provision:** Under the provision, the credit would be repealed. The provision would be effective for fuel produced and sold after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3217. Repeal of new energy efficient home credit.**

**Current law:** Under current law, an eligible contractor could claim the new energy-efficient home credit for the construction of a qualified new energy-efficient home prior to 2014. The

credit was equal to either \$1,000 or \$2,000, depending on whether it met the 30-percent or 50-percent standard as prescribed by the IRS to achieve either a 30-percent or 50-percent reduction in heating and cooling energy consumption compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2006 International Energy Conservation Code. The credit expired at the end of 2013.

**Provision:** Under the provision, the credit would be repealed. The provision would be effective for homes acquired after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 3218. Repeal of energy efficient appliance credit.**

**Current law:** Under current law, a taxpayer could claim a credit for the production of certain energy-efficient dishwashers, clothes washers, and refrigerators prior to 2014. The amount of the credit varied for each appliance depending on when the appliance was manufactured and how much energy or water it saved. The credit expired at the end of 2013.

**Provision:** Under the provision, the credit would be repealed. The provision would be effective for appliances produced after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 3219. Repeal of mine rescue team training credit.**

**Current law:** Under current law, a taxpayer could claim a credit with respect to employees serving on a mine-rescue team prior to 2014. The credit was equal to the lesser of 20 percent of the taxpayer's mine-rescue training program costs (including the wages of the employee while attending the program) or \$10,000. The credit expired at the end of 2013.

**Provision:** Under the provision, the mine rescue team training credit would be repealed. The provision would be effective for tax years beginning after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 3220. Repeal of agricultural chemicals security credit.**

**Current law:** Under current law, a taxpayer could claim a credit equal to 30 percent of certain chemical security expenditures incurred by qualifying agricultural businesses prior to 2013. The credit was limited to \$100,000 per facility, reduced by the amount of credits claimed in the prior five years, and a taxpayer's annual credit amount was limited to \$2 million. The credit is not available for expenses incurred after 2012.

**Provision:** Under the provision, the agricultural chemicals security credit would be repealed. The provision would be effective for amounts paid or incurred after 2012.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 3221. Repeal of credit for carbon dioxide sequestration.**

**Current law:** Under current law, a taxpayer may claim a credit of \$20 per metric ton for qualified carbon dioxide captured by the taxpayer at a qualified facility and disposed of by such taxpayer in secure geological storage (\$10 per metric ton if used by such taxpayer as a tertiary injectant in a qualified enhanced oil or natural gas recovery project). Both credit amounts are adjusted for inflation after 2009.

**Provision:** Under the provision, the carbon dioxide sequestration credit would be repealed. The provision would be effective for credits determined for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.1 billion over 2014-2023.

### **Sec. 3222. Repeal of credit for employee health insurance expenses of small employers.**

**Current law:** Under current law, a qualified small business employer may claim a credit for up to two years if the small business pays at least half of its employees' health insurance premiums. For tax years 2010 to 2013, the maximum credit is 35 percent of premiums paid by eligible small businesses and 25 percent of premiums paid by eligible tax-exempt organizations. Beginning in 2014, the maximum tax credit will increase to 50 percent of premiums paid by eligible small business employers and 35 percent of premiums paid by eligible tax-exempt organizations, but the credit will only be available for health insurance coverage purchased through a State exchange. A qualified small business employer generally is an employer with no more than 25 full-time equivalent employees (FTEs) during the tax year, with annual full-time equivalent wages averaging no more than \$50,000 (indexed for inflation beginning in 2014). The full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages of less than \$25,000 (indexed for inflation beginning in 2014). Tax-exempt organizations generally may apply the credit against the organization's payroll tax liability.

**Provision:** Under the provision, the credit for employee health insurance expenses of small employers would be repealed. The provision would be effective for amounts paid or incurred for tax years beginning after 2014.

**Considerations:**

- Enacted as part of the Affordable Care Act (ACA), this credit is overly complex, narrow in its application, and short-lived – in contrast to the permanent insurance expenses that employers are required to incur under the ACA.
- As a result, very few small businesses have opted to claim the benefit and a number of small business advocacy groups have expressed concern over its complexity and narrow application.

**JCT estimate:** According to JCT, the provision would increase revenues by \$11.1 billion over 2014-2023 and would reduce outlays by \$1.1 billion over 2014-2023.

**Sec. 3223. Repeal of rehabilitation credit.**

**Current law:** Under current law, a taxpayer may claim a credit for expenses incurred to rehabilitate old and/or historic buildings. A 20-percent credit is allowed for qualified rehabilitation expenditures with respect to a certified historic structure, while a 10-percent credit is allowed for qualified rehabilitation expenditures with respect to a qualified rehabilitated building. To qualify for the 10-percent credit, the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the tax year must exceed the greater of the adjusted basis of the building (and its structural components) or \$5,000.

**Provision:** Under the provision, the rehabilitation credit would be repealed. The provision would be effective for amounts paid after 2014. Under a transition rule, the credit would continue to apply to expenditures incurred through the end of 2016, to rehabilitate a qualified rehabilitated building or a certified historic structure acquired before 2015. However, for a qualified rehabilitated building, the 24-month rehabilitation period for claiming the credit must also begin on or before January 1, 2015.

**JCT estimate:** According to JCT, the provision would increase revenues by \$10.5 billion over 2014-2023.

**Sec. 3224. Repeal of energy credit.**

**Current law:** Under current law, taxpayers may claim up to a 30-percent nonrefundable, business energy credit for the cost of certain new equipment that either (1) uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) is used to produce, distribute, or use energy derived from a geothermal deposit (but only, in the case of electricity generated by geothermal power, up to the electric transmission stage). Property used to generate energy for the purposes of heating a swimming pool is not eligible solar energy property. The credit expires at the end of 2016.

**Provision:** Under the provision, the credit would be repealed. The provision is effective for property placed in service after 2016.



**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3225. Repeal of qualifying advanced coal project credit.**

**Current law:** Under current law, a taxpayer may claim an investment tax credit for power generation projects that use integrated gasification combined cycle (IGCC) or other advanced coal-based electricity generation technologies. Credits are available only for projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy.

**Provision:** Under the provision, the credit would be repealed. The provision would be effective for allocations and reallocations after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.9 billion over 2014-2023.

**Sec. 3226. Repeal of qualifying gasification project credit.**

**Current law:** Under current law, a taxpayer may claim an investment credit for certain qualifying gasification projects. Only property that is part of a qualifying gasification project and necessary for the gasification technology of such project is eligible for the gasification credit. The maximum amount of credits allocated under the program may not exceed \$600 million.

**Provision:** Under the provision, the credit would be repealed. The provision would be effective for allocations and reallocations after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.3 billion over 2014-2023.

**Sec. 3227. Repeal of qualifying advanced energy project credit.**

**Current law:** Under current law, a 30-percent credit is available for investments in certain property used in a qualified advanced energy manufacturing project. A qualified advanced energy project is a project that re-equips, expands, or establishes a manufacturing facility for certain specified green energy uses. Credits are available only for projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy. The maximum amount of credit allocated under the program may not exceed \$2.3 billion.

**Provision:** Under the provision, the credit would be repealed. The provision would be effective for allocations and reallocations after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.3 billion over 2014-2023.

**Sec. 3228. Repeal of qualifying therapeutic discovery project credit.**

**Current law:** Under current law, a taxpayer could claim a credit equal to 50 percent of its investments in qualifying therapeutic discovery projects in 2009 and 2010. Under the program, the IRS, in consultation with the Secretary of HHS, awarded certifications for qualified investments.

**Provision:** Under the provision, the credit for therapeutic discovery projects would be repealed. The provision would be effective for allocations and reallocations after 2014.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3229. Repeal of work opportunity tax credit.**

**Current law:** Under current law, an employer could claim the work opportunity tax credit if it hired individuals from one or more of nine targeted groups prior to 2014. An employer calculated the credit based on the amount of qualified wages paid to the employee. Generally, qualified wages consisted of wages attributable to services rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. The credit is not available for wages paid or incurred after 2013.

**Provision:** Under the provision, the work opportunity tax credit would be repealed. The provision would be effective for wages paid or incurred to individuals who begin work after 2013.

**Consideration:** Under the now-expired WOTC, it often has not been possible for an employer to determine whether an individual is eligible for the credit until well after that individual has been hired and certified by the appropriate State agencies. This fact calls into serious question whether the WOTC encourages the hiring of individuals from the favored groups. Nevertheless, the WOTC has been shown to result in significant compliance costs for employers.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3230. Repeal of deduction for certain unused business credits.**

**Current law:** Under current law, a taxpayer may carry unused business credits may be carried back one year and carried forward 20 years. However, a taxpayer generally may deduct unused credits after the end of the carryforward period or when a business ceases to exist.

**Provision:** Under the provision, the deduction for general business credits unused after 20 years would be repealed. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

## Subtitle D – Accounting Methods

### **Sec. 3301. Limitation on use of cash method of accounting.**

**Current law:** Under current law, taxpayers using the cash method of accounting (“cash method”) generally recognize income when actually or constructively received and expenses when paid. Taxpayers using an accrual method of accounting (“accrual method”) generally accrue 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. Taxpayers using an accrual method generally may not deduct expenses before 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.

Current law includes an array of rules for determining whether a taxpayer may use the cash method, with different kinds of businesses subject to different sets of rules. For example, a C corporation or a partnership that has a C corporation as a partner generally may use the cash method only if its average annual gross receipts are \$5 million or less. A corporation or a partnership with a corporate partner engaged in farming generally may only use a cash method of accounting if its average annual gross receipts are \$1 million or less (\$25 million or less for family farm corporations). Sole proprietors and qualified personal service corporations (i.e., corporations that primarily perform services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and that are owned by individuals performing such services) are allowed to use the cash method without regard to their average annual gross receipts. Additionally, a business generally must use an accrual method of accounting if it has inventory.

**Provision:** Under the provision, businesses with average annual gross receipts of \$10 million or less may use the cash method of accounting; whereas businesses with more than \$10 million would be required to use accrual accounting. The provision would not apply to farming businesses, which would continue to be subject to current-law accounting rules. Sole proprietors also would continue to be able to use the cash method regardless of the level of gross receipts. The provision would be effective for tax years beginning after 2014. A taxpayer generally would be permitted to include any positive adjustments to income resulting from the provision over a four-year period beginning with its first tax year beginning after 2018 in the following amounts: 10 percent included in the first year (2019); 15 percent in the second year (2020); 25 percent in the third year (2021); and 50 percent in the fourth year (2022). At the election of the taxpayer, the four-year inclusion of the adjustment could begin prior to 2019.

#### **Considerations:**

- Current law contains an array of complicated tax accounting rules and disjointed thresholds for small businesses to determine which method of accounting – the cash method or accrual method – they may use for tax purposes. The provision simplifies and harmonizes this area of law for many businesses.
- For many small businesses, the cash method is simpler and follows more closely the cash flows of their income and expenses. On the other hand, the accrual method provides a

more accurate reflection of income. The provision strikes a balance between these two objectives that respects small businesses' need for simplicity.

**JCT estimate:** According to JCT, the provisions would increase revenues by \$23.6 billion over 2014-2023.

### **Sec. 3302. Rules for determining whether taxpayer has adopted a method of accounting.**

**Current law:** Under current law, a taxpayer's method of accounting used to compute taxable income must clearly reflect income. A taxpayer generally must secure the consent of the IRS Commissioner before changing a method of accounting for Federal income tax purposes. Current law does not provide rules for determining whether a taxpayer has adopted a method of accounting. The IRS takes the position that if a taxpayer treats an item properly in the first return that reflects the item, the taxpayer has adopted a method of accounting. Similarly, under IRS guidance, when a taxpayer treats an item in the same erroneous manner on two consecutive returns, a taxpayer also has adopted a method of accounting (and any change would require the consent of the Commissioner).

**Provision:** Under the provision, the IRS guidance with respect to determining whether a taxpayer has adopted a method of accounting would be codified. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

### **Sec. 3303. Certain special rules for taxable year of inclusion.**

**Current law:** Under current law, a taxpayer is required to include any item of income in the taxpayer's gross income in the year in which the income is received, unless the taxpayer's method of accounting used to compute taxable income permits inclusion in a different period. There are, however, numerous exceptions to this rule. For example, cash and accrual method taxpayers that receive advance payments for certain goods or services may elect to defer inclusion of the income for up to two years. Cash method taxpayers who receive insurance proceeds or Federal disaster payments as a result of destruction or damage to crops may elect to defer inclusion of such proceeds in income until the following tax year. Similarly, a cash method taxpayer may defer until the following tax year income resulting from the sale or exchange of livestock if the taxpayer demonstrates that such sales would not have occurred under his normal business practices if it were not for drought, flood, or other weather-related conditions occurring in a Federally declared disaster area. Another special exception applies to utility companies required to sell electric transmission property to an independent transmission company prior to January 1, 2008 (January 1, 2014, in the case of a qualified electric utility) to implement certain Federal and State electric-restructuring policy. Under the exception, the utility companies that use the accrual method of accounting could elect to recognize gain from the sale or exchange of

qualifying transmission property ratably over an eight-year period if the proceeds are used to purchase approved reinvestment property.

**Provision:** Under the provision, a taxpayer on the accrual method of accounting for tax purposes would be required to include an item of income no later than the tax year in which such item is included for financial statement purposes. The provision also would provide that cash and accrual method taxpayers may defer the inclusion of advance payments for certain goods and services in income for tax purposes up to one year (but not longer than any deferral for financial statement purposes). Additionally, the provision would repeal (1) the exceptions for crop insurance proceeds and disaster payments (for destruction and damage to crops and natural disasters occurring after 2014), (2) the special exception for livestock sales (for sales and exchanges after 2014), and (3) the special exception for utility-restructuring transactions (for sales and dispositions after 2013). Except as noted, the provision would be effective for tax years beginning after 2014, with any adjustments resulting from accounting-method changes taken into account over the four years following the effective date.

**JCT estimate:** According to JCT, the provision would increase revenues by \$10.4 billion over 2014-2023.

#### **Sec. 3304. Installment sales.**

**Current law:** Under current law, a taxpayer generally may use the installment method to defer inclusion of amounts that are to be received from the disposition of certain types of property until payment in cash is received, with the gain from the disposition spread over the series of payments. Dealers in property may not use the installment method, except for sales of farm property, timeshares, and residential lots. Taxpayers with large installment sales are subject to an interest charge on the tax deferral to the extent that the taxpayer's aggregate installment sales exceed \$5 million. In determining the \$5 million limitation, the taxpayer includes only installment sales of more than \$150,000 arising during and remaining outstanding at the close of any tax year. The interest charge rules do not apply to sales by dealers of farm property, and special interest charges apply to sales by dealers of timeshares and residential lots.

**Provision:** Under the provision, the interest charge rules would apply to any installment sale in excess of \$150,000, provided the obligation remains outstanding at the end of the tax year, eliminating the aggregate \$5 million limitation. The provision also would repeal the exceptions and special rules for sales of farm property, timeshares, and residential lots. The provision would be effective for sales and other dispositions after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.1 billion over 2014-2023.

**Secs. 3305-3306. Repeal of special rule for prepaid subscription income; Repeal of special rule for prepaid dues income of certain membership organizations.**

**Current law:** Under current law, a special rule permits prepaid income from a newspaper, magazine or other periodical subscription to be deferred until the year in which the taxpayer provides the periodical even if such time is more than a year in the future. A similar rule permits a membership organization to defer prepaid dues income until the year in which the organization provides the services or other membership privileges for which the dues were prepaid.

**Provision:** Under the provision, the special rules for prepaid subscription income and prepaid membership dues would be repealed. Taxpayers would still be able to defer the inclusion of advanced payments until the following tax year (as provided in section 3303 of the discussion draft). The provision would be effective for payments received after 2014.

**JCT estimate:** According to JCT, the provisions would increase revenues by \$0.4 billion over 2014-2023.

**Sec. 3307. Repeal of special rule for magazines, paperbacks, and records returned after close of the taxable year.**

**Current law:** Under current law, sales of merchandise by a taxpayer on the accrual method of accounting generally must be included in income in the tax year when all events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. In cases where merchandise is returned for a credit or refund, the reduction in income generally must be recognized in the tax year in which the merchandise return occurs. A special rule permits taxpayers to elect to exclude from gross income sales of any magazine or other periodical, paperback book, or record (including discs, tapes, etc.) that is returned within two-and-a-half months (for magazines) or four-and-a-half months (in the case of paperbacks and records) after the close of the tax year in which the item was sold.

**Provision:** Under the provision, the special rule for magazines, paperbacks, and records returned after close of the tax year would be repealed. The provision would be effective for tax years beginning after 2014, with any adjustments resulting from accounting-method changes taken into account over the four years following the effective date.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.2 billion over 2014-2023.

**Sec. 3308. Modification of rules for long-term contracts.**

**Current law:** Under current law, a taxpayer that produces property pursuant to a long-term contract must determine the taxable income from the contract under the percentage-of-completion method (PCM), which generally requires the taxpayer to include in gross income the portion of the contract price equal to the percentage of the contract completed during the year.

There is an exception for certain home construction contracts and for other contracts estimated to be completed within two years by taxpayers with average gross receipts of \$10 million or less over a three-year period. Taxpayers qualifying for either exception may use the completed-contract method, under which income is generally not included until the contract is completed. Special rules apply to certain construction contracts for multi-unit housing (i.e., more than four dwelling units) under which taxpayers generally may treat 70 percent of the construction contract under PCM and 30 percent under the completed-contract method. Similarly, taxpayers with certain ship-building contracts may elect a blended approach, with 40 percent of the contract treated under PCM and 60 percent under the completed-contract method.

**Provision:** Under the provision, the completed-contract method would be limited to contracts estimated to be completed within two years for taxpayers with average gross receipts of \$10 million or less over a three-year period. The provision also would repeal the special exceptions to the PCM rules for multi-unit housing contracts and ship-building contracts. The provision would be effective for contracts entered into after 2014.

**Considerations:**

- Current law generally requires large construction companies with long-term contracts to use the PCM, under which revenues and expenses are matched in the applicable accounting period based on the extent to which the contract has been completed.
- The completed-contract method was intended to be a simplified method for small contractors and home builders. The exception, however, is not limited to small businesses in the case of home builders, which enables some very large construction companies to avoid the more appropriate matching principles under the PCM.
- The provision would modify the completed-contract method to apply simply to small business construction contractors.

**JCT estimate:** According to JCT, the provision would increase revenues by \$6.5 billion over 2014-2023.

**Sec. 3309. Nuclear decommissioning reserve funds.**

**Current law:** Under current law, a taxpayer responsible for decommissioning a nuclear power plant may establish a nuclear decommissioning reserve fund to resolve certain tort liabilities. The income of a nuclear decommissioning reserve fund is taxed at a reduced rate of 20 percent. Contributions to nuclear decommissioning reserve funds are generally deductible by an accrual method taxpayer in the tax year such contributions are made, even though the fund will not perform its obligation to pay the beneficiaries or fund the costs of decommissioning the nuclear plant until a subsequent tax year. Contributions to a nuclear decommissioning reserve fund may be returned to the contributing company provided such returned funds are included in income.

**Provision:** Under the provision, the special 20-percent tax rate for nuclear decommissioning reserve funds would be repealed, and the tax rate generally applicable to corporations would apply. For distributions by a nuclear decommissioning reserve fund that are used for non-qualified purposes (e.g., return of funds to the contributing company), the provision would

require the contributing taxpayer to include the balance of the fund in income in the tax year of the distribution. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.2 billion over 2014-2023.

### **Sec. 3310. Repeal of last-in, first-out method of inventory.**

**Current law:** Under current law, a taxpayer must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor in the taxpayer's trade or business. There are two primary inventory accounting methods: last-in, first-out (LIFO) and first-in, first-out (FIFO). Under the LIFO inventory accounting method, it is assumed that the last item entered into the inventory is the first item sold. Accordingly, the taxpayer's cost of goods sold is valued at the most recent costs, and any effects of cost fluctuations are reflected in the ending inventory, which is valued at historical costs rather than the most recent costs. A taxpayer may only use the LIFO method for tax purposes, however, if it reports income for financial statement purposes using the LIFO method. Under the FIFO inventory accounting method, it is assumed that the first item entered into inventory is the first item sold. Thus, ending inventory is valued at its most recent costs rather than at historical costs. Taxpayers that use LIFO are required to calculate and track their LIFO reserves, which is the difference between the accounting cost of inventory calculated using the FIFO method and the same inventory using the LIFO method. The LIFO reserve is the deferred taxable income that results from using the most recent inventory costs to calculate cost of goods sold, rather than the lower cost associated with historic inventory, and under certain circumstances (e.g., sales exceed purchases, dissolution or sale of the business), the deferred income is realized by the taxpayer and is thus subject to tax.

**Provision:** Under the provision, the LIFO inventory accounting method would no longer be permitted. Thus, taxpayers could use FIFO or any other method that conforms to the best accounting practice in a particular trade or business and clearly reflects income. A taxpayer would include its LIFO reserve in income over a four-year period beginning with its first tax year beginning after 2018 in the following amounts: 10 percent included in the first year (2019); 15 percent in the second year (2020); 25 percent in the third year (2021); and 50 percent in the fourth year (2022). Taxpayers could elect to begin the four-year inclusion period in an earlier tax year. Closely held entities – generally defined as having no more than 100 owners as of February 26, 2014 (using rules similar to those used for S corporations and taking indirect ownership into account) – would be subject to a reduced 7-percent tax rate on their LIFO reserves. The provision would apply to tax years beginning after 2014.

#### **Considerations:**

- The LIFO reserve is an integral component of the LIFO method of accounting. When a taxpayer chooses the LIFO method of accounting, they accept that the deferred tax liability will have to be recognized at some point. This provision is not a retroactive tax increase, but merely triggers the deferred tax liability inherent to the LIFO inventory accounting method.



- The provision provides a significant transition rule for all taxpayers, large and small, to permit them to delay the inclusion of any LIFO reserves until 2019 and then slowly take such reserves into account over a four-year period.
- Additionally, because the repeal of the LIFO method and the inclusion of the LIFO reserve in income could have a substantial effect on cash flow for small and family-owned businesses, the provision provides that LIFO reserves of closely held businesses would be subject to a reduced tax rate of 7 percent. This transition rule should provide critical relief to small businesses in numerous industries across the country.

**JCT estimate:** According to JCT, the provision would increase revenues by \$79.1 billion over 2014-2023.

### **Sec. 3311. Repeal of lower of cost or market method of inventory.**

**Current law:** Under current law, for Federal income tax purposes, taxpayers generally must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer. 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. Taxpayers that maintain inventories under the FIFO method may determine the value of ending inventory under the “lower of cost or market” (LCM) method. Under the LCM method, the taxpayer may write down the value of ending inventory (and thus take a deduction for the amount of the write-down) if its market value is less than its cost. Additionally, under the LCM method, subnormal goods (e.g., goods that are unsalable at normal prices or in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or similar causes) may be written down to the net selling price.

**Provision:** Under the provision, the lower-of-cost-or-market method would be repealed. The provision would be effective for tax years beginning after 2014. A taxpayer generally would include any positive adjustments to income resulting from the provision over a four-year period beginning with its first tax year beginning after 2018 in the following amounts: 10 percent included in the first year (2019); 15 percent in the second year (2020); 25 percent in the third year (2021); and 50 percent in the fourth year (2022). At the election of the taxpayer, the four-year inclusion of the adjustment could begin prior to 2019.

#### **Considerations:**

- The LCM rule is a special accounting rule that allows qualifying businesses to write down certain inventory to a value that is less than what the business paid. This special rule allows the business to reduce its taxable income by the write-down amount, even though no realization event has occurred (i.e., the item remains in inventory).
- If inventory is written down under LCM, there is no symmetrical requirement that it be written up should its value increase before it is sold. In that sense, LCM is a one-sided bet: “heads the taxpayer wins; tails the taxpayer ties.”

**JCT estimate:** According to JCT, the provision would increase revenues by \$3.8 billion over 2014-2023.

**Sec. 3312. Modification of rules for capitalization and inclusion in inventory costs of certain expenses.**

**Current law:** Under current law, the uniform capitalization (UNICAP) rules require certain direct costs (e.g., materials and labor) and indirect costs (e.g., overhead and administrative expenses) allocable to real or tangible personal property produced by the taxpayer to be capitalized into the basis of such property or included in inventory, as applicable. For real or personal property acquired by the taxpayer for resale, the UNICAP rules generally require direct and indirect costs allocable to such property to be included in inventory. However, the UNICAP rules do not apply to timber and certain trees; free-lance authors, photographers and artists; and businesses with \$10 million or less of average annual gross receipts that acquire property for resale.

**Provision:** Under the provision, the exception to the UNICAP rules for businesses with average annual gross receipts of \$10 million or less that acquire property for resale would be expanded to include all types of property (e.g., real property and tangible personal property), whether produced or acquired by the taxpayer. The provision would repeal the special exceptions for timber and certain trees, and for free-lance authors, photographers and artists. The provision's expanded exemption from the UNICAP rules for qualifying businesses, however, would apply in these cases. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$4.5 billion over 2014-2023.

**Sec. 3313. Modification of income forecast method.**

**Current law:** Under current law, the cost of motion picture films, sound recordings, copyrights, books, and patents may be recovered using the income-forecast method (IFM). The property's depreciation deduction for a tax year is determined by multiplying the adjusted basis of the property by a fraction equal to the gross income generated by the property during the year over the total estimated gross income anticipated by the close of the tenth tax year after the property is placed in service. A look-back rule requires a recomputation of the forecast based on actual income earned in connection with the property before the end of the third and tenth years, with interest applicable to any adjustment. Any costs that are not recovered by the end of the tenth tax year may be deducted in that year.

In determining the adjusted basis of property under the IFM, taxpayers may only include amounts when economic performance has occurred (e.g., the property is delivered or service is performed). A special exception under the IFM applies to participations and residuals (e.g., amounts under a film or recording contract that vary according the earnings), which may be included in the basis if they are paid with respect to income to be derived from the property

before the close of the tenth year. Alternatively, a taxpayer may deduct those payments as they are paid.

Under Treasury regulations, the cost of intangible assets may be recovered over the useful life of the asset, if such life can be determined with reasonable accuracy. If the useful life cannot be estimated with reasonable accuracy or a specific recovery period is not assigned to the property, a taxpayer may elect to treat the intangible as having a useful life of 15 years.

**Provision:** Under the provision, the forecast period under the IFM would be extended to 20 years, with required computations based on the income earned before the close of the fifth, tenth, fifteenth and twentieth years. The provision also would modify the rule for participations and residuals by excluding such costs from the adjusted basis of the property under the IFM and require that such costs be deducted in the year paid. As an alternative to the IFM, the provision would permit taxpayers to depreciate property otherwise qualifying for the IFM under the straight-line method over a 20-year period. Finally, the provision would direct the IRS to revise the election under the regulations concerning intangible assets with an unknown useful life to conform to the new 20-year period for the IFM. The provision generally would be effective for property placed in service after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.5 billion over 2014-2023.

#### **Sec. 3314. Repeal of averaging for farm income.**

**Current law:** Under current law, an individual engaged in certain farming or fishing businesses may elect to compute his current year tax liability by averaging, over the prior three-year period, all or a portion of his taxable income from the trade or business of farming or fishing.

**Provision:** Under the provision, the farm income-averaging method would be repealed. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.3 billion over 2014-2023.

#### **Sec. 3315. Treatment of patent or trademark infringement awards.**

**Current law:** Under current law, the Code does not provide rules regarding the treatment of patent or trademark infringement awards. The courts have held that such infringement awards constitute ordinary income as damages relating to lost profits unless the taxpayer can demonstrate that such payments reflect damages relating to impairment of capital (e.g., goodwill), in which case the payments are treated as a return of capital to the extent of the taxpayer's basis in the patent or trademark.

**Provision:** Under the provision, the judicial standard for determining the treatment of patent or trademark infringement awards would be codified. The provision would be effective for payments pursuant to judgments and settlements after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

### **Sec. 3316. Repeal of redundant rules with respect to carrying charges.**

**Current law:** Under current law, a taxpayer may elect to capitalize certain taxes and carrying charges (e.g., interest) with respect to certain property, and in such a case no deduction is permitted for the capitalized costs. This provision is redundant because other provisions of the Code permit taxes and carrying charges to be capitalized, even though such costs are otherwise deductible.

**Provision:** Under the provision, the redundant rules with respect to capitalization of certain taxes and carrying charges would be repealed. The provision would be effective for amounts paid or incurred after 2014.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

### **Sec. 3317. Repeal of recurring item exception for spudding of oil or gas wells.**

**Current law:** Under current law, an accrual-method taxpayer generally may deduct an expense only when all events have occurred that fix the fact of the liability, the amount of the liability is determinable with reasonable accuracy, and economic performance has occurred. An exception applies to certain expenses that are recurring in nature (e.g., State and local income taxes that are fixed at year-end but generally not paid until the tax return is filed in the following year), which is commonly referred to as the “recurring item” exception. To qualify, the expense must be paid no later than eight and a half months after the close of the tax year to which it relates. The recurring-item exception is not available for a tax shelter, unless the tax shelter involves drilling oil or gas wells and the drilling commences within 90 days of the close of the tax year to which the expense relate.

**Provision:** Under the provision, the special exception for oil or gas well tax shelters would be repealed, and the recurring item exception would not apply to any associated drilling expenses. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.2 billion over 2014-2023.

## Subtitle E – Financial Instruments

### Part 1 – Derivatives and Hedges

#### Sec. 3401. Treatment of certain derivatives.

**Current law:** Under current law, the tax treatment of gains and losses from entering into derivative financial transactions (e.g., futures, forward contracts, swaps, and options) is highly dependent upon the type of derivative, the profile of the taxpayer (e.g., dealers vs. non-dealers), and other factors. For example, gain or loss from entering into an option generally is not recognized until the option is exercised or lapses, and the character of the gain or loss generally is determined based upon the character of the optioned property in the hands of the taxpayer. However, certain options that are traded on exchanges – non-equity options (i.e., options on property other than stock or on an index) and dealer equity options – are marked to market (meaning that changes in the value of such options that are outstanding at the end of the tax year result in taxable gain or loss), and gain or loss on such options are treated as 60-percent long-term capital gain or loss and 40-percent short-term capital gain or loss.

**Provision:** Under the provision, derivative financial transactions generally would be marked to market at the end of each tax year, and any gains or losses from marking a derivative to market would be treated as ordinary income or loss. The provision would not apply to transactions that are properly identified as hedging transactions for tax purposes. The provision also would not apply to transactions that require the physical delivery of commodities or to certain specified transactions that are commercial (as opposed to financial) or non-speculative in nature. For offsetting financial positions that include at least one derivative position, all positions in the straddle would be marked to market. The provision would be effective for tax years ending after 2014, in the case of property acquired and positions established after 2014, and for tax years ending after 2019, in the case of any other property or position.

#### **Considerations:**

- The current-law tax treatment of gains and losses from entering into derivative transactions (e.g., futures, forward contracts, swaps, and options) is highly dependent upon the type of derivative, the profile of the taxpayer, and other factors, which can result in very different tax consequences for economically similar transactions.
- The provision would level the playing field by updating antiquated tax rules that have not kept pace with innovation in the financial products market, and by creating a more uniform and transparent tax treatment of financial products, so that all taxpayers are playing by the same rules.

**JCT estimate:** According to JCT, the provision would increase revenues by \$15.7 billion over 2014-2023.

## **Sec. 3402. Modification of certain rules related to hedges.**

**Current law:** Under current law, taxpayers are permitted to match the timing and character of taxable gains and losses on certain hedging transactions with the gains and losses associated with the price, currency or interest rate risk being hedged. Taxpayers are only allowed such hedging tax treatment, however, if they properly identify the transaction as a hedge on the day they enter into the transaction, regardless of whether the taxpayer is properly treating the transaction as a hedge for financial accounting purposes. In addition, hedging tax treatment is available only if the risk being hedged relates to ordinary property held (or to be held) by the taxpayer or obligations incurred (or to be incurred) by the taxpayer. In practice, insurance companies typically acquire debt instruments of varying durations to hedge risks associated with holding assets that are used to honor future claims arising from insurance policies that they have written. The tax treatment of these transactions under the current-law hedging rules is unclear, however, because the assets held by the insurance companies are capital assets, rather than ordinary property.

**Provision:** Under the provision, taxpayers could rely upon – for tax purposes – an identification of a transaction as a hedge that they have made for financial accounting purposes. The provision also would modify the hedging tax rules so that the rules would apply when an insurance company acquires a debt instrument to hedge risks relating to assets that support the company’s ability to honor future insurance claims. The provision would be effective for hedging transactions entered into after 2014.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

## **Part 2 – Treatment of Debt Instruments**

### **Sec. 3411. Current inclusion in income of market discount.**

**Current law:** Under current law, when a borrower issues debt at a discount (i.e., the loan proceeds are less than the principal amount to be repaid), the borrower and the lender are required to deduct and include in income, respectively, the discount as additional interest over the life of the loan. When a bond that already has been issued by the borrower is subsequently purchased on the secondary market at a discount, the purchaser is required to include the discount in taxable income as additional interest but, unlike discount when a loan is initially made, this discount does not have to be included by the purchaser of the bond until the bond is retired or the purchaser resells the bond. The amount of secondary market discount that holders must include in taxable income appears to include discount associated with deterioration in the creditworthiness of the borrower, even though it may have been intended that current law should only apply to discount associated with increases in interest rates.

**Provision:** Under the provision, purchasers of bonds at a discount on the secondary market would be required to include the discount in taxable income over the post-purchase life of the bond, rather than only upon retirement of the bond or resale of the bond by the purchaser. Any

loss that results from the retirement or resale of such a bond would be treated as an ordinary (rather than capital) loss to the extent of previously accrued market discount.

The provision also would limit taxable secondary market discount to an amount that approximates increases in interest rates since the loan was originally made. Specifically, the provision would limit this amount to the greater of (1) the original yield on the bond plus 5 percentage points, or (2) the applicable Federal rate plus 10 percentage points.

The provision would be effective for bonds acquired after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.9 billion over 2014-2023.

### **Sec. 3412. Treatment of certain exchanges of debt instruments.**

**Current law:** Under current law, when the terms of an outstanding debt instrument are significantly modified, the issue price of the modified debt instrument (i.e., the principal amount of the debt instrument for tax purposes) does not necessarily equal the issue price of the debt instrument prior to modification. In particular, the issue price of the modified debt instrument can be substantially lower than the issue price of the debt instrument prior to modification if the debt instrument has lost significant value since the loan was originally made (e.g., the value of real estate or other collateral supporting the loan has declined) – even if the lender has not forgiven any actual principal owed by the borrower. The reduction in the issue price resulting from the modification of the debt instrument constitutes taxable cancellation of indebtedness income to the borrower, although the borrower still owes the same actual principal amount as was owed prior to the modification. Conversely, the holder of a modified debt instrument may be required to recognize taxable gain as a result of modifying the debt instrument – even when the actual principal owed by the borrower has not increased – if the holder purchased the debt instrument at a discount.

**Provision:** Under the provision, the issue price of a modified debt instrument generally would be equal to the lesser of (1) the issue price of the debt instrument before it was modified, or (2) the stated principal amount of the modified debt instrument (assuming the modified debt instrument has an adequate rate of stated interest). In addition, the holder of a debt instrument generally would not recognize taxable gain or loss as a result of modifying a debt instrument. The provision would be effective for debt modifications that occur after 2014.

#### **Considerations:**

- The current law tax treatment of gains can impose prohibitive tax burdens on taxpayers who try to maintain or sell distressed assets by restructuring the debt that is secured by the assets – a process necessary to economic recovery.
- The provision would reform the tax rules as they apply to debt restructurings that do not involve a forgiveness of principal, and would reduce the prevalence of “phantom” cancellation-of-indebtedness income when debt is restructured – a common practice during economic downturns.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$0.8 billion over 2014-2023.

**Sec. 3413. Coordination with rules for inclusion not later than for financial accounting purposes.**

**Current law:** Under current law, the holder of a debt instrument that is issued with original issue discount (OID) generally accrues and includes in income (as interest) the OID over the life of the obligation, regardless of when the OID income actually is received. In the case of prepaid interest, OID treatment results in a deferral of taxable income. Certain fees earned by credit card issuers and other financial institutions have been treated as OID income, which allows these institutions to postpone the imposition of tax on this income to later tax years.

**Provision:** Under the provision, fees and other amounts received by a taxpayer would not be treated as OID income to the extent they are subject to section 3303 of the discussion draft, which would require taxpayers on the accrual method of accounting to include an item of income no later than the tax year in which such item is included for financial statement purposes. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$9.5 billion over 2014-2023.

**Sec. 3414. Rules regarding certain government debt.**

**Current law:** Under current law, individuals and other taxpayers who use a cash basis method of accounting and who purchase non-interest bearing obligations at a discount may elect to include in current income the increase in the value of the obligations as the discount accretes. (Absent such an election, the increase in value is not taken into income until maturity or disposition of the obligation.) In addition, discount on certain short-term obligations (e.g., Treasury bills) does not accrue until the obligation is paid at maturity or otherwise disposed but, in the case of taxpayers using an accrual method of accounting and certain other taxpayers, discount on short-term obligations is required to be included currently in taxable income. Also, any increase in the redemption value of a U.S. savings bond generally is includible in gross income in the tax year the bond is redeemed or the tax year of final maturity, whichever is earlier. Finally, U.S. obligations may be exchanged without recognition of gain or loss.

**Provision:** Under the provision, certain clerical amendments to the current-law rules would be made to reflect that some of the rules have been superseded by subsequently enacted tax rules relating to the accrual of original issue discount. Similarly, the current-law rule that permits U.S. obligations to be exchanged without recognition of gain or loss would be repealed because the rule has become obsolete as a result of the Treasury Department no longer issuing Series H or HH savings bonds (which were exchangeable for Series E or EE savings bonds). The provision would be effective on the date of enactment.



**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

### **Part 3 – Certain Rules for Determining Gain and Loss**

#### **Sec. 3421. Cost basis of specified securities determined without regard to identification.**

**Current law:** Under current law, when a taxpayer purchases shares of a particular company (or other substantially identical securities) at multiple times and at different prices, and later sells some (but not all) of these shares, the shares generally are deemed to have been sold on a first-in, first-out (FIFO) basis. In other words, the earliest acquired shares are treated as having been sold for purposes of determining the taxpayer's basis in the sold shares (and resulting gain or loss from the sale). Taxpayers, however, may specifically identify which shares have been sold, and such shares could have a basis that is different from the basis in the earliest acquired shares (and thus result in a different amount of gain or loss from the sale).

**Provision:** Under the provision, taxpayers who sell a portion of their holdings in substantially identical stock generally would be required to determine their taxable gain or loss on a FIFO basis. The provision generally would be coordinated with the recently enacted basis reporting requirements so that taxpayers could continue to determine basis in their stock on an account-by-account basis, except that multiple accounts with the same broker would be aggregated and treated as a single account. The provision would be effective for sales of stock occurring after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$3.8 billion over 2014-2023.

#### **Sec. 3422. Wash sales by related parties.**

**Current law:** Under current law, a taxpayer may not deduct losses from the disposition of stock or securities if the taxpayer acquires substantially identical stock or securities during the period beginning 30 days before, and ending 30 days after, the date of sale. If a loss is disallowed, the basis of the acquired stock or securities is increased to reflect the disallowed loss.

**Provision:** Under the provision, losses from the disposition of stock or securities also would be disallowed if certain parties that are closely related to the taxpayer acquire substantially identical stock or securities within 30 days before or after the disposition. If a loss has been disallowed under the provision and the taxpayer reacquires substantially identical stock or securities during the period that begins 30 days before the disposition and ends with the close of the first tax year that begins after the disposition, then the basis of the reacquired stock or securities would be increased to reflect the disallowed loss. The provision would be effective for sales of stock or securities occurring after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

**Sec. 3423. Nonrecognition for derivative transactions by a corporation with respect to its stock.**

**Current law:** Under current law, a corporation does not recognize gain or loss on the receipt of money or other property in exchange for its own stock. Likewise, a corporation does not recognize gain or loss when it redeems its stock with cash for more or less than it received when the stock was issued. In addition, a corporation does not recognize gain or loss on any lapse or acquisition of an option to buy or sell its stock.

**Provision:** Under the provision, a corporation generally would not recognize income, gains, losses, or deductions with respect to derivatives that relate to the corporation's own stock, except for certain transactions that involve the corporation acquiring its own stock and entering into a forward contract with respect to its own stock. In conjunction with section 3101 of the discussion draft, the provision would require a corporation to recognize income to the extent that the receipt of a contribution of money or property exceeds the value of stock issued in exchange for such money or property, and also would require a corporation to recognize income from the receipt of any premium received with respect to an option on its own stock. The provision would be effective for transactions entered into after the date of enactment.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.2 billion over 2014-2023.

**Part 4 – Tax Favored Bonds**

**Secs. 3431-3432. Termination of private activity bonds; Termination of credit for interest on certain home mortgages.**

**Current law:** Under current law, interest on both governmental bonds and private activity bonds (PABs) is excluded from gross income (and thus exempt from tax). Governmental bonds typically are issued to finance projects that constitute public goods (e.g., roads, schools, and parks). By contrast, the proceeds of PABs finance the activities of, or loans to, private parties, with indirect benefits accruing to the State or locality that issues the bond. The exclusion of interest on PABs generally is disallowed under the alternative minimum tax (AMT), meaning that AMT payers pay tax on such interest. Only specific categories of PABs qualify for the tax preference. Those categories include exempt facility bonds, qualified mortgage bonds, qualified veterans' mortgage bonds, qualified small issue bonds, qualified student loan bonds, qualified redevelopment bonds, and qualified 501(c)(3) bonds. Most PABs are subject to a single, aggregate national volume cap that is allocated annually among States by population, while other PABs have separate volume caps. For calendar year 2014, the per-State volume cap is the greater of (1) \$100 multiplied by the State population, or (2) \$296,825,000. These amounts are indexed for inflation.

Some State and local governments issue PABs to finance owner-occupied residences. In lieu of issuing such bonds, State and local governments may provide homebuyers a Federal tax credit for interest on certain home mortgages by providing them with mortgage credit certificates.

**Provision:** Under the provisions, interest on newly issued PABs would be included in income and thus subject to tax. Additionally, no Federal tax credits would be allowed for mortgage credit certificates issued after 2014. The provisions would be effective for bonds issued after 2014 with regard to PABs and tax years ending after 2014 with regard to mortgage credit certificates.

**Considerations:**

- The Federal government should not subsidize the borrowing costs of private businesses, allowing them to pay lower interest rates, while competitors with similar creditworthiness but that are unable to avail themselves of PABs must pay a higher interest rate on the debt they issue.
- The provisions would not apply to any previously issued bond, nor would the provisions prevent State and local governments from issuing PABs in the future; the provisions would merely remove the Federal tax subsidy for newly issued bonds.

**JCT estimate:** According to JCT, the provisions would increase revenues by \$23.9 billion over 2014-2023.

**Sec. 3433. Repeal of advance refunding bonds.**

**Current law:** Under current law, a refunding bond is any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. An advance refunding is issued more than 90 days before the redemption of the refunded bond. Interest on current refunding bonds is generally not taxable. Interest on advanced refunding bonds is generally not taxable for governmental bonds but is taxable for PABs.

**Provision:** Under the provision, interest on advanced refunding bonds (i.e., refunding bonds issued more than 90 days before the redemption of the refunded bonds) would be taxable. Interest on current refunding bonds would continue to be tax-exempt. The provision would be effective for advance refunding bonds issued after 2014.

**Considerations:**

- Current-law advanced refunding bonds provide State and local governments with incentives to issue two sets of Federally subsidized debt to finance the same activity.
- The provision would not affect the taxation of interest on refunding bonds issued within 90 days of the redemption of the refunded bond.

**JCT estimate:** According to JCT, the provision would increase revenues by \$8.3 billion over 2014-2023.

### **Sec. 3434. Repeal of tax credit bond rules.**

**Current law:** Under current law, State and local governments and other entities may issue various categories of tax credit bonds to finance specific types of projects. Each category of tax credit bond has its own set of rules regarding volume cap, if any, and allocation. Holders of tax credit bonds receive Federal tax credits fully or partially in lieu of interest payments from the issuer, depending on the level of Federal subsidy. For some of these bonds, during 2009 and 2010, issuers had the option of instead issuing taxable bonds and receiving direct payments from the Federal government.

The authority to issue some types of tax credit bonds has expired, and the volume cap to issue some of these bonds has been fully used. There are some types of tax credit bonds for which there is still outstanding volume cap and issuing authority has not expired.

**Provision:** Under the provision, the rules relating to tax credit bonds generally would be repealed. Holders and issuers would continue receiving tax credits and payments for tax credit bonds already issued, but no new bonds could be issued. The provision would be effective for bonds issued after the date of enactment.

**JCT estimate:** According to JCT, the provisions would reduce revenues by \$0.4 billion over 2014-2023, and reduce outlays by \$2.6 billion over 2014-2023.

## **Subtitle F – Insurance Reforms**

### **Sec. 3501. Exception to pro rata interest expense disallowance for corporate-owned life insurance restricted to 20-percent owners.**

**Current law:** Under current law, business interest deductions are reduced to the extent the interest is allocable to insurance policy cash values based on a pro rata formula, unless the insurance policy insures the lives of officers, directors, employees, or 20-percent owners of the business. A similar rule applies in the case of businesses that are insurance companies.

**Provision:** Under the provision, the exception to the pro rata interest expense disallowance rule would not apply to officers, directors, or employees, and thus only would apply to 20-percent owners of the business that holds the insurance contract. The provision would be effective for insurance contracts issued after 2014 with any material increase in the death benefit or other material changes to existing contracts being treated as new contracts.

#### **Considerations:**

- The provision was included in the Obama Administration’s fiscal year 2014 budget proposal.
- The provision would further limit the ability of leveraged businesses to fund deductible interest expenses with tax-exempt or tax-deferred income credited under life insurance, endowment, or annuity contracts insuring certain types of individuals.

- Specifically, the provision would more narrowly target the current-law exception to arrangements that are more likely to reflect business succession planning strategies.

**JCT estimate:** According to JCT, the provision would increase revenues by \$7.3 billion over 2014-2023.

### **Sec. 3502. Net operating losses of life insurance companies.**

**Current law:** Under current law, net operating losses of a trade or business generally may be carried back up to two tax years or carried forward up to 20 tax years. In the case of life insurance companies, however, net operating losses may be carried back up to three tax years or carried forward up to 15 tax years.

**Provision:** Under the provision, life insurance companies would be allowed to carry net operating losses back up to two tax years or forward up to 20 tax years, in conformity with the general net operating loss carryover rules. The provision would be effective for losses arising in tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.3 billion over 2014-2023.

### **Sec. 3503. Repeal of small life insurance company deduction.**

**Current law:** Under current law, life insurance companies may deduct 60 percent of their first \$3 million of life insurance-related income. The deduction is phased out for companies with income between \$3 million and \$15 million. In addition, the deduction is not available to life insurance companies with assets of at least \$500 million.

**Provision:** Under the provision, the special deduction for small life insurance companies would be repealed. The provision would be effective for tax years beginning after 2014.

#### **Consideration:**

- The provision would eliminate a tax subsidy for businesses in a particular industry that is not available to similar businesses in other industries.
- Eliminating this subsidy also would remove a tax preference that is provided to the segment of the insurance industry in which the risk distribution benefits of pooling are the weakest.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.3 billion over 2014-2023.

#### **Sec. 3504. Computation of life insurance tax reserves.**

**Current law:** Under current law, life insurance companies may deduct net increases in life insurance company reserves, while net decreases in such reserves are included in gross income. In computing changes in reserves, the life insurance reserve for a contract generally is the greater of the net surrender value of the contract or the reserve determined under rules provided in the Code, which for discounting purposes employ a prescribed interest rate that is equal to the greater of the applicable Federal rate or the prevailing State assumed interest rate. The “prevailing State assumed interest rate” is equal to the highest assumed interest rate permitted to be used in at least 26 States in computing regulatory life insurance reserves. The discount rate used by property and casualty (P&C) insurance companies for reserves is the average applicable Federal mid-term rate over the 60 months ending before the beginning of the calendar year for which the determination is made.

**Provision:** Under the provision, the current-law prescribed discount rate for life insurance reserves would be replaced with the average applicable Federal mid-term rate over the 60 months ending before the beginning of the calendar year for which the determination is made, plus 3.5 percentage points. The provision would be effective for tax years beginning after 2014. The effect of the provision on computing reserves for contracts issued before the effective date would be taken into account ratably over the succeeding eight tax years.

**Consideration:** Replacing the current-law prescribed interest rate with an interest rate based on an enhanced mid-term applicable Federal rate that generally tracks corporate bond rates over the long run would better reflect economic reality. The current-law rule that uses a regulatory-based measurement generally understates income.

**JCT estimate:** According to JCT, the provision would increase revenues by \$24.5 billion over 2014-2023.

#### **Sec. 3505. Adjustment for change in computing reserves.**

**Current law:** Under current law, taxpayers are required to make adjustments to taxable income when they change a tax accounting method, so that the accounting method change does not result in an omission or duplication of income or expense. For taxpayers other than life insurance companies, an adjustment that reduces taxable income generally is taken into account in the tax year during which the accounting method change occurs, while an adjustment that increases taxable income generally may be taken into account over the course of four tax years, beginning with the tax year during which the accounting method change occurs. For life insurance companies, an adjustment in computing reserves (which is similar to a change in tax accounting method for other businesses) may be taken into account over ten years (regardless of whether the adjustment reduces or increases taxable income).

**Provision:** Under the provision, the special 10-year period for adjustments to take into account changes in computing reserves by life insurance companies would be repealed. As a result, the general rule for making tax accounting method adjustments would apply to changes in

computing reserves by life insurance companies. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$2.5 billion over 2014-2023.

**Sec. 3506. Modification of rules for life insurance proration for purposes of determining the dividends received deduction.**

**Current law:** Under current law, for insurance companies, deductions are limited or disallowed in certain circumstances if they are related to the receipt of exempt income. Under so-called “proration” rules, life insurance companies are required to reduce deductions, including dividends-received deductions and reserve deductions to account for the fact that a portion of dividends and tax-exempt interest received is used to fund tax-deductible reserves for the companies’ obligations to policyholders. This portion is determined by a formula that computes the respective shares of net investment income that belong to the company and to the policyholders. Current law is unclear as to what methods companies may use to compute the company share.

**Provision:** Under the provision, the portion of dividends and tax-exempt interest received that is set aside for obligations to policyholders would be determined separately for the company’s general account (which supports non-variable insurance products) and for each separate account (which supports variable life insurance and annuity contracts). In addition, the formula for determining this portion would be modified so that it compares mean reserves to mean assets of each account (rather than computing the respective shares of net investment income that belong to the company and to the policyholders). The provision would be effective for tax years beginning after 2014.

**Consideration:** The current-law rules for computing net investment income are essentially based on a previous system of life insurance company taxation that was changed over 30 years ago, and the provision would provide an updated measure of the company and policyholder shares of net investment income that is simpler and more accurate.

**JCT estimate:** According to JCT, the provision would increase revenues by \$4.5 billion over 2014-2023.

**Sec. 3507. Repeal of special rule for distributions to shareholders from pre-1984 policyholders surplus account.**

**Current law:** Tax rules for insurance companies that were enacted in 1959 included a rule that half of a life insurer’s operating income was taxed only when the company distributed it, and a “policyholders surplus account” kept track of the untaxed income. In 1984, this deferral of taxable income was repealed, although existing policyholders’ surplus account balances remained untaxed until they were distributed. Legislation enacted in 2004 provided a two-year

holiday that permitted tax-free distributions of these balances during 2005 and 2006. During this period, most companies eliminated or significantly reduced their balances.

**Provision:** Under the provision, the rules for policyholders' surplus accounts would be repealed. The provision would generally be effective for tax years beginning after 2014, and any remaining balances would be subject to tax, payable in eight annual installments.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

### **Sec. 3508. Modification of proration rules for property and casualty insurance companies.**

**Current law:** Under current law, deductions are limited or disallowed in certain circumstances if they are related to the receipt of exempt income. Under so-called "proration" rules that reflect the fact that reserves generally are funded in part by certain untaxed income, property and casualty (P&C) insurance companies are required to reduce reserve deductions for losses incurred by 15 percent of (1) the company's tax-exempt interest, (2) the deductible portion of dividends received, and (3) the increase for the tax year in the cash value of life insurance, endowment, or annuity contracts the company owns.

**Provision:** Under the provision, the fixed 15-percent reduction in the reserve deduction for P&C insurance companies would be replaced with a formula whereby the reserve deduction is reduced by a percentage that is equal to the ratio of the tax-exempt assets of the company to all assets of the company. The provision would be effective for tax years beginning after 2014.

**Consideration:** The provision would replace an arbitrary fixed-percentage reduction in reserve deductions with a formula that would result in P&C insurance companies more accurately measuring the reserve deduction.

**JCT estimate:** According to JCT, the provision would increase revenues by \$2.9 billion over 2014-2023.

### **Sec. 3509. Repeal of special treatment of Blue Cross and Blue Shield organizations, etc.**

**Current law:** Under current law, charitable and social welfare organizations are eligible for tax-exempt status only if no substantial part of their activities consists of providing commercial-type insurance. When this rule was enacted in 1986, special rules were provided for existing, tax-exempt Blue Cross and Blue Shield (BCBS) organizations that stood to lose their tax-exempt status. These rules also apply to other health insurance organizations that satisfy certain requirements.

The special rules provide a deduction equal to 25 percent of claims incurred and expenses incurred in administering such claims, to the extent the amount of claims and expenses incurred exceeds the adjusted surplus of the organization at the beginning of the tax year. In addition,



these rules provide an exception from the application of a 20-percent reduction in the deduction for increases in unearned premiums that applies generally to P&C companies. The special rules also provide that these organizations are treated as stock insurance companies for purposes of the Code.

**Provision:** Under the provision, the special rules for BCBS and certain other health insurance organizations would be repealed. With regard to the 25-percent deduction and the exception from the application of the 20-percent reduction in the deduction for increases in unearned premiums, the provision would be effective for tax years beginning after 2014. With regard to the treatment of these organizations as stock insurance companies, the provision would be effective for tax years beginning after 2016.

**Consideration:** Special transition rules enacted in 1986 when the BCBS organizations initially became subject to tax are no longer necessary and provide preferential tax treatment to some health insurance providers over other providers in a market in which health insurance premiums are now regulated.

**JCT estimate:** According to JCT, the provision would increase revenues by \$4.0 billion over 2014-2023.

### **Sec. 3510. Modification of discounting rules for property and casualty insurance companies.**

**Current law:** Under current law, a P&C insurance company may deduct unpaid losses that are discounted using mid-term applicable Federal rates and based on a loss payment pattern. The loss payment pattern for each line of insurance business is determined by reference to the industry-wide historical loss payment pattern applicable to such line of business, although companies may elect to use their own particular historical loss payment patterns.

The loss payment pattern is computed based upon the assumption that all losses are paid (1) in general, during the accident year and the three calendar years following the accident year, or (2) in the case of lines of business relating to auto or other liability, medical malpractice, workers' compensation, multiple peril lines, international coverage, and reinsurance, during the accident year and the ten calendar years following the accident year. In the case of long-tail lines of business, a special rule extends the loss payment pattern period, so that the amount of losses which would have been treated as paid in the tenth year after the accident year is treated as paid in the tenth year and in each subsequent year (up to five years) in an amount equal to the amount of the losses treated as paid in the ninth year after the accident year.

**Provision:** Under the provision, P&C insurance companies would use the corporate bond yield curve (as specified by Treasury) to discount the amount of unpaid losses. In addition, the special rule that extends the loss payment pattern period for long-tail lines of business would be applied similarly to all lines of business (but without the 5-year limitation on the extended period), so that (1) in general, the amount of losses that would have been treated as paid in the third year after the accident year would be treated as paid in the third year and in each subsequent year in

an amount equal to the amount of the losses treated as paid in the second year after the accident year, and (2) in the case of lines of business relating to auto or other liability, medical malpractice, workers' compensation, multiple peril lines, international coverage, and reinsurance, the amount of losses which would have been treated as paid in the tenth year after the accident year would be treated as paid in the tenth year and in each subsequent year in an amount equal to the amount of the losses treated as paid in the ninth year after the accident year. The provision also would repeal the election to use company-specific, rather than industry-wide, historical loss payment patterns. The provision generally would be effective for tax years beginning after 2014, with a transition rule that would spread adjustments relating to pre-effective date losses and expenses over such tax year and the succeeding seven tax years.

**Considerations:**

- Replacing the mid-term applicable Federal rate with the corporate bond yield would result in a more accurate measurement of income for P&C insurance companies.
- In addition, generally applying the rules for determining the loss payment pattern period that currently only apply to long-tail lines of business would provide consistent treatment for all lines of insurance business.

**JCT estimate:** According to JCT, the provision would increase revenues by \$17.9 billion over 2014-2023.

**Sec. 3511. Repeal of special estimated tax payments.**

**Current law:** Under current law, insurance companies may elect to claim a deduction equal to the difference between the amount of reserves computed on a discounted basis and the amount computed on an undiscounted basis. Companies that make this election are required to make a special estimated tax payment equal to the tax benefit attributable to the deduction. In addition, the deductions are added to a special loss discount account and, as losses are paid in future years, amounts are subtracted from the account and made subject to tax (net of prior special estimated tax payments). Amounts added to the special loss discount account are automatically subtracted from the account and made subject to tax if they have not already been subtracted after 15 years.

**Provision:** Under the provision, the elective deduction and related special estimated tax payment rules would be repealed. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

**Sec. 3512. Capitalization of certain policy acquisition expenses.**

**Current law:** Under current law, the expenses of a life insurance company that are associated with earning a stream of premium income generally are required to be spread over ten years rather than deducted immediately, to reflect the fact that such income ordinarily is collected over

a period of years. The expenses that are spread are calculated using a simplified method that reflects expense ratios for three broad categories of insurance contracts. The expenses that must be spread are the lesser of: (1) a specified percentage of the net premiums received on each of a company's three categories of insurance contracts; or (2) the company's general deductions. For annuity contracts, the specified percentage is 1.75 percent; for group life insurance contracts, it is 2.05 percent; and for all other specified insurance contracts, it is 7.7 percent.

**Provision:** Under the provision, the categories of insurance contracts and the percentages of expenses to be spread would be updated to reflect current expense ratios for insurance products. The three categories of insurance contracts would be replaced with two categories: (1) group contracts; and (2) all other specified contracts. The percentage of net premiums that would be spread over ten years would be 5 percent for group insurance contracts and 12 percent for all other specified contracts. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$11.7 billion over 2014-2023.

#### **Secs. 3513-3514. Tax reporting for life settlement transactions; Clarification of tax basis of life insurance contracts.**

**Current law:** Under current law, the seller of a life insurance contract (including a sale back to the issuer, or "settlement") generally must report as taxable income the difference between the amount received from the buyer and the adjusted basis in the contract. The IRS has taken the position that a taxpayer's basis in a life insurance contract generally is equal to all premiums paid by the taxpayer if the taxpayer settles the contract, but that the taxpayer's basis must be reduced by the cost of insurance (i.e., the non-investment component of the premiums paid) if the taxpayer sells the contract to a third party.

The buyer of a previously issued life insurance contract who subsequently receives a death benefit generally is subject to tax on the difference between the death benefit received and the sum of the amount paid for the contract and premiums subsequently paid by the buyer.

**Provision:** Under the provision, a taxpayer that purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding \$500,000 would be required to report (1) the purchase price, the identity of the buyer and seller, and the issuer and policy number to both the IRS and the seller, and (2) the identity of the buyer and seller, and the issuer and policy number to the issuing insurance company. Upon the payment of any policy benefits to the buyer of a previously issued life insurance contract, the insurance company would be required to report the gross benefit payment, the identity of the buyer, and the insurance company's estimate of the buyer's basis to the IRS and to the payee. This aspect of the provision would be effective for reportable sales of life insurance contracts and payments of death benefits occurring after 2014.

In addition, a taxpayer's basis in a life insurance contract would not be reduced by the cost of insurance, regardless of whether the taxpayer settles or sells the contract. This aspect of the provision would be effective for transactions entered into after August 25, 2009.

**JCT estimate:** According to JCT, the provisions, along with section 3515 of the discussion draft, would increase revenues by \$0.2 billion over 2014-2023.

### **Sec. 3515. Exception to transfer for valuable consideration rules.**

**Current law:** Under current law, a payment received under a life insurance contract upon the death of the insured is excluded from income. If the life insurance contract was transferred for valuable consideration, however, the recipient must include the payment less the recipient's basis in the contract, unless (1) the contract has a carryover basis, or (2) the contract was transferred to the person whose life is insured under the contract or to a partner of the insured, or a partnership or corporation in which the insured is a partner or shareholder.

**Provision:** Under the provision, the exception for carryover basis transfers and transfers to the person whose life is insured (or to a partner of the insured, or a partnership or corporation in which the insured is a partner or shareholder) would not apply if the acquirer of the life insurance contract has no substantial relationship with the insured apart from the acquirer's interest in the contract (i.e., the acquirer must include the amount of the payment on the death of the insured, reduced by the acquirer's basis in the contract). The provision would be effective for transfers after 2014.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for sections 3513-3514 of the discussion draft.

## **Subtitle G – Pass-Thru and Certain Other Entities**

### **Part 1 – S Corporations**

#### **Considerations for Subtitle G, Part 1:**

- The S corporation provisions in the discussion draft are intended to encourage C corporations to elect S status and provide greater flexibility to current S corporations in their day-to-day operations.
- The provisions are drawn from Option 1 of the Committee's March 12, 2013, discussion draft, and reflect the more incremental approach to passthrough reform.
- The S corporation provisions address a number of complexities for S corporations under current law, simplifying the rules, eliminating penalties for inadvertent errors, and reducing the tax burden on S corporations generally.

### **Sec. 3601. Reduced recognition period for built-in gains made permanent.**

**Current law:** Under current law, an S corporation is subject to an entity-level tax at the highest corporate rate on certain built-in gains of property that it held while operating as a C corporation. The tax applies to gain recognized within ten years from the date that the C corporation elected to be an S corporation. Through 2013, a temporary provision reduced this period to five years.

**Provision:** Under the provision, the temporary five-year period would be made permanent. The provision would be effective for tax years beginning after 2013.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$3.0 billion over 2014-2023.

### **Sec. 3602. Modifications to S corporation passive investment income rules.**

**Current law:** Under current law, an S corporation that previously operated as a C corporation may be subject to tax at the highest corporate rate on certain passive income if more than 25 percent of its gross receipts are derived from passive investment income. In addition, if the S corporation exceeds the 25-percent passive income threshold for three consecutive years, the corporation's election to be treated as an S corporation is terminated automatically.

**Provision:** Under the provision, the passive-income threshold would be increased from 25 percent to 60 percent. The provision also would repeal the current-law provision terminating the S corporation election for excessive passive income. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$3.6 billion over 2014-2023.

### **Sec. 3603. Expansion of qualifying beneficiaries of an electing small business trust.**

**Current law:** Under current law, an S corporation is limited to 100 or fewer shareholders, which generally must be individuals who are U.S. citizens or residents or certain exempt organizations and trusts. Current law also permits special trusts, known as electing small business trusts (ESBTs), to be S corporation shareholders. 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. The portion of an ESBT that consists of the stock of an S corporation is treated as a separate trust. In general, this trust is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. Such income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

**Provision:** Under the provision, a nonresident alien individual could be a potential current beneficiary of an ESBT. Accordingly, a nonresident alien individual would be permitted to own shares in an S corporation, provided such ownership is indirect through an ESBT. The provision would be effective on January 1, 2015.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$0.1 billion over 2014-2023.

#### **Sec. 3604. Charitable contribution deduction for electing small business trusts.**

**Current law:** Under current law, an electing small business trust (ESBT) may be a shareholder of an S corporation. Because an ESBT is a trust, it must follow the rules for deducting charitable contributions that are applicable to trusts, rather than those applicable to individuals. Generally, a trust is allowed a deduction for charitable contributions without any limitation on the amount of the deduction relative to the trust's gross income. If a trust makes contributions in excess of its gross income, no carryover of the excess is allowed as a deduction in a future year. In contrast, an individual may deduct charitable contributions up to certain percentages of adjusted gross income and is generally permitted to carry forward excess contributions for five years.

**Provision:** Under the provision, the charitable contribution rules applicable to individuals, rather than to trusts, would apply to ESBTs. Thus, the percentage limitations and carryforward provisions applicable to individuals would apply to contributions made by the portion of an ESBT holding S corporation stock. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$0.1 billion over 2014-2023.

#### **Sec. 3605. Permanent rule regarding basis adjustment to stock of S corporations making charitable contributions of property.**

**Current law:** Under current law, if an S corporation contributes money or other property to a charity, each shareholder takes into account his pro rata share of the contribution in determining his own income tax liability. A shareholder reduces the basis in his S corporation stock by the amount of the S corporation's charitable contribution that flows through to the shareholder. For contributions made in tax years beginning before 2014, the basis reduction in the S corporation stock is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. For contributions made in tax years beginning after 2013, the amount of the reduction is the shareholder's pro rata share of the fair market value of the contributed property.

**Provision:** Under the provision, the pre-2014 basis-adjustment rule would be made permanent. Thus, an S corporation shareholder would reduce the basis in his S corporation stock by his pro rata share of the adjusted basis of the contributed property. This rule would provide consistent

treatment of charitable contributions between S corporation shareholders and partners in a partnership. The provision would be effective for tax years beginning after 2013.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$1.1 billion over 2014-2023.

### **Sec. 3606. Extension of time for making S corporation elections.**

**Current law:** Under current law, a small business corporation may elect to be treated as an S corporation for any tax year at any time during the preceding tax year or by the 15th day of the third month of the tax year for which the election is made. An election to be an S corporation made by the 15th day of the third month of a corporation's tax year is effective for that tax year if the corporation meets all eligibility requirements for the portion of the tax year prior to filing the election and all the required shareholders consent to the election. If these requirements are not met, the election becomes effective for the following tax year. An election continues in effect for subsequent tax years until it is terminated (including revocation by the taxpayer).

Similar rules apply to an election to treat an S corporation subsidiary as a qualified S corporation subsidiary (QSub) – which allows the S corporation to treat the subsidiary as a division of the S corporation and file a single return. In addition, Qualified Subchapter S Trusts (QSST) and Electing Small Business Trusts (ESBT) may elect to qualify as S corporation shareholders if the election is made by the 15th day of the third month after the transfer of stock to the trust.

**Provision:** Under the provision, the election process would be simplified by permitting a small business corporation to elect on its income tax return to be treated as an S corporation for the tax year to which the return relates, provided that the return is filed not later than the applicable due date (with extensions). The provision also would provide that the IRS may accept as timely a late filed revocation if there is reasonable cause shown. In addition, the provision would apply election procedures to QSubs that are similar to the rules for electing S corporation status. Lastly, the provision would permit the IRS to coordinate the election rules for a QSST and ESBT with the new election rules for S corporations and QSubs. The provision would apply to elections for tax years beginning after 2014. In the case of revocation, the provision would apply to revocations after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by less than \$50 million over 2014-2023.

### **Sec. 3607. Relocation of C corporation definition.**

**Current law:** Under current law, the definition of a C corporation as being a corporation other than an S corporation is located in Subchapter S of the Code.

**Provision:** Under the provision, the definition would be moved to Code section 7701, which provides generally applicable definitions. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

## **Part 2 – Partnerships**

### **Considerations for Subtitle G, Part 2:**

- The partnership provisions are generally drawn from Option 1 of the Committee’s March 12, 2013, discussion draft, and reflect a more incremental approach to passthrough reform.
- The partnership provisions establish additional limits on the use of partnerships as tax avoidance structures without interfering with the legitimate business operations of partnerships, clarify confusing areas of partnership law, and better align partnership rules with the relevant S corporation rules.

### **Sec. 3611. Repeal of rules relating to guaranteed payments and liquidating distributions.**

**Current law:** Under current law, guaranteed payments made by a partnership to a partner generally are payments made without regard to the income of the partnership and are for services or for the use of capital (e.g., loans) provided by the partner. Guaranteed payments are distinct from a partnership distribution of income or capital, and from payments by the partnership to a partner not acting in his capacity as a partner. Guaranteed payments generally are deductible by the partnership and includible in the partner’s taxable income.

Current law also provides rules for treating payments made in the liquidation of a retiring or deceased partner’s partnership interest. Such payments are treated either as (1) a distributive share or guaranteed payment or (2) payments in exchange for the partner’s interest in partnership property. For a deceased partner, income earned prior to death (i.e., income in respect of a decedent) is includible in the deceased partner’s gross income in the year of death, and special rules apply for determining the basis of the partnership interest in the hands of the successor partner.

**Provision:** Under the provision, the rules relating to guaranteed payments to partners would be repealed. Thus, payments received by partners would constitute either payments in their capacity as partners (i.e., part of their distributive shares of partnership income or loss) or in their capacity as non-partners (i.e., as an independent third party). In addition, the provision would repeal the special rule for deceased or retiring partners that treats certain payments in liquidation as guaranteed payments, subjecting such payments to the general rules applicable to the transaction (e.g., the provisions relating to payments of deferred compensation) or the applicable rules governing income in respect of a decedent. The provision would be effective for tax years beginning after 2014 and transfers to decedents made after 2014. In addition, the provision would apply to payments made in liquidation to partners retiring or dying after 2014.



**JCT estimate:** According to JCT, the provision would increase revenues by \$0.3 billion over 2014-2023.

**Sec. 3612-3614. Mandatory adjustments to basis of partnership property in case of transfer of partnership interests; Mandatory adjustments to basis of undistributed partnership property; Corresponding adjustments to basis of properties held by partnership where partnership basis adjusted.**

**Current law:** Under current law, if a partnership makes a one-time election, or if the partnership has a substantial built-in loss (i.e., the partnership's adjusted basis in its property exceeds the fair market value by more than \$250,000) immediately after a transfer of a partnership interest by a partner, the partnership must make adjustments to the basis of partnership property. Similar rules apply in the case of a partnership distribution of property to a partner. The adjustments are intended to account for (1) the difference that can arise between a partner's adjusted basis in the partnership property and the partner's basis in his partnership interest and (2) the difference in the partnership's adjusted basis in its property with respect to partners who do not receive distributions of property. Certain securitization partnerships and electing investment partnerships are exempt from the basis-adjustment requirement with respect to substantial built-in losses in certain instances. When basis adjustments are required under current law, no corresponding adjustments are required by upper- or lower-tier partnerships owning an interest in the partnership making the basis adjustment.

**Provision:** Under the provision, mandatory adjustment of a partnership's basis in partnership property would be required when a partner transfers his interest in a partnership or a partnership distributes property to a partner. These rules would also apply to securitization and electing investment partnerships. In addition, corresponding adjustments would be required in cases involving tiered partnerships. The provision would be effective for transfers and distributions after 2014.

**JCT estimate:** According to JCT, the provisions would increase revenues by \$1.1 billion over 2014-2023.

**Sec. 3615. Charitable contributions and foreign taxes taken into account in determining limitation on allowance of partner's share of loss.**

**Current law:** Under current law, a partner generally may only deduct certain expenditures and losses (including capital losses) of a partnership to the extent of the partner's adjusted basis in his partnership interest. Charitable contributions and foreign taxes paid by a partnership are not subject to this limitation and, as a result, can be deducted even if they exceed the partner's basis.

**Provision:** Under the provision, a partner would be required to take into account charitable contributions and foreign taxes paid by a partnership in calculating the limitation on the partner's share of losses, conforming the partnership rules to the S corporation rules and thus preventing a

partner from deducting losses in excess of basis. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.9 billion over 2014-2023.

### **Sec. 3616. Revisions related to unrealized receivables and inventory items.**

**Current law:** Under current law, gain or loss from the sale or exchange of a partnership interest generally is treated as gain or loss from a capital asset. Gain is treated as ordinary income, however, on the sale or exchange of a partnership interest when the partnership holds unrealized receivables (i.e., uncollected payments for goods or services) or appreciated inventory (i.e., appreciated more than 120 percent). Certain distributions by a partnership to a partner are also treated as sales or exchanges when a partnership holds unrealized receivables or substantially appreciated inventory.

**Provision:** Under the provision, any distribution of an inventory item would be treated as a sale or exchange between the partner and the partnership, eliminating the requirement that inventory be substantially appreciated in value to trigger gain recognition. The provision also would simplify the definition of an unrealized receivable by providing that the term include any property other than an inventory item, but only to the extent of the amount that would be treated as ordinary income if the property were sold for its fair market value. The provision would be effective for distributions and partnership tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.8 billion over 2014-2023.

### **Sec. 3617. Repeal of time limitation on taxing precontribution gain.**

**Current law:** Under current law, if a partner contributes appreciated property to a partnership, the partner does not recognize gain or loss at the time of the contribution, but the pre-contribution built-in gain or loss is preserved in the contributing partner's capital account. If the partnership subsequently distributes the property to another partner within seven years of the contribution, the contributing partner generally recognizes the pre-contribution gain or loss. Similar rules apply if the contributing partner receives other property of the partnership within seven years in what amounts to a disguised sale of the originally contributed property.

**Provision:** Under the provision, a partner who contributes property with pre-contribution built-in gains or losses to a partnership would be required to recognize the pre-contribution gain or loss when the partnership distributes such property. No limitation period would apply. The provision would be effective for property contributed to a partnership after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.4 billion over 2014-2023.

### **Sec. 3618. Partnership interests created by gift.**

**Current law:** Under current law, a person is treated as a partner if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether such interest was obtained by purchase or gift from another person. In the case of a partnership interest purchased by one family member from another, the interest is treated as created by gift and the fair market value of the interest is treated as donated capital to the partnership. Current law also provides special rules to prevent donors of partnership interests from assigning income with respect to services that the donor performs for the partnership or with respect to the donor's contributed capital.

**Provision:** Under the provision, the rule would be clarified to provide that a person is treated as a partner in a partnership in which capital is a material income-producing factor whether such interest was obtained by purchase or gift and regardless of whether such interest was acquired from a family member. The rules preventing assignment of income would continue to apply to transfers of partnership interests by gift. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.8 billion over 2014-2023.

### **Sec. 3619. Repeal of technical termination.**

**Current law:** Under current law, a partnership terminates only if: (1) no part of any business, financial operations, or venture of the partnership continues to be carried on by any of its partners, or (2) within a 12-month period there is a sale or exchange of 50 percent or more of the total interests in partnership capital and profits. The second type of termination is commonly referred to as a technical termination. When a technical termination occurs, the business of the partnership continues in the same legal form, but the partnership must make new elections for various accounting methods, depreciation lives, and other purposes.

**Provision:** Under the provision, the technical termination rule would be repealed. Thus, the partnership would be treated as continuing even if more than 50 percent of the total capital and profits interests of the partnership are sold or exchanged, and new elections would not be required or permitted. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.5 billion over 2014-2023.

### **Sec. 3620. Publicly traded partnership exception restricted to mining and natural resources partnerships.**

**Current law:** Under current law, a publicly traded partnership is a partnership the interests in which are traded on an established securities market or are readily tradable on a secondary

market. A publicly traded partnership generally is treated as a C corporation for Federal tax purposes. An exception from such treatment applies to a publicly traded partnership (other than a regulated investment company, management company or unit investment trust) if 90 percent or more of the partnership's gross income is qualifying income. Qualifying income includes: interest, dividends, capital gains, and rents from real property; income and gains from certain activities relating to minerals or natural resources (e.g., mining, production, refining, and transporting); and income and gains from certain commodities and derivatives.

**Provision:** Under the provision, the special exceptions for publicly traded partnerships would be repealed other than for partnerships with 90 percent of their income from activities relating to mining and natural resources (e.g., mining, production, refining, and transporting). Thus, publicly traded partnerships would generally be treated as C corporations. The provision would be effective for tax years beginning after 2016.

**JCT estimate:** According to JCT, the provision would increase revenues by \$4.3 billion over 2014-2023.

### **Sec. 3621. Ordinary income treatment in the case of partnership interests held in connection with performance of services.**

**Current law:** Under current law, a partner holding a partnership interest includes in income his distributive share of partnership income and gain (whether or not actually distributed). The character of partnership items passes through to the partners as if the items were realized directly by the partners. A partner's basis in the partnership interest is increased by any amount of gain included in the partner's income and is decreased by any losses. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest. Similarly, when a partner sells his partnership interest, gain generally is recognized to the extent the amount received exceeds the partner's basis in the partnership interest. The extent to which such gain is capital in character depends on the holding period and special partnership rules that recharacterize capital gains as ordinary income in certain cases.

It is common for partnerships to be used for investment purposes. In particular, private equity funds are organized as partnerships. In a typical private equity fund, the general partner contributes a small amount of capital and manages the assets, typically stock of companies, in exchange for a profits interest (or "carried interest") in the partnership (generally a 20-percent profits interest). Limited partners provide the additional capital needed to acquire assets. In addition, the general partner is paid regular fees for managing the assets, which generally consists of improving the operations, governance, capital structure and strategic position of companies. In general, gain from the sale of stock of the companies owned by the fund results in capital gain. Thus, the general partner that manages the partnership will receive a distribution of capital gain based on his profits interest when the partnership sells the stock of any company owned by the partnership.

**Provision:** Under the provision, certain partnership interests held in connection with the performance of services would be subject to a rule that characterizes a portion of any capital

gains as ordinary income. This rule would apply to partnership distributions and dispositions of partnership interests. An applicable partnership interest would include any interest transferred, directly or indirectly, to a partner in connection with the performance of services by the partner, provided that the partnership is engaged in a trade or business conducted on a regular, continuous and substantial basis consisting of: (1) raising or returning capital, (2) identifying, investing in, or disposing of other trades or businesses, and (3) developing such trades or businesses. The provision would not apply to a partnership engaged in a real property trade or business.

The recharacterization formula generally would treat the service partner's applicable share of the invested capital of the partnership as generating ordinary income by multiplying that share by a specified rate of return (the Federal long-term rate plus 10 percentage points), intended to approximate the compensation earned by the service partner for managing the capital of the partnership. The recharacterization amount would be determined (but not realized) on an annual basis and tracked over time. To the extent a service partner contributes capital to the partnership, the result would be less capital gain being characterized as ordinary income. Any distribution or gain from the sale of a partnership interest (i.e., a realization event) then would be treated as ordinary to the extent of the partner's recharacterization account balance for the tax year. Amounts in excess of the recharacterization account balance would be capital gain. The invested capital of a partnership is, as of any day, the total cumulative value, determined at the time of contribution, of all money and other property contributed to the partnership on or before such day. Partner loans to the partnership and indebtedness entitled to share in the equity of the partnership would qualify as invested capital.

If a taxpayer, at any time during a tax year, holds directly or indirectly more than one applicable partnership interest in a single partnership interest, all interests in a partnership would be aggregated and treated as a single interest.

The provision would be effective for tax years beginning after 2014.

### **Considerations:**

- Current law generally taxes the profits derived from the development and sale of property in the ordinary course of a trade or business as ordinary income, not capital gain. In contrast, the inherent enterprise value of a successful business, which is recognized by the owners only when the business is sold or liquidated, generally is treated as capital gain.
- A partnership (e.g., private equity fund) that is in the business of raising capital, investing in other businesses, developing such businesses, and ultimately selling them, is in the trade or business of selling businesses. The businesses bought and sold by the partnership are its inventory.
- For the tax law to be applied consistently, the profits derived by such an investment partnership and paid to its managing partners through management fees and a profits interest in the partnership (generally referred to as a carried interest), should be treated as ordinary income.
- The provision is intended to provide such consistent treatment by treating a portion of the annual earnings of a qualifying partnership as ordinary income. To the extent a

managing partner invests capital in the partnership or extraordinary gains are realized, the earnings would still be taxed as capital gains.

- The provision is designed to clarify a murky area of the tax law to provide consistent outcomes for similarly situated taxpayers through rules that are administrable and avoid the unintended adverse consequences of previous proposals to address this issue.

**JCT estimate:** According to JCT, the provision would increase revenues by \$3.1 billion over 2014-2023.

### **Sec. 3622. Partnership audits and adjustments.**

**Current law:** Under current law, three different regimes exist for auditing partnerships. For partnerships with 10 or fewer partners, the IRS generally applies the audit procedures for individual taxpayers, auditing the partnership and each partner separately. For most large partnerships with more than 10 partners, the IRS conducts a single administrative proceeding (under the so-called TEFRA rules, which were adopted as part of the Tax Equity and Fiscal Responsibility Act of 1982) to resolve audit issues regarding partnership items that are more appropriately determined at the partnership level than at the partner level. Under the TEFRA rules, once the audit is completed and the resulting adjustments are determined, the IRS must recalculate the tax liability of each partner in the partnership for the particular audit year.

A third audit regime applies to partnerships with 100 or more partners that elect to be treated as Electing Large Partnerships (ELPs) for reporting and audit purposes. A distinguishing feature of the ELP audit rules is that unlike the TEFRA partnership audit rules, partnership adjustments generally flow through to the partners for the year in which the adjustment takes effect, rather than the audit year. As a result, the current-year partners' share of current-year partnership items of income, gains, losses, deductions, or credits are adjusted to reflect partnership adjustments relating to a prior year audit that take effect in the current year. The adjustments generally do not affect prior-year returns of any partners (except in the case of changes to any partner's distributive share).

**Provision:** Under the provision, the current TEFRA and ELP rules would be repealed, and the partnership audit rules would be streamlined into a single set of rules for auditing partnerships and their partners at the partnership level. Similar to the current TEFRA rule excluding partnerships with fewer than 10 partners, the provision would permit smaller partnerships with 100 or fewer partners (other than partners that generally are passthrough entities themselves) to opt out of the new rules, in which case the partnership and partners would be audited under the general rules applicable to individual taxpayers.

Under the streamlined audit approach, the IRS would examine the partnership's items of income, gains, losses, deductions, credits and partners' distributive shares for a particular year of the partnership (the "reviewed year"). Any adjustments would be taken into account by the partnership (not the individual partners) in the year that the audit or any judicial review is completed (the "adjustment year"). Partnerships would have the option of demonstrating that the adjustment would be lower if the adjustment included partner-level information from the

reviewed year rather than imputed amounts based solely on the partnership's information in such year. A partnership would also have the option of initiating an adjustment for a reviewed year, such as when it believes additional payment is due, with the adjustment taken into account in the adjustment year. In cases in which the partnership believes a refund is due, the partnership would continue to file an amended return and provided amended information returns to each partner. The provision would be effective for partnership tax years ending after 2014, with partnerships permitted to elect to apply the new rules for any partnership tax year beginning after the date of enactment.

**JCT estimate:** According to JCT, the provision would increase revenues by \$13.4 billion over 2014-2023.

### **Part 3 – REITs and RICs**

#### **Considerations for Subtitle G, Part 3:**

- Since 1960, real estate investment trusts (REITs) have provided a tax-efficient vehicle for average investors to acquire diversified and passive interests in real estate.
- Recently, several companies that operate as taxable C corporations have explored converting into REITs for the purpose of avoiding corporate income tax.
- The REIT rules were not intended to facilitate erosion of the corporate tax base by allowing operating companies to convert from taxable C corporations into REITs.
- Some of these provisions would discourage erosion of the corporate tax base by making it more difficult for operating companies to convert into REITs, and by limiting REIT-eligible assets to those assets that are more closely related to real estate.
- At the same time, other provisions would improve the REIT rules as they apply to traditional REITs, making the REIT structure a more attractive investment vehicle.

#### **Sec. 3631. Prevention of tax-free spinoffs involving REITs.**

**Current law:** Under current law, a corporation is permitted to distribute (or spin off) to shareholders the stock of a controlled corporation on a tax-free basis if the transaction satisfies certain requirements. One such requirement is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years. In 2001, the IRS ruled that a REIT could satisfy the active trade or business requirement for tax-free spin-off transactions, even though gain on the sale of property that is stock in trade of a REIT, or property that is includible in inventory of a REIT, does not satisfy the REIT income tests.

**Provision:** Under the provision, the 2001 IRS ruling would be overturned, so that REITs could not satisfy the active trade or business requirement for tax-free spin-off transactions. In addition, neither a distributing corporation nor a controlled corporation would be permitted to elect to be treated as a REIT for ten years following a tax-free spin-off transaction. The provision generally would be effective for distributions after February 26, 2014.

**JCT estimate:** According to JCT, the provision, along with section 3647 of the discussion draft, would increase revenues by \$5.9 billion over 2014-2023.

**Sec. 3632. Extension of period for prevention of REIT election following revocation or termination.**

**Current law:** Under current law, a taxpayer generally may not elect to be treated as a REIT within five years after the termination or revocation of a prior REIT election.

**Provision:** Under the provision, the five-year waiting period for electing to be treated as a REIT following the termination or revocation of a prior REIT election would be extended to ten years. The provision would be effective for terminations and revocations after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

**Sec. 3633. Certain short-life property not treated as real property for purposes of REIT provisions.**

**Current law:** Under current law, a REIT must derive at least 95 percent of its income from certain specified real-estate-related and other investment income, and 75 percent of its income from such specified real-estate-related investment income. Gains from the sale or disposition of real property satisfy the 95-percent and 75-percent REIT income tests. In addition, at least 75 percent of the assets of a REIT must be comprised of real estate assets, cash and cash items, and government securities. The term “real estate assets” is defined to include real property and interests in real property.

**Provision:** Under the provision, the term “real property” would not include tangible property with a class life of less than 27.5 years (as defined under the depreciation rules) for purposes of the REIT income and asset tests. The provision would be effective for tax years beginning after 2016.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.6 billion over 2014-2023.

**Sec. 3634. Repeal of special rules for timber held by REITs.**

**Current law:** Under current law, the IRS has ruled that gains from the sale or disposition of real property that satisfy the REIT income tests (described above) include capital gains from the sale of standing timber. Such gains also include capital gains from the cutting and sale of timber during tax years that ended after May 22, 2008 and began on or before May 22, 2009.



In addition, certain gain from the sale of property held by a REIT in connection with the trade or business of producing timber qualifies under a safe harbor that protects such gain from being classified as prohibited transaction income that otherwise would be subject to a 100-percent prohibited transaction excise tax. The excise tax generally is imposed on REIT income derived from the sale of property that constitutes stock in trade, inventory, or property held by the REIT primarily for sale to customers in the ordinary course of the REIT's trade or business. Certain aspects of the special safe harbor for timber property sales only apply to the first tax year that began after May 22, 2008 and before May 22, 2009.

For certain "timber REITs," mineral royalty income from real property held in connection with the trade or business of producing timber is treated as satisfying the REIT income tests, and up to 25 percent of the value of a timber REIT's assets may consist of stock in a taxable REIT subsidiary. (This special limitation was enacted at a time when the general limitation on the value of such stock was 20 percent, which later was also increased to 25 percent for all REITs.) These special rules for timber REITs apply to the first tax year that began after May 22, 2008 and before May 22, 2009.

**Provision:** Under the provision, the term "real property" for purposes of the REIT rules would not include timber, consistent with the repeal of capital gains treatment for sales of standing and cut timber elsewhere in the discussion draft. In addition, the other temporary special rules for timber sales and timber REITs that have expired would be repealed. The provision would be effective for tax years beginning after 2016.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.2 billion over 2014-2023.

### **Sec. 3635. Limitation on fixed percentage rent and interest exceptions for REIT income tests.**

**Current law:** Under current law, rents from real property and interest generally satisfy the 95-percent and 75-percent REIT income tests. In general, rents from real property and interest do not include amounts that are contingent on the income or profits of the tenant or debtor, but do include amounts that are based on a fixed percentage of receipts or sales of the tenant or debtor.

**Provision:** Under the provision, rents from real property and interest would not include amounts that are based on a fixed percentage of receipts or sales to the extent that such amounts are received or accrued from a single tenant that is a C corporation and the amounts received or accrued from such tenant constitute more than 25 percent of the total amount received or accrued by the REIT that is based on a fixed percentage of receipts or sales. The provision would be effective for tax years ending after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

**Secs. 3636-3637. Repeal of preferential dividend rule for publicly offered REITs; Authority for alternative remedies to address certain REIT distribution failures.**

**Current law:** Under current law, REITs may deduct dividend distributions to their shareholders, but they are required to distribute annually as a dividend at least 90 percent of their income (other than net capital gain and certain other items). A preferential dividend does not qualify for the REIT dividend deduction and does not count toward satisfying the requirement that REITs distribute 90 percent of their income every year. A dividend is “preferential” unless it is distributed pro rata to all shareholders, with no preference to any share of stock over others within the same class of stock, and no preference to one class of stock over other classes of stock (except to the extent the class is entitled to a preference).

**Provisions:** Under the provisions, the preferential dividend rule would be repealed for publicly offered REITs. In addition, the IRS would have authority to provide an appropriate remedy for a preferential dividend distribution by non-publicly offered REITs in lieu of treating the dividend as not qualifying for the REIT dividend deduction and not counting toward satisfying the requirement that REITs distribute 90 percent of their income every year. Such authority would apply if the preferential distribution is inadvertent or due to reasonable cause and not due to willful neglect.

The provisions would be effective for distributions in tax years beginning after 2014.

**JCT estimate:** According to JCT, the provisions would reduce revenues by less than \$50 million over 2014-2023.

**Sec. 3638. Limitations on designation of dividends by REITs.**

**Current law:** Under current law, a REIT dividend is ordinary income to the REIT shareholder rather than a qualified dividend subject to a reduced rate of tax, unless the REIT designates such dividends as being attributable to income that is taxed to the REIT at regular corporate tax rates because it was not previously distributed, or to qualified dividends received by the REIT from other corporations. A REIT also may identify certain dividends as capital gain dividends to the extent of the REIT’s net capital gain, which would be subject to tax in the hands of the REIT shareholders at the capital gains rate.

**Provision:** Under the provision, the aggregate amount of dividends that could be designated by a REIT as qualified dividends or capital gain dividends would not be permitted to exceed the dividends actually paid by the REIT. The provision would be effective for distributions in tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

### **Sec. 3639. Non-REIT earnings and profits required to be distributed by REIT in cash.**

**Current law:** Under current law, REITs that accumulated earnings and profits prior to becoming a REIT (e.g., an entity that operated as a taxable C corporation prior to making an election to become a REIT) are required to distribute such earnings and profits (e.g., in cash, property, or stock) by the end of the first tax year after electing to become a REIT.

**Provision:** Under the provision, REITs would be required to distribute their pre-REIT earnings and profits in cash. The provision would be effective for distributions after February 26, 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

### **Sec. 3640. Debt instruments of publicly offered REITs and mortgages treated as real estate assets.**

**Current law:** Under current law, a REIT must derive at least 95 percent of its income from certain specified real estate-related and other investment income, and 75 percent of its income from such specified real estate-related investment income. In addition, at least 75 percent of the assets of a REIT must be comprised of real estate assets, cash and cash items, and government securities. The term “real estate assets” is defined to include real property and interests in real property.

**Provision:** Under the provision, debt instruments issued by publicly offered REITs, as well as interests in mortgages on interests in real property, would be treated as real estate assets for purposes of the 75-percent asset test. Income from debt instruments issued by publicly offered REITs would be treated as qualified income for purposes of the 95-percent income test, but not the 75-percent income test (unless they already are treated as qualified income under current law). In addition, not more than 25 percent of the value of a REIT’s assets would be permitted to consist of such debt instruments. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by less than \$50 million over 2014-2023.

### **Sec. 3641. Asset and income test clarification regarding ancillary personal property.**

**Current law:** Under current law, a REIT must derive at least 95 percent of its income from certain specified real estate-related and other investment income, and 75 percent of its income from such specified real estate-related investment income. In addition, at least 75 percent of the assets of a REIT must be comprised of real estate assets, cash and cash items, and government securities. The term “real estate assets” is defined to include real property and interests in real property.

**Provision:** Under the provision, certain ancillary personal property that is leased with real property would be treated as real property for purposes of the 75-percent asset test (similar to the current-law treatment of rents from such property for purposes of the REIT income tests). In addition, an obligation secured by a mortgage on such property would be treated as real property for purposes of the 75-percent income and asset tests, provided the fair market value of the personal property does not exceed 15 percent of the total fair market value of the combined real and personal property. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by less than \$50 million over 2014-2023.

### **Sec. 3642. Hedging provisions.**

**Current law:** Under current law, a REIT must derive at least 95 percent of its income from certain specified real-estate-related and other investment income, and 75 percent of its income from such specified real-estate-related investment income. Income from certain REIT hedging transactions generally is not included as gross income under either the 95-percent or 75-percent income tests.

**Provision:** Under the provision, the current-law treatment of REIT hedges would be extended to include income from hedges of previously acquired hedges that a REIT entered to manage risk associated with liabilities or property that have been extinguished or disposed. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by less than \$50 million over 2014-2023.

### **Sec. 3643. Modification of REIT earnings and profits calculation to avoid duplicate taxation.**

**Current law:** Under current law, REIT shareholders who receive distributions are treated as having received a dividend to the extent of the REIT's current and accumulated earnings and profits. Distributions in excess of earnings and profits are treated as a return of shareholders' capital (reducing the shareholders' basis on their REIT stock) and as capital gain of the shareholders to the extent the distributions exceed shareholders' stock basis in the REIT. A REIT may deduct a distribution to shareholders from its taxable income, and can satisfy the requirement that REITs distribute as dividends at least 90 percent of their taxable income, only to the extent of distributions that are made out of its earnings and profits. REIT earnings and profits are computed in the same manner as earnings and profits of other corporations and can differ from taxable income. However, a special rule for REITs provides that current earnings and profits are not reduced by any amount that does not reduce REIT taxable income.

**Provision:** Under the provision, current (but not accumulated) REIT earnings and profits for any tax year would not be reduced by any amount that is not allowable in computing taxable

income for the tax year and was not allowable in computing its taxable income for any prior tax year (e.g., certain amounts resulting from differences in the applicable depreciation rules). The provision would apply only for purposes of determining whether REIT shareholders are taxed as receiving a REIT dividend or as receiving a return of capital (or capital gain if a distribution exceeds a shareholder's stock basis). The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by less than \$50 million over 2014-2023.

#### **Sec. 3644. Reduction in percentage limitation on assets of REIT which may be taxable REIT subsidiaries.**

**Current law:** Under current law, a REIT generally may not own more than 10 percent of the vote or value of a single entity. However, there is an exception for ownership of taxable REIT subsidiaries (TRSs) that are taxed as corporations, provided the securities of one or more TRSs do not represent more than 25 percent of the value of the REIT's assets. The 25-percent limitation was increased from 20 percent in legislation enacted in 2008.

**Provision:** Under the provision, the 25-percent TRS stock limitation would be reduced back to 20 percent. The provision would be effective for tax years beginning after 2016.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

#### **Sec. 3645. Treatment of certain services provided by taxable REIT subsidiaries.**

**Current law:** Under current law, certain income from foreclosed real property satisfies the 95-percent and 75-percent REIT income tests. In addition, REITs are subject to a 100-percent prohibited transactions tax that prohibits REITs from being dealers in real property and limits the number of real property sales that a REIT may conduct.

A TRS generally may engage in any kind of business activity, except that it is not permitted to operate either a lodging or health care facility, although a TRS is permitted to rent certain lodging or health care facilities from its parent REIT and is permitted to hire an independent contractor to operate such facilities. A 100-percent excise tax applies to certain non-arm's length transactions between a TRS and its parent REIT.

**Provision:** Under the provision, TRSs would be permitted to operate foreclosed real property without causing income from the property to fail to satisfy the REIT income tests. In addition, TRSs would be permitted to develop and market REIT real property without subjecting the REIT to the 100-percent prohibited transactions tax. The provision also would expand the 100-percent excise tax on non-arm's length transactions to include services provided by the TRS to its parent REIT. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by less than \$50 million over 2014-2023.

**Sec. 3646. Study relating to taxable REIT subsidiaries.**

**Current law:** Under current law, rents from real property include amounts received or accrued from TRSs, provided both the REIT and the TRS satisfy certain requirements. A TRS generally is permitted to engage in any kind of business activity, but is subject to corporate tax on its taxable income. Legislation enacted in 1999 creating TRSs required the Treasury Department to conduct a study and submit a report to Congress regarding the number of TRSs in existence and the aggregate amount of taxes paid by TRSs.

**Provision:** Under the provision, the Treasury Department would be required to conduct a biannual study, and submit a report to the Ways and Means Committee and Senate Finance Committee, regarding the number of TRSs in existence, the aggregate amount of taxes paid by TRSs, and the amount by which transactions between TRSs and their parent REITs reduce the taxable income of the TRSs. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3647. C corporation election to become, or transfer assets to, a RIC or REIT.**

**Current law:** Under current law, a REIT or regulated investment company (RIC) that previously operated as a C corporation is subject to an entity-level tax at the highest corporate tax rate on certain built-in gains of property that it held while operating as a C corporation. The tax applies to gain recognized within ten years from the date that the C corporation elected to be a REIT or RIC. For 2013, the period was reduced to five years.

**Provision:** Under the provision, the current-law entity-level tax on built-in gains would be imposed at the time the C corporation elects to become a REIT or RIC or transfers assets to the REIT or RIC in a carryover basis transaction, without regard to when the gain otherwise would be recognized by the REIT or RIC. The provision would be effective for elections and transfers after February 26, 2014.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for section 3631 of the discussion draft.

**Sec. 3648. Interests in RICs and REITs not excluded from definition of United States real property interests.**

**Current law:** Under current law, the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) imposes tax on dispositions by foreign persons of interests in real property that is

located in the United States. Specifically, FIRPTA treats the gain or loss from such dispositions as effectively connected with a U.S. trade or business. In addition, FIRPTA imposes a 10-percent withholding tax on the gross proceeds from such dispositions. An interest in U.S. real property includes an interest in a U.S. corporation the assets of which, at any time during the five-year period preceding the disposition, have consisted predominantly of U.S. real property. However, an interest in U.S. real property does not include an interest in a U.S. corporation that does not hold any interests in U.S. real property at the time of disposition and, during the five-year period preceding the disposition of an interest in the U.S. corporation by a foreign person, disposed of its interests in U.S. real property in transactions in which the full amount of any gain was recognized for tax purposes.

**Provision:** Under the provision, the FIRPTA exception for interests in U.S. corporations that have disposed of all of their interests in U.S. real property in taxable transactions during the five-year period preceding disposition of an interest in the U.S. corporation by a foreign person would not apply to interests in REITs or RICs that disposed of their interests in U.S. real property with respect to which the REIT or RIC claimed a dividends paid deduction. The provision would be effective for dispositions after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

#### **Sec. 3649. Dividends derived from RICs and REITs ineligible for deduction for United States source portion of dividends from certain foreign corporations.**

**Current law:** Under current law, U.S. corporations generally may claim a deduction for dividends received from a 10-percent owned foreign corporation to the extent the dividend is attributable to either (1) income of the foreign subsidiary that is effectively connected with the conduct of a U.S. trade or business, or (2) dividends received by the foreign subsidiary from a U.S. corporation that is at least 80-percent owned by the foreign subsidiary. In addition, RICs and REITs may deduct dividend distributions to their shareholders, although shareholders that are U.S. corporations generally may not claim a deduction for such dividends.

**Provision:** Under the provision, the deduction for dividends received from a foreign subsidiary would not apply to dividends that are attributable to dividends received by the foreign subsidiary from a RIC or REIT.

The provision would be effective for distributions after February 26, 2014.

**JCT estimate:** According to JCT, the provisions would increase revenues by \$0.5 billion over 2014-2023.

## Part 4 – Personal Holding Companies

### **Sec. 3661. Exclusion of dividends from controlled foreign corporations from the definition of personal holding company income for purposes of the personal holding company rules.**

**Current law:** Under current law, a tax of 20 percent is imposed on the passive income of certain corporations (in addition to the regular corporate income tax) to prevent the retention of corporate earnings in avoidance of the individual income tax. Corporations are subject to the additional tax if five or fewer individuals own more than 50 percent of the corporation's stock and more than 60 percent of the corporation's income consists of certain types of passive income such as dividends, interest, and royalties. The tax is imposed on such passive income only to the extent the income has not been distributed as a dividend by the corporation. The passive income that is subject to the tax includes dividends that are received by the corporation from any foreign subsidiaries, even if such dividends are derived from an active trade or business of the foreign subsidiary.

**Provision:** Under the provision, dividends received from a foreign subsidiary would not be subject to the additional 20-percent tax (although they would continue to be subject to the regular corporate income tax). The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

## Subtitle H – Taxation of Foreign Persons

### **Sec. 3701. Prevention of avoidance of tax through reinsurance with non-taxed affiliates.**

**Current law:** Under current law, insurance companies generally may deduct premiums paid for reinsurance. If the reinsurance transaction results in a transfer of reserves and reserve assets to the reinsurer, potential tax liability for earnings on those assets is generally shifted to the reinsurer as well. While insurance income of a foreign subsidiary of a U.S. insurance company generally is subject to current U.S. taxation (absent the temporary exception for active financing income), insurance income of a foreign-owned foreign company that is not engaged in a U.S. trade or business generally is not subject to U.S. income tax. Instead, insurance and reinsurance policies issued by foreign insurers and reinsurers with respect to U.S. risks generally are subject to an excise tax, unless waived by treaty. In the case of reinsurance policies, this excise tax is equal to 1 percent of the premium paid.

**Provision:** Under the provision, U.S. insurance companies would not be permitted to deduct reinsurance premiums paid to a related company that is not subject to U.S. taxation on the premiums, unless the related company elects to treat the premium income as effectively connected to a U.S. trade or business (and thus subject to U.S. tax). However, if the taxpayer demonstrates to the IRS that a foreign jurisdiction taxes the reinsurance premiums at a rate as high as or higher than the U.S. corporate rate, the deduction for the reinsurance premiums would be allowed. Additionally, to match income and deductions, any income from reinsurance



recovered by the U.S. insurance company, as well as any ceding commissions received in connection with a premium deduction that has been disallowed, would not be subject to U.S. tax. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$8.7 billion over 2014-2023.

**Sec. 3702. Taxation of passenger cruise gross income of foreign corporations and nonresident alien individuals.**

**Current law:** Under current law, a foreign individual or corporation generally is subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business. However, income derived by a foreign individual or corporation from the international operation of a ship is exempt from U.S. tax if the country in which the individual or corporation is a resident grants an equivalent exemption to U.S. taxpayers. Otherwise, a 4-percent U.S. tax is imposed on U.S.-source gross income from regularly scheduled shipping if the foreign individual or corporation has a fixed place of business in the United States that is involved in earning such income.

**Provision:** Under the provision, the income of foreign taxpayers that is derived from the operation of passenger cruise ships within U.S. territorial waters would be subject to U.S. tax, without regard to whether the country in which the taxpayer is a resident grants an equivalent exemption to U.S. taxpayers. In addition, the 4-percent U.S. tax on U.S.-source shipping income would apply without regard to whether the shipping is regularly scheduled or the foreign individual or corporation has a fixed place of business in the United States. The provision would be effective for tax years beginning after 2014.

**Considerations:**

- Over 70 percent of travelers on passenger cruise ships are from the United States, and cruise line companies rely heavily on taxpayer-funded U.S. maritime infrastructure and Coast Guard resources during both normal operations and in the event of emergencies. By flagging their ships in other countries, however, these companies pay little or no U.S. Federal income tax under a long-standing exemption that originally was intended to apply to the transport of cargo and passengers between the United States and other countries.
- According to the U.S. Department of Transportation Maritime Administration, the overall utilization rate for passenger cruise vessels in 2011 exceeded 100 percent, which is primarily a function of cruise lines setting fares to fill ships, so it is unlikely that cruise ship passengers would be affected by this provision through price increases.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.9 billion over 2014-2023.

### **Sec. 3703. Restriction on insurance business exception to passive foreign investment company rules.**

**Current law:** Under current law, U.S. shareholders of a passive foreign investment company (PFIC) are taxed currently on the PFIC's earnings. A PFIC is defined as any foreign corporation (1) 75 percent or more of the gross income of which is passive, and (2) at least 50 percent of the assets of which produce passive income. Among other exceptions, passive income does not include any income that is derived in the active conduct of an insurance business if the PFIC is predominantly engaged in an insurance business and would be taxed as an insurance company were it a U.S. corporation.

**Provision:** Under the provision, the PFIC exception for insurance companies would be amended to apply only if (1) the PFIC would be taxed as an insurance company were it a U.S. corporation, (2) more than 50 percent of the PFIC's gross receipts for the tax year consist of premiums, and (3) loss and loss adjustment expenses, unearned premiums, and certain reserves constitute more than 35 percent of the PFIC's total assets. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.4 billion over 2014-2023.

### **Sec. 3704. Modification of limitation on earnings stripping.**

**Current law:** Under current law, a U.S. corporation generally may deduct interest payments, including payments to a related party. However, if the taxpayer's debt-to-equity ratio exceeds 1.5 to 1, interest payments to certain related parties that are not subject to U.S. tax (e.g., foreign corporations) are disallowed to the extent the taxpayer has "excess interest expense," – i.e., net interest expense (interest expense less interest income) in excess of 50 percent of the taxpayer's adjusted taxable income (defined as taxable income without regard to deductions for net interest expense, net operating losses, certain cost recovery, and domestic production activities). Any disallowed interest deductions may be carried forward indefinitely, while any "excess limitation" (the excess of 50 percent of the corporation's adjusted taxable income over the corporation's net interest expense) may be carried forward three years.

**Provision:** Under the provision, the threshold for excess interest expense would be reduced to 40 percent of adjusted taxable income. In addition, corporations would no longer be permitted to carry forward any excess limitation. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$2.9 billion over 2014-2023.

## **Sec. 3705. Limitation on treaty benefits for certain deductible payments.**

**Current law:** Under current law, certain payments of fixed or determinable, annual or periodical (FDAP) income – such as interest, dividends, rents, and annuities – to foreign recipients are subject to a statutory 30-percent withholding tax. Income tax treaties between the United States and other countries, however, often reduce or eliminate this withholding tax for payments from one treaty country to residents of the other treaty country.

**Provision:** Under the provision, if a payment of FDAP income is deductible in the United States and the payment is made by an entity that is controlled by a foreign parent to another entity in a tax treaty jurisdiction that is controlled by the same foreign parent, then the statutory 30-percent withholding tax on such income would not be reduced by any treaty unless the withholding tax would be reduced by a treaty if the payment were made directly to the foreign parent. The provision would be effective for payments made after the date of enactment.

**JCT estimate:** According to JCT, the provision would increase revenues by \$6.9 billion over 2014-2023.

## **Subtitle I – Provisions Related to Compensation**

### **Part 1 – Executive Compensation**

#### **Sec. 3801. Nonqualified deferred compensation.**

**Current law:** Under current law, compensation generally is taxable to an employee and deductible by an employer in the year earned, with two significant exceptions. First, for compensation provided as part of a qualified defined benefit or defined contribution pension plan, the employee does not take such compensation into income until the year in which a distribution from the plan occurs, while the employer generally may take the deduction in the year the compensation is earned. Second, for non-qualified deferred compensation, the employee does not take such compensation into income until the year received, but the employer's deduction is postponed until that time. The employee generally must take non-qualified deferred compensation into income, however, if the compensation is put into a trust protected from the employer's creditors in bankruptcy as soon as there is no substantial risk of forfeiture with regard to the compensation. In addition, if the employer is located in a jurisdiction in which the employer is not effectively subject to income tax (i.e., certain foreign jurisdictions), the compensation is immediately taxable as soon as it is not subject to a substantial risk of forfeiture. Other rules apply to deferred compensation paid by a State or local government or tax-exempt organization, in which case an employee may defer tax so long as the deferred compensation is less than the limit on employee contributions for 401(k) plans (i.e., \$17,500 for 2014).

**Provision:** Under the provision, an employee would be taxed on compensation as soon as there is no substantial risk of forfeiture with regard to that compensation (i.e., receipt of the compensation is not subject to future performance of substantial services). The provision would

be effective for amounts attributable to services performed after 2014. The current-law rules would continue to apply to existing non-qualified deferred compensation arrangements until the last tax year beginning before 2023, when such arrangements would become subject to the provision.

**Considerations:**

- The provision repeals a current-law tax benefit for which only highly compensated employees are generally eligible.
- The provision creates simplicity in an area of taxation that is extremely complex under current law.

**JCT estimate:** According to JCT, the provision would increase revenues by \$9.2 billion over 2014-2023.

**Sec. 3802. Modification of limitation on excessive employee remuneration.**

**Current law:** Under current law, a corporation generally may deduct compensation expenses as an ordinary and necessary business expense. The deduction for compensation paid or accrued with respect to a covered employee of a publicly traded corporation, however, is limited to no more than \$1 million per year. The deduction limitation applies to all remuneration paid to a covered employee for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash, subject to several significant exceptions: (1) commissions; (2) performance-based remuneration, including stock options; (3) payments to a tax-qualified retirement plan; and (4) amounts that are excludable from the executive's gross income.

A covered employee is the chief executive officer (CEO) and the next four highest compensated officers based on the Securities and Exchange Commission (SEC) disclosure rules. Due to changes in the applicable SEC disclosure rules, IRS guidance has interpreted "covered employee" to mean the principal executive officer and the three highest compensated officers as of the close of the tax year.

**Provision:** Under the provision, the exceptions to the \$1 million deduction limitation for commissions and performance-based compensation would be repealed. The provision also would revise the definition of "covered employee" to include the CEO, the chief financial officer, and the three other highest paid employees, realigning the definition with current SEC disclosure rules. Under the modified definition, once an employee qualifies as a covered person, the deduction limitation would apply for Federal tax purposes to that person so long as the corporation pays remuneration to such person (or to any beneficiaries). The provision would be effective for tax years beginning after 2014.

**Considerations:**

- The significant exceptions to the current limit on the 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.

- This shift has led to perverse consequences as some executives focus on – and could, in rare cases, manipulate – quarterly results (off of which their compensation is determined), rather than on the long-term success of the company.

**JCT estimate:** According to JCT, the provision would increase revenues by \$12.1 billion over 2014-2023.

**Sec. 3803. Excise tax on excess tax-exempt organization executive compensation.**

**Current law:** Under current law, the deduction allowed to publicly traded C corporations for compensation paid with respect to chief executive officers and certain highly paid officers is limited to no more than \$1 million per year. Similarly, current law limits the deductibility of certain severance-pay arrangements (“parachute payments”). No parallel limitation applies to tax-exempt organizations with respect to executive compensation and severance payments.

**Provision:** Under the provision, a tax-exempt organization would be subject to a 25-percent excise tax on compensation in excess of \$1 million paid to any of its five highest paid employees for the tax year. The excise tax would apply to all remuneration paid to a covered person for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash, except for payments to a tax-qualified retirement plan, and amounts that are excludable from the executive’s gross income.

Once an employee qualifies as a covered person, the excise tax would apply to compensation in excess of \$1 million paid to that person so long as the organization pays him remuneration. The excise tax also would apply to excess parachute payments paid by the organization to such individuals. Under the provision, an excess parachute payment generally would be a payment contingent on the employee’s separation from employment with an aggregate present value of three times the employee’s base compensation or more. The provision would be effective for tax years beginning after 2014.

**Considerations:**

- Current law generally has no limit on excessive compensation paid by a tax-exempt organization to its senior management other than the limitation on private inurement, the consequence of which can be revocation of the organization’s exemption.
- Tax-exempt organizations enjoy a tax subsidy from the Federal government as a result of the requirement that they use their resources for specific purposes. Some may question whether excessive executive compensation diverts resources from those particular purposes.
- The provision is consistent with the limitation on the deductibility of executive compensation by taxable publicly traded corporations.
- Given that exemption from Federal income tax constitutes a significant benefit conferred upon tax-exempt organizations, the case for discouraging excess compensation paid out to such organizations’ executives may be even stronger than it is for publicly traded companies.

**JCT estimate:** According to JCT, the provision would increase revenues by \$4.0 billion over 2014-2023.

**Sec. 3804. Denial of deduction as research expenditure for stock transferred pursuant to an incentive stock option.**

**Current law:** Under current law, an employer that transfers a share of stock to an individual pursuant to an incentive stock option plan or employee stock purchase plan may not claim a deduction as an ordinary and necessary business expense under Code section 162 for the value of such stock. Some taxpayers have taken the position that notwithstanding the foregoing prohibition, a deduction is permitted as wages paid with respect to research expenditures under Code section 174.

**Provision:** Under the provision, the rules with respect to incentive stock option plans and employee stock purchase plans would be clarified to deny a deduction under any provision of the Code for a transfer of stock to an individual under such plans. The provision would be effective for stock transferred after February 26, 2014.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

**Part 2 – Worker Classification**

**Sec. 3811. Determination of worker classification.**

**Current law:** Under current law, the determination of whether a worker is an employee or an independent contractor is generally made under a common-law facts and circumstances test that seeks to determine whether the worker is subject to the control of the service recipient, not only as to the nature of the work performed, but also as to the circumstances under which it is performed. Various provisions under current law, however, specifically classify a worker as an employee or an independent contractor. For example, certain real estate agents and direct sellers are treated for all tax purposes as independent contractors, while full-time life insurance salesmen are treated as employees only for employment tax and employee benefit purposes. In some cases, salesmen are treated as employees just for employment tax purposes. Under a special safe harbor rule (section 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes, even though the worker may be an employee, if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met.

**Provision:** Under the provision, workers qualifying for a safe harbor would not be treated as an employee and the service recipient would not be treated as the employer for any Federal tax purpose. The safe harbor also would apply to three-party arrangements in which a payor other than the service recipient pays the worker. To qualify for the safe harbor, the worker would have to satisfy certain sales or service criteria and the worker and service recipient would be required

to have a written agreement meeting specified requirements. In addition, the service recipient would withhold tax on the first \$10,000 of payments made to the worker in a year at a rate of 5 percent. Amounts withheld under the safe harbor would be creditable by the worker against quarterly estimated-tax requirements.

In any case in which the IRS determines that the requirements of the safe harbor were not satisfied, the provision generally would limit the IRS to reclassification of the worker as an employee and service provider as an employer on a prospective basis. To avoid retroactive reclassification, the worker or service provider would have to have satisfied the written agreement and the reporting and withholding requirements of the safe harbor and have had a reasonable basis for claiming that the safe harbor applied.

The provision would be effective for services performed and payments made after 2014.

**Considerations:**

- Under current law, the IRS uses a subjective 20-factor common law test to determine a worker's status. As a result, businesses – especially small businesses – that hire, and individuals who want to work as, independent contractors, face considerable uncertainty as to whether the IRS will respect that classification.
- In cases where the IRS reclassifies an independent contractor as an employee, often years after the contractor and service recipient entered into their business arrangement, the result can be significant liability for back taxes, interest, and penalties.
- The provision would provide much-needed certainty by providing a safe harbor under which a worker would be classified as an independent contractor if certain objective criteria are met, and the IRS generally would be barred from retroactively reclassifying the independent contractor if a good faith effort were made to qualify for the safe harbor.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$2.6 billion over 2014-2023.

## **Subtitle J – Zones and Short-Term Regional Benefits**

### **Sec. 3821. Repeal of provisions relating to Empowerment Zones and Enterprise Communities.**

**Current law:** Under current law, the Secretary of Housing and Urban Development and the Secretary of Agriculture were authorized to designate certain urban and rural areas as Enterprise Communities and Empowerment Zones. Since 1996, Empowerment Zones have replaced Enterprise Communities. The tax benefits available to designated zones included: (1) a 20-percent wage credit available to employers for the first \$15,000 of qualified wages paid to an employee who was a resident and performs substantially all employment services within the Empowerment Zone; (2) expanded tax-exempt financing by State and local governments for certain zone facilities as well as zone academy bonds for certain public schools located in an Empowerment Zone; and (3) deferred recognition of gain on the sale of qualified Empowerment Zone assets held for more than one year and replaced within 60 days by another qualified asset in

the same zone. The Enterprise Community designations generally expired at the end of 2004. The Empowerment Zones designation expired after 2013.

**Provision:** Under the provision, Enterprise Communities and Empowerment Zones and the associated special tax benefits would be repealed. The provision generally would be effective on the date of enactment, except for sales of qualified Empowerment Zone assets before the date of enactment, and bonds issued before 2014.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 3822. Repeal of DC Zone provisions.**

**Current law:** Under current law, certain economically depressed census tracts within the District of Columbia were designated as the District of Columbia Enterprise Zone (DC Zone). Businesses and individual residents within the DC Zone were eligible for special tax incentives generally through the end of 2011. The tax benefits included: (1) a zero-percent capital gains rate with respect to the sale of certain qualified DC Zone assets, provided that the property was held for more than five years; and (2) expanded tax-exempt bond financing for certain zone facilities as well as zone academy bonds for certain public schools located in the zone.

**Provision:** Under the provision, the DC Zone and the associated special tax incentives would be repealed. The provision generally would be effective on the date of enactment, except for qualifying capital assets and residences acquired, and bonds issued, before 2012.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 3823. Repeal of provisions relating to renewal communities.**

**Current law:** Under current law, the Community Renewal Tax Relief Act of 2000 authorized the designation of 40 “Renewal Communities” within which special tax incentives were available generally through the end of 2009. The tax benefits included: (1) up to \$12 million to be allocated by a State to each Renewal Community for commercial revitalization expenditures (i.e., the cost of a new building, or the cost of substantially rehabilitating an existing building, used for commercial purposes and located in a Renewal Community), for which the taxpayer may elect either to deduct one-half of the commercial revitalization expenditures for the tax year the building is placed in service or amortize all the expenditures ratably over a 120-month period; (2) a zero-percent capital gains rate with respect to gain from the sale of certain Renewal Community assets for gains attributable to the period between 2002 and 2014 (inclusive), provided that the property was held for more than five years; and (3) access to zone academy bonds for certain public schools located in an Empowerment Zone.

**Provision:** Under the provision, the Renewal Communities and the associated special tax incentives would be repealed. The provision generally would be effective on the date of



enactment, except for qualifying assets and property acquired and placed in service, and wages paid or incurred, before 2010.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 3824. Repeal of various short-term regional benefits.**

**Current law:** Under current law, special tax benefits applied to certain designated areas for recovery from specific disasters. In 2002, the New York Liberty Zone was designated to assist with the recovery from the terrorist attacks on September 11, 2001. The tax benefits for the Liberty Zone included: (1) additional 30-percent first-year depreciation for qualified Liberty Zone property placed in service before 2006 (2009 for certain real property); (2) enhanced tax-exempt bond financing for New York Liberty Bonds issued before 2014; and (3) five-year replacement period for compulsory or involuntarily converted Liberty Zone assets as a result of the terrorist attacks.

In 2005, the Gulf Opportunity Zone (GO Zone) was designated to provide relief for areas damaged by Hurricanes Katrina, Rita, and Wilma. The primary tax benefits for these areas included: (1) enhanced tax-exempt bond financing for Gulf Opportunity Zone Bonds issued before 2012; (2) five-year carryback of certain losses resulting from GO Zone damages; (3) increased rehabilitation credit for qualifying expenditures before 2012; (4) special education tax benefits for individuals attending educational institutions in the GO Zone in 2005 and 2006; and (5) certain housing tax benefits for residents of the GO Zone in 2005 and 2006.

**Provision:** Under the provision, the Liberty Zone and GO Zone designations and the associated special tax benefits would be repealed. The provision generally would be effective on the date of enactment or, if earlier, the date on which the particular tax benefit expires or the date by which the bonds must be issued under current law.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

# **Title IV – Participation Exemption System for the Taxation of Foreign Income**

## **Subtitle A – Establishment of Exemption System**

### **Sec. 4001. Deduction for dividends received by domestic corporations from certain foreign corporations.**

**Current law:** Under current law, U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether earned in the United States or abroad. Foreign income earned by a foreign subsidiary of a U.S. corporation generally is not subject to U.S. tax until the income is distributed as a dividend to the U.S. corporation. To mitigate the double taxation on earnings of the foreign corporation, the United States allows a credit for foreign income taxes paid. The foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign income. When foreign tax credits are insufficient to offset the U.S. tax liability on the repatriated earnings, the additional U.S. tax the U.S. corporation must pay is referred to as the “U.S. residual tax.” A U.S. taxpayer may elect to deduct foreign income taxes paid rather than claim the credit.

**Provision:** Under the provision, the current-law system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when these earnings are distributed would be replaced with a dividend-exemption system. Under the exemption system, 95 percent of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10 percent or more of the foreign corporation would be exempt from U.S. taxation. No foreign tax credit or deduction would be allowed for any foreign taxes (including withholding taxes) paid or accrued with respect to any exempt dividend. The provision would be effective for tax years of foreign corporations beginning after 2014, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

#### **Considerations:**

- The provision would allow U.S. companies to compete on a more level playing field against foreign multinationals when selling products and services abroad.
- The provision would eliminate the “lock-out” effect that results from the U.S. residual tax under current law, which discourages U.S. companies from bringing their foreign earnings back into the United States.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$212.0 billion over 2014-2023.

### **Sec. 4002. Limitation on losses with respect to specified 10-percent owned foreign corporations.**

**Current law:** Under current law, any gain that is recognized by a U.S. parent corporation on the sale or exchange of its stock in a foreign subsidiary generally is treated as a dividend distribution

by the foreign subsidiary to its U.S. parent to the extent of earnings and profits (E&P) that have been accumulated by the foreign subsidiary while it had been owned by the U.S. parent.

In some cases, U.S. companies may operate businesses in foreign countries directly through a branch rather than a separate foreign subsidiary. In these situations, U.S. companies pay U.S. taxes on the foreign earnings or deduct losses on a current basis, as if earned directly by the U.S. parent.

**Provisions:** Under the provision, a U.S. parent would reduce the basis of its stock in a foreign subsidiary by the amount of any exempt dividends received by the U.S. parent from its foreign subsidiary. Such basis reductions would apply only for purposes of determining the amount of a loss (but not the amount of any gain) on any sale or exchange of the foreign subsidiary stock by its U.S. parent. The provision would be effective for dividends received in tax years beginning after 2014.

In addition, if a U.S. corporation transfers substantially all of the assets of a foreign branch to a foreign subsidiary, the U.S. corporation would be required to include in income the amount of any post-2014 losses that previously were incurred by the branch to the extent the U.S. corporation receives exempt dividends from any of its foreign subsidiaries. The provision would be effective for transfers after 2014.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for section 4001 of the discussion draft.

### **Sec. 4003. Treatment of deferred foreign income upon transition to participation exemption system of taxation.**

**Current law:** Under current law, U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether earned in the United States or abroad. Foreign income earned by a foreign subsidiary that is owned by a U.S. corporation generally is not subject to U.S. tax until the income is distributed as a dividend to the U.S. corporation. To mitigate the double taxation on earnings of the foreign corporation, the United States allows a credit for foreign income taxes paid. The foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign income

**Provision:** Under the provision, U.S. shareholders owning at least 10 percent of a foreign subsidiary would include in income for their last tax year beginning before 2015 their pro rata share of the post-1986 historical E&P of the foreign subsidiary to the extent such E&P has not been previously subject to U.S. tax. The E&P would be bifurcated into E&P retained in the form of cash, cash equivalents, or certain other short-term assets, and E&P that has been reinvested in the foreign subsidiary's business (property, plant and equipment). The portion of the E&P that consists of cash or cash equivalents would be taxed at a special rate of 8.75 percent, while any remaining E&P would be taxed at a special rate of 3.5 percent. Foreign tax credits would be partially available to offset the U.S. tax.

At the election of the U.S. shareholder, the tax liability would be payable over a period of up to eight years, based on a schedule of 8 percent of the net tax liability in each of the first 5 years; 15 percent in the sixth year; 20 percent in the seventh year and 25 percent in the eighth year. The tax revenues generated directly by this one-time tax on accumulated E&P would be deposited into the Highway Trust Fund (HTF) as the revenues are received from taxpayers. Consistent with the current allocation of fuel excise tax revenues between the Highway Account and the Mass Transit Account in the HTF, 80 percent of the revenues raised by this provision would be allocated to the Highway Account, and 20 percent of the revenues would be allocated to the Mass Transit Account.

If the U.S. shareholder is an S corporation, the provision would not apply until the S corporation ceases to be an S corporation, substantially all of the assets of the S corporation are sold or liquidated, the S corporation ceases to exist or conduct business, or stock in the S corporation is transferred.

The provision would be effective for tax years of foreign corporations beginning after 2014, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

**Considerations:**

- The provision would provide \$126.5 billion of revenue for the Highway Trust Fund to address the deep funding shortfall that currently exists for Federal transportation infrastructure projects, enough to eliminate the cumulative shortfall in the trust fund through 2021.
- The provision would eliminate the need for U.S. companies to separately track E&P that was accumulated by their foreign subsidiaries prior to adoption of the dividend-exemption system, so that all distributions from foreign subsidiaries would be treated in the same manner under the dividend-exemption system.
- The provision would moderate the tax burden on illiquid accumulated E&P that has been reinvested in the foreign subsidiary's business.

**JCT estimate:** According to JCT, the provision would increase revenues by \$170.4 billion over 2014-2023, \$126.5 billion of which would be attributable directly to the one-time tax on accumulated E&P, with the remainder attributable to indirect revenue effects.

**Sec. 4004. Look-thru rule for related controlled foreign corporations made permanent.**

**Current law:** Under current law, a U.S. parent of a foreign subsidiary generally is subject to current U.S. tax on dividends, interest, royalties, rents, and other types of passive income earned by the foreign subsidiary, regardless of whether the foreign subsidiary distributes such income to the U.S. parent. However, for tax years of foreign subsidiaries beginning before 2014, and tax years of U.S. shareholders in which or with which such tax years of the foreign subsidiary end, a special "look-through" rule provided that passive income received by one foreign subsidiary from a related foreign subsidiary generally was not includible in the taxable income of the U.S.

parent, provided such income was not subject to current U.S. tax or effectively connected with a U.S. trade or business.

**Provision:** Under the provision, the look-through rule would be made permanent. The provision would be effective for tax years of foreign corporations beginning after 2013, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$13.1 billion over 2014-2023.

## **Subtitle B – Modifications Related to Foreign Tax Credit System**

### **Sec. 4101. Repeal of section 902 indirect foreign tax credits; determination of section 960 credit on current year basis.**

**Current law:** Under current law, foreign income earned by a foreign subsidiary of a U.S. corporation generally is not subject to U.S. tax until the income is distributed as a dividend to the U.S. corporation. To mitigate the double taxation on earnings of the foreign corporation, the United States allows a credit for foreign income taxes paid. The foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income.

Under certain circumstances, the U.S. parent corporation is subject to U.S. tax on certain foreign income of its foreign subsidiaries (“subpart F income”) even if the income is not repatriated. A U.S. parent corporation generally may claim a credit for foreign taxes paid on the subpart F income.

**Provision:** Under the provision, no foreign tax credit or deduction would be allowed for any taxes (including withholding taxes) paid or accrued with respect to any dividend to which the dividend exemption under section 4001 of the discussion draft would apply. A foreign tax credit would be allowed for any subpart F income that is included in the income of the U.S. shareholder on a current year basis, without regard to pools of foreign earnings kept abroad. The provision would be effective for tax years of foreign corporations beginning after 2014 and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for section 4001 of the discussion draft.

### **Sec. 4102. Foreign tax credit limitation applied by allocating only directly allocable deductions to foreign source income.**

**Current law:** Under current law, a portion of expenses incurred in the United States by a U.S. parent of a foreign subsidiary that are not directly attributable to income earned by the foreign subsidiary must be allocated against foreign-source income for purposes of calculating the U.S. parent’s foreign-source income. The allocation of these expenses to foreign-source income

reduces the amount of foreign tax credits a U.S. parent may use to reduce its U.S. tax on foreign-source income. Some of the expenses that are allocated include stewardship expenses, general and administrative expenses, and interest expenses.

**Provision:** Under the provision, only expenses that are directly attributable to income earned by a foreign subsidiary would be allocated against foreign-source income for purposes of calculating the U.S. parent's foreign-source income and the amount of foreign tax credits the U.S. parent may use to reduce its U.S. tax on foreign-source income. Directly allocable deductions include items such as salaries of sales personnel, supplies, and shipping expenses directly related to the production of foreign-source income. The provision would be effective for tax years of foreign corporations beginning after 2014, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for section 4001 of the discussion draft.

#### **Sec. 4103. Passive category income expanded to include other mobile income.**

**Current law:** Under current law, income earned by foreign subsidiaries is categorized as either active or passive income. Passive income generally includes (but is not limited to) dividends, rents, royalties and capital gains. Additionally, the foreign taxes paid on the income are separated into active and passive baskets. Only foreign taxes paid on passive income may be taken into account in determining the amount of foreign tax credits that may be claimed against U.S. tax on passive income.

**Provision:** Under the provision, the use of foreign tax credits would be restricted to two baskets: mobile and active. The mobile basket would include certain related-party sales income, foreign intangible income, and current-law passive income. The active basket would include all other income. The provision would be effective for tax years of foreign corporations beginning after 2014, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for section 4211 of the discussion draft.

#### **Sec. 4104. Source of income from sales of inventory determined solely on basis of production activities.**

**Current law:** Under current law, in determining the source of income for foreign tax credit purposes, up to 50 percent of the income from the sale of inventory property that is produced within the United States and sold outside the United States (or vice versa) may be treated as foreign-source income, even though the production activity takes place entirely within the United States.

**Provision:** Under the provision, income from the sale of inventory property produced within and sold outside the United States (or vice versa) would be allocated and apportioned between sources within and outside the United States solely on the basis of the production activities with respect to the inventory. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.8 billion over 2014-2023.

## **Subtitle C – Rules Related to Passive and Mobile Income**

### **Part 1 – Modification of Subpart F Provisions**

#### **Sec. 4201. Subpart F income to only include low-taxed foreign income.**

**Current law:** Under current law, a U.S. parent of a foreign subsidiary is subject to current U.S. tax on certain income of the foreign subsidiary (“subpart F income”), regardless of whether or not the income is distributed to the U.S. parent. Subpart F income generally includes certain forms of passive and highly mobile income that are easily transferred to subsidiaries in low-tax countries. Examples of subpart F income include dividends, interest, rents, royalties, and certain related-party sales or services transactions. If, however, the subpart F income has been taxed at a rate that is at least 90 percent of the U.S. tax rate (i.e., 31.5 percent for C corporations), then the U.S. parent may elect to treat that income as non-subpart F income.

**Provision:** Under the provision, the 90-percent threshold for treating foreign income as subpart F income would be increased to 100 percent (i.e., 25 percent for C corporations) for foreign personal holding company income. For foreign base company sales income, however, the threshold would be reduced to 50 percent of the U.S. rate (i.e., 12.5 percent for C corporations) and to 60 percent of the U.S. rate (i.e., 15 percent) for foreign base company intangible income. In addition, such treatment would no longer be elective. The provision would be effective for tax years of foreign corporations beginning after 2014, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for section 4211 of the discussion draft.

#### **Sec. 4202. Foreign base company sales income.**

**Current law:** Under current law, a U.S. parent of a foreign subsidiary is subject to current U.S. tax under subpart F on income earned by the foreign subsidiary from certain related-party sales transactions (“foreign base company sales income” or FBCSI), regardless of whether the foreign subsidiary distributes such income to the U.S. parent. In general, FBCSI is income earned by a foreign subsidiary from buying or selling personal property from or to, or on behalf of, related persons if the property is (1) manufactured, produced, grown or extracted outside of the country

in which the foreign subsidiary is organized, and (2) used, consumed, or disposed of outside of such country.

**Provision:** Under the provision, FBCSI no longer would include income earned by a foreign subsidiary that is incorporated in a country that has a comprehensive income tax treaty with the United States, or to income that has been taxed at an effective tax rate of 12.5 percent or greater. The provision would be effective for tax years of foreign corporations beginning after 2014, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for section 4211 of the discussion draft.

#### **Sec. 4203. Inflation adjustment of de minimis exception for foreign base company income.**

**Current law:** Under current law, a U.S. parent of a foreign subsidiary is subject to current U.S. tax under subpart F on FBCSI and foreign income from issuing (or reinsuring) insurance or annuity contracts, regardless of whether the foreign subsidiary distributes such income to the U.S. parent. However, a de minimis rule states that if the gross amount of such income is less than the lesser of 5 percent of the foreign subsidiary's gross income or \$1 million, then the U.S. parent is not subject to current U.S. tax on any of the income. The \$1 million threshold is not adjusted for inflation.

**Provision:** Under the provision, the \$1 million threshold would be adjusted for inflation. The provision would be effective for tax years of foreign corporations beginning after 2014 and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

**JCT estimate:** The revenue effect of the provision over 2014-2023 is included in the JCT estimate provided for section 4211 of the discussion draft.

#### **Sec. 4204. Active finance exception extended with limitation for low-taxed foreign income.**

**Current law:** Under current law, a U.S. parent of a foreign subsidiary generally is subject to current U.S. tax under subpart F on dividends, interest, royalties, rents, and other types of passive income (collectively "foreign personal holding company income") earned by the foreign subsidiary, regardless of whether the foreign subsidiary distributes such income to the U.S. parent. However, for tax years of foreign subsidiaries beginning before 2014, and tax years of U.S. shareholders in which or with which such tax years of the foreign subsidiary end, there was a temporary exception for such income if it was derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business ("active financing income").

**Provision:** Under the provision, the exception would be extended for five years for active financing income that is subject to a foreign effective tax rate of 12.5 percent or higher. Active



financing income that is subject to a lower foreign tax rate would not be exempt, but would be subject to a reduced U.S. tax rate of 12.5 percent, before the application of foreign tax credits. The provision would be effective for tax years of foreign corporations beginning after 2013 and before 2019, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$18.4 billion over 2014-2023.

### **Sec. 4205. Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment.**

**Current law:** Foreign shipping income earned between 1976 and 1986 was not subject to current U.S. tax under subpart F if the income was reinvested in certain qualified shipping investments. Such income becomes subject to current U.S. tax in a subsequent year to the extent that there is a net decrease in qualified shipping investments during that subsequent year.

**Provision:** Under the provision, the imposition of current U.S. tax on previously excluded foreign shipping income of a foreign subsidiary if there is a net decrease in qualified shipping investments would be repealed. The provision would be effective for tax years of foreign corporations beginning after 2014, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

## **Part 2 – Prevention of Base Erosion**

### **Sec. 4211. Foreign intangible income subject to taxation at reduced rate; intangible income treated as subpart F income.**

**Current law:** Under current law, a U.S. parent of a foreign subsidiary is subject to current U.S. tax on its pro rata share of the subsidiary's subpart F income, regardless of whether the income is distributed to the U.S. parent. In addition, income earned by the U.S. parent directly for the use of its intangibles exploited abroad, usually in the form of royalties, is subject to U.S. tax upon receipt of the income. Under the transfer pricing rules, however, if a foreign subsidiary of the U.S. parent owns intangible property in a foreign jurisdiction, the U.S. parent generally may allocate substantial profits to the foreign subsidiary without violating the subpart F rules, thus deferring U.S. tax on those profits until they are distributed to the U.S. parent.

**Provision:** Under the provision, a U.S. parent of a foreign subsidiary would be subject to current U.S. tax on a new category of subpart F income, "foreign base company intangible income" (FBCII). FBCII would equal the excess of the foreign subsidiary's gross income over

10 percent of the foreign subsidiary's adjusted basis in depreciable tangible property (excluding income and property that are related to commodities).

The U.S. parent could claim a deduction equal to a percentage of the foreign subsidiary's FBCII that relates to property that is sold for use, consumption, or disposition outside the United States or to services that are provided outside the United States. The deduction also would be available to U.S. corporations that earn foreign intangible income directly (rather than through a foreign subsidiary). The deductible percentage of FBCII and foreign intangible income would be 55 percent for tax years beginning in 2015, and would phase down (in conjunction with the phase-in of the 25-percent corporate rate) to 52 percent in 2016, 48 percent in 2017, 44 percent in 2018, and 40 percent for tax years beginning in 2019 or later.

With regard to the treatment of FBCII as subject to current U.S. tax, the provision would be effective for tax years of foreign corporations beginning after 2014, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end. With regard to the deduction of a percentage of such income, the provision would be effective for tax years beginning after 2014.

**Considerations:**

- Under current law, the allocation of income by U.S. companies to intangible property that is located in low-tax or no-tax jurisdictions (through migration out of the United States or otherwise) is an acute source of erosion of the U.S. tax base.
- The adoption of a dividend exemption international tax system could, on its own and without appropriate safeguards, exacerbate this incentive by allowing profits that have been shifted to be repatriated with minimal U.S. tax consequences.
- The provision would remove tax incentives to locate intangible property in low-tax or no-tax jurisdictions by providing neutral tax treatment of income attributable to intangible property, regardless of whether such property is located within or outside the United States.
- At the same time, the provision would provide a reduced U.S. tax rate on such income to the extent derived from foreign customers in recognition that it is difficult to identify precisely when the allocation of income to intangible property in foreign jurisdictions results in erosion of the U.S. tax base.
- The provision includes a significant refinement to the international tax reform discussion draft released by the Committee on October 26, 2011 by providing a simplified approach to calculating income that is subject to the provision, in effect exempting normal returns on investments in tangible property.

**JCT estimate:** According to JCT, the provision, along with sections 4103, 4201, 4202, and 4203 of the discussion draft, would increase revenues by \$115.6 billion over 2014-2023.

**Sec. 4212. Denial of deduction for interest expense of United States shareholders which are members of worldwide affiliated groups with excess domestic indebtedness.**

**Current law:** Under current law, corporations generally may deduct all of their interest expense even if the debt was acquired to capitalize foreign subsidiaries. Expense allocation rules, however, may require the interest expense to be allocated against foreign source income, which may limit the amount of foreign tax credits the U.S. parent may utilize.

**Provision:** Under the provision, the deductible net interest expense of a U.S. parent of one or more foreign subsidiaries would be reduced by the lesser of the extent to which (1) the indebtedness of the U.S. parent (including other members of the U.S. consolidated group) exceeds 110 percent of the combined indebtedness of the worldwide affiliated group (including both related domestic and related foreign entities), or (2) net interest expense exceeds 40 percent of the adjusted taxable income of the U.S. parent. Any disallowed interest expense could be carried forward to a subsequent tax year. The provision would be effective for tax years beginning after 2014.

**Considerations:**

- While reducing the corporate tax rate would reduce the incentive for U.S. companies to maintain excessive leverage, it is important to provide measures to discourage excessive leverage directly in conjunction with the adoption of a dividend-exemption system.
- The provision would prevent U.S. companies from generating excessive interest deductions in the United States on debt that is incurred to produce exempt foreign income in a dividend-exemption system.
- The provision recognizes standard non-tax business practices that involve parent corporations incurring debt to finance the acquisition or establishment of foreign subsidiaries by (1) allowing the U.S. group to have 10 percent more leverage than the worldwide group, and (2) providing an indefinite carryforward of disallowed interest expense.

**JCT estimate:** According to JCT, the provision would increase revenues by \$24.0 billion over 2014-2023.

## **Title V – Tax Exempt Entities**

### **Considerations for Title V:**

- The Ways and Means Oversight Subcommittee, in numerous hearings in the 112th and 113th Congresses, has explored a variety of issues involving tax-exempt entities and public charities. In particular, the Subcommittee has learned that public charities are engaging in more commercial activities than ever before and are using more complex organizational structures to do so. Many organizations, such as AARP, are now earning significant profits licensing their own names to for-profit businesses (which is not taxable to an exempt organization) to avoid engaging in an active trade or business themselves. In addition, the IRS issued a report detailing how colleges and universities were abusing the unrelated business income tax (UBIT) rules by using loss-generating business activities to shelter gain from profitable businesses. The discussion draft would modify the UBIT rules to address these and similar loopholes.
- Another issue that has arisen in testimony is the potential for non-compliance within the tax-exempt sector. The discussion draft would address these issues by clarifying that a tax-exempt organization should, in general, either be a private foundation or a public charity. This would encourage greater transparency while still preserving diversity and innovation in the tax-exempt sector.
- The net investment excise tax on private foundations has long been a source of confusion and frustration for taxpayers. Private foundations, both large and small, recommended to the Committee's Tax Reform Working Group on Charitable/Exempt Organizations that the net investment tax be reduced to a flat 1 percent to ease compliance. The discussion draft would adopt this recommendation to ease the administrative burden on foundations and encourage more funding of charitable activities.

### **Subtitle A – Unrelated Business Income Tax**

#### **Sec. 5001. Clarification of unrelated business income tax treatment of entities treated as exempt from taxation under section 501(a).**

**Current law:** Under current law, income derived from a trade or business regularly carried on by an organization exempt from tax under Code section 501(a) (including pension plans) that is not substantially related to the performance of the organization's tax-exempt functions is subject to the unrelated business income tax (UBIT). The highest corporate rate is applied to unrelated business income. A college or university that is an agency or instrumentality of a State government (or political subdivision) generally is subject to UBIT on any unrelated business taxable income. It is unclear, however, whether certain State and local entities (such as public pension plans) that are exempt under Code section 115(l) as government-sponsored entities as well as section 501(a) are subject to the UBIT rules.

**Provision:** Under the provision, all entities exempt from tax under section 501(a), notwithstanding the entity's exemption under any other provision of the Code, would be subject to the UBIT rules. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

**Sec. 5002. Name and logo royalties treated as unrelated business taxable income.**

**Current law:** Current law designates certain activities as *per se* unrelated trades or businesses for UBIT purposes, including advertising activities and debt management plan services.

**Provision:** Under the provision, any sale or licensing by a tax-exempt organization of its name or logo (including any related trademark or copyright) would be treated as a *per se* unrelated trade or business, and royalties paid with respect to such licenses would be subject to UBIT. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.8 billion over 2014-2023.

**Sec. 5003. Unrelated business taxable income separately computed for each trade or business activity.**

**Current law:** Under current law, income subject to UBIT is based on the gross income of any unrelated trade or business less the deductions directly connected with carrying on such activity. In cases where a tax-exempt organization conducts two or more unrelated trades or businesses, the unrelated business taxable income is the aggregate gross income of all the unrelated trades or businesses less the aggregate deductions allowed with respect to all such unrelated trades or businesses. As a result, losses generated by one unrelated trade or business may be used to offset income derived from another unrelated trade or business.

**Provision:** Under the provision, a tax-exempt organization would be required to calculate separately the net unrelated taxable income of each unrelated trade or business. In addition, any loss derived from an unrelated trade or business could only be used to offset income from that unrelated trade or business, with any unused loss subject to the general rules for net operating losses – i.e., such losses may be carried back two years and carried forward 20 years. Thus, losses generated by one unrelated trade or business could not be used to offset income derived from another unrelated trade or business. The provision would generally be effective for tax years beginning after 2014. However, NOLs generated prior to 2015 may be carried forward to offset income from any unrelated trade or business, but NOLs generated after 2014 may only be carried back to offset income with respect to the unrelated trade or business from which the net operating loss arose.

**JCT estimate:** According to JCT, the provision would increase revenues by \$3.2 billion over 2014-2023.

#### **Sec. 5004. Exclusion of research income limited to publicly available research.**

**Current law:** Under current law, income derived from a research trade or business is exempt from UBIT in the following cases: (1) research performed for the United States (including agencies and instrumentalities) or any State (or political subdivision); (2) research performed by a college, university or hospital for any person; and (3) research performed by an organization operated primarily for the purposes of carrying on fundamental research the results of which are freely available to the general public.

**Provision:** Under the provision, the exception from the UBIT rules for fundamental research would be limited to income derived from the research made available to the public. Thus, income from research not made publicly available would be treated as unrelated trade or business income and subject to the UBIT rules. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.7 billion over 2014-2023.

#### **Sec. 5005. Parity of charitable contribution limitation between trusts and corporations.**

**Current law:** Under current law, for purposes of determining unrelated business taxable income subject to UBIT, an organization may deduct contributions made to other organizations. If the contributing tax-exempt entity is organized as a corporation, the charitable contribution deduction is limited to 10 percent of the entity's unrelated business taxable income – the same limitation that applies to corporations. But, if the contributing tax-exempt entity is organized as a trust, the deduction is limited to 50 percent of the entity's unrelated business taxable income – the same limitation that applies to individuals.

**Provision:** Under the provision, charitable contributions for purposes of determining UBIT would be limited to 10 percent of the unrelated business taxable income whether the contributing entity is organized as a corporation or a trust. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

#### **Sec. 5006. Increased specific deduction.**

**Current law:** Under current law, UBIT is based on the gross income of any unrelated trade or business less the deductions directly connected with carrying on such activity. However, all tax-exempt organizations may claim a \$1,000 deduction against gross income subject to UBIT.

**Provision:** Under the provision, the deduction would be increased to \$10,000. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$0.3 billion over 2014-2023.

**Sec. 5007. Repeal of exclusion of gain or loss from disposition of distressed property.**

**Current law:** Under current law, UBIT is based on the gross income of any unrelated trade or business, including gains or losses from the sale, exchange, or other disposition of inventory. An exception to the inclusion of such gains or losses applies to certain real property acquired by the tax-exempt organization from a bank or savings and loan association that held the property in receivership or conservatorship or as a result of a foreclosure. To qualify, the tax-exempt organization generally may not expend substantial amounts to improve or develop the distressed property and must dispose of such property within 30 months of acquisition.

**Provision:** Under the provision, the UBIT exception for acquisitions of distressed property would be repealed. Accordingly, a tax-exempt organization would be required to include in its unrelated trade or business income gain or loss resulting from the sale of such property to customers. The provision would be effective for property acquired after 2014.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

**Sec. 5008. Qualified sponsorship payments.**

**Current law:** Under current law, for purposes of the UBIT rules, an unrelated trade or business does not include the activity of soliciting and receiving qualified sponsorship payments. A qualified sponsorship payment generally is any payment made by a business sponsor with respect to which the business receives no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the business in connection with the tax-exempt organization's activities. Such a use or acknowledgment does not include advertising of such sponsor's products or services (i.e., qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use such products or services).

**Provision:** Under the provision, the UBIT exception for qualified sponsorship payments would be modified in two respects. First, if the use or acknowledgement refers to any of the business sponsor's product lines, the payment would not be a qualified sponsorship payment, and, therefore, would be treated by the tax-exempt organization as income from an advertising trade or business – which is a *per se* unrelated trade or business. Second, if a tax-exempt organization receives more than \$25,000 of qualified sponsorship payments for any one event, any use or acknowledgement of a sponsor's name or logo may only appear with, and, in substantially the same manner as, the names of a significant portion of the other donors to the event. Whether the number of donors is a significant portion is determined based on the total number of donors and the total contributions to the event, but in no event shall fewer than 2 other donors be treated as a

significant portion of other donors. Thus, a single business could not be listed as an exclusive sponsor of an event that generates more the \$25,000 in qualified sponsorship payments. Such a contribution would be treated as advertising income by the tax-exempt organization and subject to UBIT. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

## **Subtitle B – Penalties**

### **Sec. 5101. Increase in information return penalties.**

**Current law:** Under current law, tax-exempt organizations are required to file certain information returns each year depending on their exempt status. If a tax-exempt organization does not timely and completely file a required information return (e.g., Form 990) or does not furnish the correct information, it must pay \$20 for each day the failure continues (\$100 a day for organizations with annual gross receipts exceeding \$1 million). The maximum penalty for each return may not exceed the lesser of \$10,000 (\$50,000 for a large organization) or 5 percent of the gross receipts of the organization for the year. Penalties also apply to information required of tax-exempt trusts and in certain other cases, such as when a tax-exempt organization dissolves or liquidates all or part of its assets. Exceptions from these penalties apply where the organization can show the failure was due to reasonable cause. There also are penalties for willful failures and for filing fraudulent returns and statements. A manager of an organization subject to these penalties who fails to respond to a written demand from the IRS to file an information return by a date certain is required to pay a penalty of \$10 for each day after the deadline has passed, limited to a maximum of \$5,000.

A manager or other person who fails to allow for the public inspection of a tax-exempt organization's annual returns and other publicly available documents is subject to a penalty of \$20 for each day the failure continues, limited to a maximum of \$10,000. An identical penalty and overall limitation also applies to a section 527 organization that fails to make required disclosures or fails to show any information required to be shown by such disclosures or to show the correct information. In addition, a person who fails to allow the public inspection of an entity's exempt status application materials or notice materials is subject to a penalty of \$20 for each day such failure continues, with no overall limitation.

In addition, a trust is subject a penalty of \$10 a day for failure to file an information return. Any organization that was tax exempt in any of the five years preceding a liquidation, dissolution, termination, or substantial contraction is subject to a penalty of \$10 a day for failure to file a final return. In both cases, the maximum penalty cannot exceed \$5,000. However, a trust with gross income in excess of \$250,000 is subject to a penalty of \$100 a day and a maximum fine of \$50,000. Furthermore, a manager of an organization subject to these penalties who fails to respond to a written demand from the IRS to file a required return by a date certain is subject to a fine of \$10 for each day after the deadline has passed, limited to maximum of \$5,000.



A tax-exempt organization also is subject to a penalty of \$100 per day for each day the entity fails to file the required disclosure of its participation in any prohibited tax shelter transaction and the identity of any other known party to such transaction.

**Provision:** Under the provision, the penalties for failure to file various returns, disclosures, or public documents on organizations and managers would be increased. The penalty for a tax-exempt organization's failure to file an information return would be increased from \$20 to \$40 per day. For an organization with more than \$1 million in gross receipts, the penalty would be increased from \$100 to \$200 per day. For a manager of such an organization, the penalty would be increased from \$10 to \$20 per day. In the case of a person who fails to allow for the public inspection of a tax-exempt organization's annual returns and other publicly available documents, the penalty would be increased from \$20 to \$40 per day. The penalty for failure to allow for the public inspection of an entity's exempt status application or notice materials would also be increased from \$20 to \$40 per day. In the case of trust or a terminating tax-exempt organization, the penalty would be increased from \$10 to \$20 per day. The penalty for a trust with gross income in excess of \$250,000 would be increased from \$100 to \$200 per day, and the penalty for the manager of a trust or terminating exempt entity would also be increased from \$10 to \$20 per day. The penalty for failure to file a tax-shelter disclosure form would be increased from \$100 to \$200 per day. The provision would be effective for information returns required to be filed on or after January 1, 2015.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

### **Sec. 5102. Manager-level accuracy-related penalty on underpayment of unrelated business income tax.**

**Current law:** Under current law, individuals and corporations are subject to a 20-percent accuracy-related penalty with respect to the portion of an underpayment that is attributable to any substantial understatement of income tax. The accuracy-related penalty may be reduced or abated in certain cases.

A separate accuracy-related penalty applies to a reportable transaction or a listed transaction. A reportable transaction is defined as one that the IRS determines must be disclosed because it has a potential for tax avoidance or evasion. A listed transaction is a reportable transaction that is specifically identified by the IRS as a tax avoidance transaction (or substantially similar to such a tax avoidance transaction). The penalty rate for reportable and listed transactions that are disclosed by the taxpayer is 20 percent, while the penalty rate for an undisclosed transaction is 30 percent. Defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Tax-exempt organizations subject to UBIT must file a return each year (Form 990-T), reporting unrelated business taxable income. Under current law, the 20-percent accuracy-related penalty and the penalty for reportable transactions and listed transactions apply to tax-exempt organizations, but only at the entity level. No manager-level penalty applies in such cases,

unlike other penalties under current law that impose a penalty on both the tax-exempt organization and its managers (e.g., penalties applicable to public charities with respect to excess-benefit transactions and penalties on private foundations relating to self-dealing).

**Provision:** Under the provision, a 5-percent penalty would apply to managers of a tax-exempt organization when an accuracy-related penalty is applied to the organization for any substantial understatement of UBIT. The manager-level penalty would be limited to \$20,000. The provision also would apply a 10-percent penalty on managers of a tax-exempt organization for an understatement of UBIT relating to a reportable transaction or listed transaction. The manager-level penalty for reportable transactions and listed transactions would be limited to \$40,000. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

## **Subtitle C – Excise Taxes**

### **Sec. 5201. Modification of intermediate sanctions.**

**Current law:** Under current law, disqualified persons and managers who engage in excess benefit transactions with tax-exempt organizations (other than private foundations) are subject to an excise tax on the amount of the economic benefit that exceeds the value of the consideration (including the performance of services) received for providing the benefit. A disqualified person (other than a manager acting only in that capacity) is subject to a 25-percent excise tax, and, if such tax is imposed, a manager who knowingly participated in the transaction (unless such participation was not willful and due to reasonable cause) is subject to a 10-percent excise tax. However, under Treasury regulations, a manager may avoid the excise tax for knowingly participating in an excess-benefit transaction if the manager relies on advice provided by an appropriate professional, including legal counsel, certified public accountants, and independent valuation experts.

A disqualified person generally is any person in a position to exercise substantial influence over the affairs of the public charity (e.g., officers, directors, or trustees) at any time in the five-year period before the excess-benefit transaction occurred. In the case of donor advised funds, the donor and donor advisors are specifically designated as disqualified persons, and in the case of a supporting organization, its investment advisors are disqualified persons. A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

Under Treasury regulations, a tax-exempt organization in certain cases may avail itself of a rebuttable presumption with respect to compensation arrangements and property transfers for purposes of determining if the excise tax applies. If the requirements of the rebuttable presumption are met, the IRS may overcome the presumption of reasonableness if it develops sufficient contrary evidence to rebut the comparability data relied upon by the authorized body.

**Provision:** Under the provision, the excise tax on excess-benefit transaction would be expanded to apply not only to public charities, but also to labor, agricultural, and horticultural organizations (under Code section 501(c)(5)) and business leagues, chambers of commerce, real-estate boards, and boards of trade (under Code section 501(c)(6)).

The provision would impose an excise tax of 10 percent on the tax-exempt organization when the excess-benefit excise tax is imposed on a disqualified person. The entity-level tax would be avoidable if the organization follows minimum standards of due diligence or other procedures to ensure that no excess benefit is provided by the organization to a disqualified person. The minimum standards of due diligence would be satisfied if the transaction was approved by an independent body of the organization that relied on comparability data prior to approval and documented the basis for approving the transaction. The provision would overrule the Treasury regulations by providing that no presumption of reasonableness is created by the organization satisfying the minimum standards of due diligence for purposes of imposing the excise tax on disqualified persons and managers.

Additionally, managers would no longer be able to rely on the professional advice safe harbor under Treasury regulations. Thus, a manager's reliance on professional advice, by itself, would not preclude the manager from being subject to the excise tax for participating in an excess-benefit transaction.

The provision also would expand the definition disqualified persons to include athletic coaches and investment advisors regardless of whether the investment advisor provides services to a supporting organization.

The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

### **Sec. 5202. Modification of taxes on self-dealing.**

**Current law:** Under current law, disqualified persons and managers who engage in self-dealing transactions with private foundations are subject to an excise tax. Self-dealing transactions between a private foundation and a disqualified person generally include: (1) a sale or exchange, or leasing, of property; (2) lending of money or other extension of credit; and (3) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation. The excise tax is imposed on the very act of self-dealing, irrespective of whether fair market value is paid (except for the payment of compensation, which is permitted at fair market value). The tax is imposed on the entire amount involved in the transaction (except for the payment of compensation, with respect to which the tax is imposed on compensation in excess of fair market value).

A disqualified person is subject to an excise tax of 10 percent of the value of a self-dealing transaction. If such a tax is imposed on a disqualified person, a tax of 5 percent of the amount

involved is imposed on a foundation manager who knowingly participated in the act of self-dealing (unless such participation was not willful and was due to reasonable cause) up to \$10,000 per act. If the act of self-dealing is not corrected, a tax of 200 percent of the amount involved is imposed on the disqualified person and a tax of 50 percent of the amount involved (up to \$10,000 per act) is imposed on a foundation manager who refused to agree to correct the act of self-dealing. However, under Treasury regulations, a private foundation manager may avoid the excise tax for knowingly participating in a self-dealing transaction if the manager relies on advice provided by an appropriate professional, including legal counsel, certified public accountants, and independent valuation experts.

A disqualified person generally is any person in a position to exercise substantial influence over the affairs of the private foundation (e.g., officers, directors, or trustees). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

**Provision:** Under the provision, an excise tax of 2.5 percent would be imposed on a private foundation when the self-dealing tax is imposed on a disqualified person. The tax rate would be 10 percent for cases in which the self-dealing involves the payment of compensation.

Additionally, foundation managers would no longer be able to rely on the professional advice safe harbor. Thus, a manager's reliance on professional advice, by itself, would not preclude the manager from being subject to the excise tax for participating in a self-dealing transaction.

The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

### **Sec. 5203. Excise tax on failure to distribute within 5 years contribution to donor advised fund.**

**Current law:** Under current law, public charities (including community foundations) exempt from tax under Code section 501(c)(3) are permitted to establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Such accounts are commonly referred to as "donor advised funds." Donors who make contributions to charities sponsoring such funds generally may claim a charitable contribution deduction at the time of the contribution, even though the contributed funds may be held in the account without distribution for significant periods. While the sponsoring charities generally must have legal ownership and control over the funds held in a donor advised fund, there is no requirement that the funds be distributed to other charitable organizations within any period of time. Donor advised funds also are not subject to the private foundation net investment excise tax.

**Provision:** Under the provision, donor advised funds would be required to distribute contributions within five years of receipt. An eligible distribution is a distribution made to a

public charity. Failure to make an eligible distribution would subject the sponsoring charitable organization to an annual excise tax equal to 20 percent of the undistributed funds. The provision would be effective for contributions made after 2014. For contributions made before, and remaining in the donor advised fund on, January 1, 2015, the five-year distribution period would begin on January 1, 2015.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

#### **Sec. 5204. Simplification of excise tax on private foundation investment income.**

**Current law:** Under current law, private foundations and certain charitable trusts are subject to a 2-percent excise tax on their net investment income. However, an organization may reduce the excise tax rate to 1 percent by meeting certain requirements regarding distributions to qualifying tax-exempt organizations during a tax year.

A special rule excludes “exempt operating foundations” from the excise tax. To be an exempt operating foundation, an organization must: (1) be an operating foundation, which is an organization that spends at least 85 percent of its adjusted net income or its minimum investment return, whichever is less, directly for the active conduct of its exempt activities, (2) be publicly supported for at least ten tax 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. A disqualified person generally is any person in a position to exercise substantial influence over the affairs of the organization (e.g., officers, directors, or trustees).

**Provision:** Under the provision, the excise tax rate on net investment income would be reduced to 1 percent. The rules providing for a reduction in the excise tax rate from 2 percent to 1 percent would be repealed. The provision also would repeal the exception from the excise tax for exempt operating foundations. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$1.6 billion over 2014-2023.

#### **Sec. 5205. Repeal of exception for private operating foundation failure to distribute income.**

**Current law:** Under current law, private foundations generally are required to pay out a minimum amount each year in distributions to accomplish one or more of the organization’s exempt purposes, including reasonable and necessary administrative expenses. Failure to pay out the minimum amount results in an initial excise tax on the foundation of 30 percent of the undistributed amount. An additional tax of 100 percent of the undistributed amount applies if an initial tax is imposed and the required distributions generally have not been made within the

following year. Private operating foundations are not subject to the payout requirements. To qualify as a private operating foundation, the organization must spend at least 85 percent of its adjusted net income or its minimum investment return, whichever is less, directly for the active conduct of its exempt activities.

**Provision:** Under the provision, the special exclusion for private operating foundations would be repealed. Thus, private operating foundations would be subject to the excise tax for failure to distribute income like private foundations generally. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

### **Sec. 5206. Excise tax based on investment income of private colleges and universities.**

**Current law:** Under current law, private foundations and certain charitable trusts are subject to a 2-percent excise tax on their net investment income. The excise tax on net investment income does not apply to public charities, including colleges and universities, even though some such organizations may have substantial investment income similar to private foundations.

**Provision:** Under the provision, certain private colleges and universities would be subject to a 1-percent excise tax on net investment income. The provision would only apply to private colleges and universities with assets (other than those used directly in carrying out the institution's educational purposes) valued at the close of the preceding tax year of at least \$100,000 per full-time student. State colleges and universities would not be subject to the provision. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.7 billion over 2014-2023.

## **Subtitle D – Requirements for Organizations Exempt from Tax**

### **Sec. 5301. Repeal of tax-exempt status for professional sports leagues.**

**Current law:** Under current law, a professional football league is specifically granted tax-exempt status as a 501(c)(6) organization, an exemption that generally applies to trade or professional associations. The IRS has interpreted the exemption for “professional football leagues” to include all professional sports leagues.

**Provision:** Under the provision, professional sports leagues would not be eligible for tax-exempt status as a trade or professional association under Code section 501(c)(6). The provision would not apply to amateur sports leagues, which would continue to qualify as tax-exempt entities. The provision would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

**Sec. 5302. Repeal of exemption from tax for certain insurance companies and co-op health insurance issuers.**

**Current law:** Under current law, a property and casualty insurance company generally is exempt from tax if its gross receipts for the tax year do not exceed \$600,000 and its premiums constitute more than 50 percent of gross receipts. A mutual property and casualty insurance company is exempt from tax if its gross receipts for the tax year do not exceed \$150,000 and more than 35 percent of such gross receipts consist of premiums. A qualified nonprofit health insurance issuer under the Affordable Care Act (ACA), which has received a loan or grant under the ACA's co-op program, also is exempt from tax.

**Provision:** Under the provision, the exemption would be repealed for qualified property and casualty insurance companies and for qualified health insurance issuers. The provision would be effective for tax years beginning after 2014. Affected companies would not be required to make an adjustment for a change in accounting method for their first tax year beginning after December 31, 2014, and the basis of any asset held on the first day of such tax year would be equal to its fair market value on such day.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.7 billion over 2014-2023.

**Sec. 5303. In-State requirement for workmen's compensation insurance organizations.**

**Current law:** Under current law, organizations created by, and organized and operated under, State law exclusively to provide workmen's compensation insurance required by State law (or if an employer faces significant disincentives for not purchasing such insurance), or coverage incidental to such insurance, and meeting other requirements related to such organizations having strong connections to State governments are exempt from tax. Current law does not preclude exempt workmen's compensation insurance organizations from providing benefits to employees outside of the State under the laws of which it is created, organized and operated.

**Provision:** Under the provision, an exempt workmen's compensation insurance organization would be exempt from tax only if it provides no insurance coverage other than workmen's compensation insurance required by State law (or if an employer faces significant disincentives for not purchasing such insurance), or coverage incidental to such insurance. The provision would apply to insurance policies issued, and renewals, after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

#### **Sec. 5304. Repeal of Type II and Type III supporting organizations.**

**Current law:** Under current law, organizations exempt from tax under Code section 501(c)(3) are classified either as public charities, if publicly supported, or private foundations. Certain organizations that provide support to another public charity may also be classified as public charities rather than private foundations, even if not publicly supported. To qualify as a supporting organization, an organization must meet all three of the following tests: (1) the organizational-and-operational test, (2) the lack-of-outside-control test, and (3) the relationship test. Under the relationship test, a supporting organization must hold one of three relationships with the supported public charity. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as a Type I supporting organization); (2) supervised or controlled in connection with a publicly supported organization (a Type II supporting organization); or (3) operated in connection with a publicly supported organization (a Type III supporting organization). In effect, the classification of a supporting organization depends on how close its relationship is to the supported organization, with Type I supporting organizations having the closest relationship (akin to a parent-subsidiary relationship).

**Provision:** Under the provision, Type II and Type III supporting organizations would be repealed. Thus, organizations that support public charities would need to qualify as a supporting organization that is operated, supervised, or controlled by a publicly supported organization (i.e., a Type I supporting organization), or they would be treated as private foundations. The provision would generally be effective for entities organized after the date of enactment. Type II and III supporting organizations existing on the date of enactment would have until the end of 2015, to qualify as a public charity or a supporting organization (previously a Type I supporting organization) or be treated as a private foundation.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.4 billion over 2014-2023.



# **Title VI – Tax Administration and Compliance**

## **Subtitle A – IRS Investigation-Related Reforms**

### **Considerations for Subtitle A:**

- The IRS investigation-related reforms in the discussion draft would address problems identified thus far during the course of the Committee’s ongoing IRS investigation. The provisions offer simple, commonsense administrative solutions to prevent the future abuse of taxpayers and to increase access to the courts for aggrieved organizations.
- The streamlined notification process to operate as a 501(c)(4) organization draws from the Committee’s in-depth analysis of the internal IRS processes and its review of all 501(c)(4) applicants over a two-year period. The Committee has found that a significant percentage of the Exempt Organizations Division’s time and budget is currently spent analyzing Form 1024, an expensive exemption application that many small organizations do not understand is optional.
- Moreover, the Committee has found that the IRS is allocating a significant amount of time attempting to predict future activities of 501(c)(4) organizations with miniscule operating budgets, while allocating virtually no resources to compliance audits based on actual activities that risk tax-revenue losses.
- The new streamlined notification process for 501(c)(4) organizations would save small groups unnecessary filing costs and would allow a risk-based approach for the IRS to monitor compliance in this area.
- The investigation-related provisions also respond to the Committee’s ongoing investigatory work involving unauthorized disclosures of confidential donor information by the IRS. The provisions would reduce the opportunities for unlawful disclosures of certain taxpayer information by the IRS, limit reporting of donor information where no tax administration interest exists, and restrict IRS employee use of personal e-mail for official business.
- Based on the Committee’s ongoing investigation, which has found significant instances where taxpayer rights had been violated by the IRS, the provisions would enhance taxpayer rights by requiring new IRS reporting and employee training.
- Stand-alone pieces of legislation making several of these proposed changes (including those in sections 6005, 6006, and 6010 of the discussion draft) have previously passed the House of Representatives but have not yet been taken up by the Senate.

### **Sec. 6001. Organizations required to notify Secretary of intent to operate as 501(c)(4).**

**Current law:** Under current law, social welfare organizations described in Code section 501(c)(4) are not required to obtain a determination of their exempt status from the IRS before commencing operations. Rather, such organizations are exempt if they are not organized for profit but operated exclusively for the promotion of social welfare, and if no part of the net earnings of which inures to the benefit of any private shareholder or individual. However, such organizations may request a formal determination of exempt status by filing Form 1024, Application for Recognition of Exemption under Section 501(a). An organization typically files a Form 1024 to be recognized formally as a tax-exempt organization and to obtain certain

benefits such as exemption from certain State taxes and nonprofit mailing privileges. Once a social welfare organization commences operations (whether or not it applies or is formally approved for exempt status), the organization is required to file an annual information return, Form 990, Return of Organization Exempt from Income Tax.

Recent investigations of the IRS' handling of applications for exemption by section 501(c)(4) organizations have raised concerns about the extent of human resources the IRS dedicates to processing elective Form 1024 applications for exemption and the vulnerabilities for abuse in the current approval process.

**Provision:** Under the provision, any organization seeking to be recognized as exempt under Code section 501(c)(4) would be required, within 60 days of formation, to notify the IRS that it has commenced operations as a social welfare organization. Within 60 days of receiving the notification, the IRS would be required to issue an acknowledgement of the organization's intent to operate as such an exempt organization. A social welfare organization that fails to file the required notification of commencement of operations by the deadline would be subject to a penalty of \$20 per day up to \$5,000 and a manager-level penalty if the organization fails to file after a request from the IRS. With its first Form 990 information return, the organization would be required to provide such information as the IRS may require supporting the organization's qualification for exempt status. It is anticipated that this information would be similar to the information provided currently on Form 1024. If an organization wishes to receive a formal determination of exempt status, it would be able to request a ruling from the IRS.

The provision would apply to section 501(c)(4) organizations that are organized after 2014. Current organizations that have not filed a Form 1024 or a Form 990 would be required within 180 days of the date of enactment to meet the new notification requirement and provide the required information supporting the organization's qualification for exempt status with the Form 990 for the tax year in which the notice is filed.

**JCT estimate:** According to JCT, the provision would increase revenues by less than \$50 million over 2014-2023.

### **Sec. 6002. Declaratory judgments for 501(c)(4) organizations.**

**Current law:** Under current law, an organization that has qualified for tax exemption under Code section 501(c)(3) or section 521, or has applied for such status, may seek judicial relief if the IRS challenges the organization's initial or continuing qualification for tax exemption. Such declaratory judgment relief may be granted by the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. District Court for the District of Columbia. However, similar relief is not available for a section 501(c)(4) social welfare organization.

**Provision:** Under the provision, declaratory judgment relief would be extended to controversies involving the initial or continuing qualification of section 501(c)(4) social-welfare organizations. The provision would be effective for pleadings filed after the date of enactment.

**JCT estimate:** According to JCT, the provision would reduce revenues by less than \$50 million over 2014-2023.

**Sec. 6003. Restriction on donation reporting for certain 501(c)(4) organizations.**

**Current law:** Under current law, organizations exempt from tax under Code section 501(c) generally are required to file an annual information return, Form 990, Return of Organization Exempt from Income Tax, with the IRS reflecting contributions, income, expenses and other information. Certain organizations, including social welfare organizations exempt under Code section 501(c)(4), must include Schedule B, Schedule of Contributors, listing any donor who contributes \$5,000 or more (in money or property) during the year. The IRS is required to make information returns filed by exempt organizations available to the public. However, Schedule B is excluded from disclosure to protect donor personal information required by the schedule. Recent investigations of the IRS' handling of applications for exemption by section 501(c)(4) organizations have raised concerns about improper disclosure of Schedule B donor information to the public.

**Provision:** Under the provision, a social welfare organization exempt under Code section 501(c)(4) would be required to include on Schedule B only information concerning a donor who both (1) contributes \$5,000 or more (in money or property) during the current tax year and (2) is either an officer or director of the organization or one of the five highest compensated employees of the organization for the current or any preceding tax year. Schedule B would continue to be excluded from the public disclosure requirement for information returns filed by exempt organizations. The provision would be effective for returns for tax years beginning after 2013.

**JCT estimate:** According to JCT, the provision would reduce revenues by less than \$50 million over 2014-2023.

**Sec. 6004. Mandatory electronic filing for annual returns of exempt organizations.**

**Current law:** Under current law, a tax-exempt organization generally must file its annual tax return (i.e., Form 990) electronically only if the organization files at least 250 returns (e.g., Form W-2 for employees, Form 1099 for certain service providers) during the calendar year. Organizations that are not required to file a Form 990 or Form 990-EZ, generally because their gross receipts are normally less than \$50,000 annually, must file an annual notice (Form 990-N) in electronic format. Certain tax-exempt organizations with unrelated business taxable income must report such income and associated tax on Form 990-T, which currently cannot be filed electronically. Current law limits the authority of the Treasury Department to require electronic filing of returns. As a result, only very small and very large tax-exempt organizations are required to file electronically.

Current law also requires the IRS to make available to the public information from the annual returns filed by tax-exempt organizations. Certain information relating to donors to such

organizations is excluded. The IRS currently makes the required data available only in a restricted format that limits the usefulness of the data to the public.

**Provision:** Under the provision, all tax-exempt organizations that file Form 990 series returns would be required to file electronically. The provision also would require the IRS to make the electronically filed Form 990 returns data publicly available in a machine readable format in a timely manner, after ensuring that any donor or other taxpayer information is redacted. The provision would be effective for tax years beginning after the date of enactment, with transition relief for smaller organizations that are not currently required to file electronically.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 6005. Duty to ensure that IRS employees are familiar with and act in accord with certain taxpayer rights.**

**Current law:** Under current law, the Commissioner of Internal Revenue has such duties and powers as the Treasury Secretary prescribes, including the power to administer, manage, conduct, direct, and supervise the execution and application of the tax laws and related statutes.

**Provision:** Under the provision, the Commissioner's duties would be expanded to include ensuring that IRS employees are familiar with and act in accordance with taxpayer rights under the tax laws, including the right to be informed, the right to be assisted, the right to be heard, the right to pay no more than the correct amount of tax, the right of appeal, the right to certainty, the right to privacy, the right to confidentiality, the right to representation, and the right to a fair and just tax system. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 6006. Termination of employment of IRS employees for taking official actions for political purposes.**

**Current law:** Under current law, there are ten enumerated acts or omissions that, if committed by an IRS employee, will result in mandatory termination of the employee (also known as the "ten deadly sins"). These acts or omissions include threatening to audit a taxpayer for the purpose of extracting personal gain or benefit.

**Provision:** Under the provision, the enumerated acts or omissions that result in mandatory termination of an IRS employee would be expanded to include performing, delaying, or failing to perform (or threatening to perform, delay, or fail to perform) any official action or audit with respect to a taxpayer for the purpose of extracting personal gain or benefit or for political purposes. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 6007. Release of information regarding the status of certain investigations.**

**Current law:** Under current law, it is unlawful for Federal employees to disclose certain taxpayer information or inspect taxpayer returns or records without authorization. Current law also limits the lawful disclosure of taxpayer information by employees of the Treasury Department (including the IRS and the Treasury Inspector General for Tax Administration) to certain enumerated circumstances. Because of these restrictions, in cases in which a taxpayer makes a complaint regarding unlawful disclosure of information, current law does not permit the Treasury Department to provide the affected taxpayer with information concerning the status or resolution of the complaint.

**Provision:** Under the provision, the enumerated circumstances in which taxpayer information may be lawfully disclosed by the Treasury Department would be expanded to include disclosure to certain complainants (or their representatives) of information regarding the status and results of any investigation initiated by their complaint. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

### **Sec. 6008. Review of IRS examination selection procedures.**

**Current law:** Under current law, the IRS' four operating divisions (wage and investment, small business/self-employed, large business and international, and tax-exempt and government entities) have discretion to develop and implement criteria for selection of cases for enforcement action. Concerns have been raised regarding the impartiality and appropriateness of such enforcement actions, especially with respect to certain tax-exempt organizations.

**Provision:** Under the provision, the Comptroller General would be directed to undertake an initial review of each IRS operating division to assess the processes used to determine how enforcement cases are selected and worked, and would be directed to report to Congress and the Treasury Secretary the results of the initial review and any recommendations to improve the case selection and case work processes for each division. The Comptroller General also would be directed to conduct a follow-up review to determine whether the recommendations included in the initial report have been implemented. Following the initial and follow-up reviews, the Comptroller General would be directed to conduct further reviews of each IRS division every four years, and would be directed to report to Congress and the Treasury Secretary the results of these reviews. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 6009. IRS employees prohibited from using personal email accounts for official business.**

**Current law:** Under current law, there is no statutory prohibition against the use of personal email accounts by IRS employees to conduct official agency business. The Internal Revenue Manual restricts IRS employees from sending emails that contain “sensitive but unclassified” data outside the IRS network, unless approved by senior agency management, but the manual does not specifically reference the use of personal email accounts.

**Provision:** Under the provision, IRS employees would be prohibited by statute from using any personal email account to conduct official agency business. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 6010. Moratorium on IRS conferences.**

**Current law:** Under current law, the IRS has discretion to hold conferences relating to employee training and other management purposes, and to incur travel expenses relating to such conferences. On May 31, 2013, the Treasury Inspector General for Tax Administration (TIGTA) issued a report titled, “Review of the August 2010 Small Business/Self-Employed Division’s Conference in Anaheim, California,” which identified excessive spending on IRS conferences and other deficiencies in management procedures.

**Provision:** Under the provision, the IRS would be precluded from holding any conference until TIGTA submits a report to Congress certifying that the IRS has implemented all of the recommendations included in TIGTA’s May 31, 2013 report. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 6011. Applicable standard for determinations of whether an organization is operated exclusively for the promotion of social welfare.**

**Current law:** Under current law, Code section 501(c)(4) provides a tax exemption for organizations not organized for profit but operated exclusively for the promotion of social welfare. Treasury regulations provide that an organization is operated exclusively for the promotion of social welfare if it is engaged primarily in promoting in some way the common good and general welfare of the people of a community. Social welfare organizations are permitted to engage in “direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office” (“political campaign intervention”) so long as the organization is primarily engaged in activities that promote social welfare.

Under current Treasury regulations, whether an activity constitutes political campaign intervention (and thus does not promote social welfare), and the measurement of the organization's social welfare activities relative to its total activities, depends on all the facts and circumstances of the particular case. The rules concerning political campaign intervention apply only to activities involving candidates for elective public office; the rules do not apply to activities involving officials who are selected or appointed, such as executive branch officials and judges. The lobbying and advocacy activities of a section 501(c)(4) organization generally are not limited, provided the activities are in furtherance of the organization's exempt purpose.

On November 29, 2013, the Department of the Treasury and the IRS published proposed regulations regarding the political campaign activities of section 501(c)(4) organizations. The proposed regulations, once finalized, would replace the present-law facts-and-circumstances test used in determining whether a section 501(c)(4) organization has engaged in political campaign intervention with an enumerated list of activities that constitute political campaign activities (and which therefore do not promote social welfare).

**Provision:** The provision would require the IRS to apply the standards and definitions in effect on January 1, 2010, to determine whether an organization is operated exclusively for the promotion of social welfare for purposes of Code section 501(c)(4). The provision also would prohibit the Secretary or his delegate from issuing, revising, or finalizing any regulation (including the proposed regulations issued on November 29, 2013), revenue ruling, or other guidance that is not limited to a particular taxpayer relating to the standards or definitions used to determine whether an organization is operated exclusively for the promotion of social welfare for purposes of Code section 501(c)(4). The provision would be effective on the date of enactment and expire one year after such date.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

## **Subtitle B – Taxpayer Protection and Service Reforms**

### **Sec. 6101. Extension of IRS authority to require truncated Social Security numbers on Form W-2.**

**Current law:** Under current law, employers are required to furnish annual written statements to their employees containing certain information regarding wages and benefits (i.e., Form W-2). Current law requires that the statement include the employee's Social Security number (SSN). Other statements provided to taxpayers (e.g., Forms 1099) are subject to more general rules that require the filer to include the taxpayer's "identifying number" on the form. For some statements, the Treasury Department and IRS have regulatory authority to require or permit filers to use a number other than the taxpayer's SSN. Concerns have been raised that a taxpayer's SSN could be stolen from a Form W-2 or other paper payee statement and used to file false or fraudulent tax returns.

**Provision:** Under the provision, employers would be required to include an “identifying number” for each employee, rather than an employee’s SSN, on Form W-2. Thus, the Treasury Department and the IRS would have the regulatory authority to require or permit a truncated SSN on Form W-2 as well as Form 1099 to reduce the potential for identity theft and the filing of false or fraudulent tax returns. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

### **Sec. 6102. Free electronic filing.**

**Current law:** Under current law, the IRS has entered into arrangements 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 \$58,000 or less (for 2013 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 the Free File Program, and Free File Alliance companies also do not pay any fee to the IRS to participate in the program.

**Provision:** Under the provision, the IRS would be directed to continue working cooperatively with the private-sector technology industry to maintain a program that provides free individual income tax preparation and individual income tax electronic filing services to lower-income and elderly taxpayers. (The current Free File Program would satisfy this requirement.) The IRS would be required to provide regulations or other guidance with respect to the program, including (1) the qualifications, selection process, terms of participation, and any other procedures with respect to businesses seeking to participate in the program; (2) a process for periodic review of participants approved for the program; and (3) a procedure for removal of any participant that no longer qualifies for the program or has failed to comply with the program’s rules and procedures. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

### **Sec. 6103. Pre-populated returns prohibited.**

**Current law:** Under current law, a taxpayer generally has responsibility for preparing and filing a tax return if the taxpayer has taxable gross income for a tax year. Certain taxpayers may elect to have the IRS prepare the return based on information provided by the taxpayer. Similarly, under the substitute for return program, the IRS may make a return based on information available to or obtained by the IRS for a taxpayer who fails to prepare and file a return by the required due date or for a taxpayer who makes, willfully or otherwise, a false or fraudulent



return. The IRS has an obligation under current law to make reasonable efforts to verify any third-party information upon which the agency relies under the substitute for return program or bear the burden of proof if such information is subject to judicial review. If the IRS ultimately determines that a non-filing taxpayer had no filing requirement, any tax, penalty, and interest assessed generally is abated.

**Provision:** Under the provision, the IRS would be prohibited from instituting any program under which it prepares or otherwise provides taxpayers with proposed or final returns or statements intended to be used by the taxpayer to satisfy his reporting obligation under the Code. Thus, the IRS would not have authority to implement a broad-based program under which it pre-populates a return with third-party information supplied to the agency (e.g., Form W-2 wage statements, Form 1099s for interest, dividends or capital gains) and provides such return to a taxpayer for filing. The provision would be effective on the date of enactment.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

#### **Sec. 6104. Form 1040SR for seniors.**

**Current law:** Under current law, a taxpayer generally is responsible for preparing and filing a tax return if the taxpayer has taxable gross income for a tax year. The IRS has broad discretion under current law to provide all necessary forms to enable taxpayers to satisfy their return-filing obligations. Taxpayers with relatively uncomplicated financial circumstances and modest income are generally eligible to file their taxes using the simplest tax form – Form 1040EZ. However, individuals who are age 65 or older are expressly prohibited from using Form 1040EZ, thereby requiring them to use other more complicated forms.

**Provision:** Under the provision, the IRS would be required to develop a simple tax return to be known as Form 1040SR, which would be as similar as practicable to the current Form 1040EZ. The new form would be available for use by individuals over the age of 65 who receive common types of retirement income. The provision would be effective for tax years beginning after 2014.

**Consideration:** Under current IRS rules, taxpayers with relatively uncomplicated financial lives are generally eligible to file their taxes using the simplest tax return – Form 1040EZ. However, no matter how simple and straightforward their returns, seniors are expressly denied the opportunity to use the most convenient tax form simply because they are over the age of 65. As a result, seniors must use other more complicated forms, forcing them to struggle through the myriad pages of instructions, worksheets, and schedules to file their taxes or spend their retirement income on a professional tax preparer to do so. The provision would correct this inequity and require the IRS to make available a simple tax form specifically for seniors.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

**Sec. 6105. Increased refund and credit threshold for Joint Committee on Taxation review of C corporation return.**

**Current law:** Under current law, the IRS may not issue a refund or credit of any income or certain other taxes in excess of \$2 million until 30 days after the IRS provides a report regarding the refund or credit to the Joint Committee on Taxation (JCT). As a matter of administrative practice, JCT staff reviews the facts surrounding the proposed refund or credit and communicates any concerns back to the IRS, which can then modify the refund or credit at its discretion.

**Provision:** Under the provision, the threshold for JCT review of refunds or credits with respect to returns filed by C corporations would be increased to \$5 million. The provision would be effective on the date of enactment, except with respect to pending refund or credit reports that have been transmitted by the IRS to JCT prior to such date.

**JCT estimate:** According to JCT, the provision would have negligible revenue effect over 2014-2023.

**Subtitle C – Tax Return Due Date Simplification**

**Secs. 6201-6203. Due dates for returns of partnerships, S corporations, and C corporations; Modification of due dates by regulation; Corporations permitted statutory automatic 6-month extension of income tax returns.**

**Current law:** Under current law, taxpayers required to file income tax returns must file such returns in the manner prescribed by the IRS and subject to the due dates established in the Code (if any) or by regulations. Accordingly, a C corporation or an S corporation is required to file its tax return by March 15 (or within two and a half months after the close of its tax year). A partnership is required to file its returns by April 15 (or within three and a half months after the close of its tax year), the same date that applies to individuals and sole proprietors.

Current law provides corporations with an automatic three-month extension of the filing due date, with corporations permitted to apply for an additional three-month extension (for a total of six months).

**Provision:** Under the provision, the schedule for filing tax returns would be modified as follows:

- A partnership or S corporation would be required to file by March 15 (or two and a half months after the close of its tax year).
- A C corporation would be required to file by April 15 (or three and a half months after the close of its tax year).

The provision also would provide C corporations with an automatic six-month extension of the applicable filing date. Similarly, the provision would codify certain extensions currently provided by regulations.

The provision generally would be effective for tax years beginning after 2014. For C corporations with fiscal years ending on June 30, the new filing date would not apply to any tax year beginning in 2022.

**JCT estimate:** According to JCT, the provisions would increase revenues by \$0.1 billion over 2014-2023.

## **Subtitle D – Compliance Reforms**

### **Sec. 6301. Penalty for failure to file.**

**Current law:** Under current law, a taxpayer who fails to file a tax return within 60 days of the due date is subject to a minimum penalty equal to the lesser of \$135 or 100 percent of the amount required to be shown on the return.

**Provision:** Under the provision, the minimum penalty for failure to file a tax return would be increased to \$400. The provision would be effective for tax returns the due date for the filing of which (including extensions) is after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.3 billion over 2014-2023.

### **Sec. 6302. Penalty for failure to file correct information returns and provide payee statements.**

**Current law:** Under current law, a multi-tier penalty structure applies to a taxpayer that fails to file correct information returns (e.g., IRS Form 1099) with the IRS. The penalties are based on the duration of the delinquency, the size of the taxpayer, and the taxpayer's intent. A separate, but parallel, penalty regime applies to taxpayers that fail to provide the payee with a correct copy of the information return (e.g., IRS Form 1099) filed with the IRS. The current amount for both penalty regimes is \$100 for each information return not corrected before August 1st following the filing due date, with a maximum for each penalty of \$1.5 million for any taxpayer in a calendar year. If the failure is corrected within 30 days of the due date, the penalty is reduced to \$30 per return, with a maximum of \$250,000 for each penalty. If the failure is corrected after 30 days but before August 1st, the penalty is \$60 per return with a maximum of \$500,000 for each penalty. For taxpayers with gross receipts of not more than \$5 million, the maximum amount of the general penalty is \$500,000, the maximum for corrected returns within 30 days is \$75,000, and the maximum for corrected returns after 30 days, but before August 1st, is \$200,000. For taxpayers who intentionally disregard the filing requirements, the penalty is \$250 per return with no maximum.

**Provision:** Under the provision, the penalty for failure to file correct information returns and the penalty for failure to furnish correct payee statements would be adjusted as follows:

Level of Culpability	Amount per Return	Maximum per Year	Maximum for Small Business
Corrected within 30 days of due date	Current: \$30 Provision: \$50	Current: \$250,000 Provision: \$500,000	Current: \$75,000 Provision: \$175,000
Corrected after 30 days but before August 1st	Current: \$60 Provision: \$100	Current: \$500,000 Provision: \$1,500,000	Current: \$200,000 Provision: \$500,000
Continuing delinquency on or after August 1st	Current: \$100 Provision: \$250	Current: \$1,500,000 Provision: \$3,000,000	Current: \$500,000 Provision: \$1,000,000
Intentional failure	Current: \$250 Provision: \$500	Current: No limit Provision: No limit	Current: No limit Provision: No limit

The provisions would be effective for information returns and payee statements required to be filed after 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

**Sec. 6303. Clarification of 6-year statute of limitations in case of overstatement of basis.**

**Current law:** Under current law, taxes generally are required to be assessed within three years after the date on which the taxpayer filed the return. However, if a taxpayer omits substantial income on a return (i.e., in excess of 25 percent of the amount of gross income that was stated in the return), any tax with respect to that return generally may be assessed within six years of the date on which the return was filed. The Supreme Court has ruled that the six-year statute of limitations does not apply to a return on account of the taxpayer having substantially overstated the adjusted basis of property, the sale or exchange of which results in an understatement of gain.

**Provision:** Under the provision, the six-year statute of limitations would apply to a return on which the taxpayer claims an adjusted basis for any property that is more than 125 percent of the correct adjusted basis. The provision would be effective for returns filed after the date of enactment and for returns filed on or before the date of enactment if the general statute of limitations has not expired.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.1 billion over 2014-2023.

**Sec. 6304. Reform of rules related to qualified tax collection contracts.**

**Current law:** Under current law, the IRS has authority to enter into qualified tax collection contracts with private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities of any type, and to arrange payment of such taxes by the taxpayers. Qualified tax collection contracts are subject to a number of administrative safeguards: (1) provisions of the Fair Debt Collection Practices Act apply; (2) taxpayer protections that are statutorily applicable to the IRS and its employees are applicable to the private-sector debt

collection companies and to their employees; and (3) subcontractors of the private debt collection companies are subject to a number of restrictions regarding their contact with taxpayers.

**Provision:** Under the provision, the IRS would be required to use qualified tax collection contracts to collect certain inactive tax receivables. These receivables would include accounts removed from active inventory due to lack of IRS resources, accounts for which more than a third of the statute of limitations has expired without being assigned to an IRS employee for collection, and assigned accounts that have gone more than 365 days without interaction between the IRS and the taxpayer. However, certain receivables would not be assigned to private debt collection companies, including accounts subject to a pending or active offer-in-compromise or installment agreement, accounts relating to innocent spouse cases and taxpayers in combat zones, accounts of minors, deceased taxpayers or victims of identity theft, and accounts under examination, litigation, criminal investigation, levy, or subject to a right of appeal. The provision also would permit taxpayers in a presidentially declared disaster area to request that the private debt collector suspend collections and return the account to the IRS. The provision would be effective for tax receivables identified by the IRS after the date of enactment.

**Considerations:**

- From 2006 to 2009, the IRS conducted a pilot private debt collection program to help the agency collect certain tax debts that the agency did not have the resources to pursue.
- Despite successfully collecting \$98.2 million through the private debt collection program, the Obama Administration terminated the pilot program in 2009.
- The provision would require the IRS to restore the private debt collection program to collect specific types of inactive tax debts that the agency is never going to collect due to resource constraints.
- With the current fiscal constraints and personnel limitations facing the IRS, the provision would ensure that the IRS uses every tool at its disposal to collect delinquent tax debts that otherwise will go uncollected and eventually become uncollectable once the statute of limitations expires.
- At the same time, the private debt collection program would be subject to numerous critical safeguards to ensure that the rights of taxpayers from whom such tax debts would be collected are carefully protected.

**JCT estimate:** According to JCT, the provision would increase revenues by \$4.4 billion over 2014-2023, and increase outlays by \$2.2 billion over 2014-2023.

**Sec. 6305. 100 percent continuous levy on payments to Medicare providers and suppliers.**

**Current law:** Under current law, the Treasury Department is authorized to continuously levy up to 15 percent of a payment to a Medicare provider to collect delinquent tax debt. Through the Federal Payment Levy Program, the Treasury Department deducts (levies) a portion of a government payment to an individual or business to collect unpaid taxes.

**Provision:** Under the provision, the Treasury Department would be authorized to levy up to 100 percent of a payment to a Medicare provider to collect unpaid taxes. The provision would be effective for levies issued after the date of enactment.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.7 billion over 2014-2023.

### **Sec. 6306. Treatment of refundable credits for purposes of certain penalties.**

**Current law:** Under current law, a 20-percent accuracy-related penalty applies to the underpayment of tax. There is uncertainty as to the extent to which refundable credits are taken into account when determining the amount of the underpayment subject to the penalty. The Tax Court recently held that refundable credits count toward the underpayment of tax but only to the extent that tax liability is reduced to zero, but not to the extent that the credits produce a tax refund.

A separate 20-percent penalty applies when taxpayers make erroneous claims for refunds or credits. This penalty does not apply under current law to the earned income tax credit (EITC). The IRS may only assert either the penalty for erroneous claims for refund or credit or the penalty for underpayment of tax described above, but not both.

**Provision:** Under the provision, the penalty for underpayment of tax would take into account the full amount of refundable credits. The provision would be effective for returns filed after February 26, 2014 and returns filed on or before such date if the general statute of limitations has not expired.

The provision also would amend the penalty for erroneous claims for refunds or credits to apply to taxpayers who erroneously claim the new credit for employment-related taxes (section 1103 of the discussion draft). The provision would be effective for claims filed after February 26, 2014.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.1 billion over 2014-2023.

## **Title VII – Excise Taxes**

### **Sec. 7001. Repeal of medical device excise tax.**

**Current law:** Under current law, the manufacturer, producer, or importer of any taxable medical device must pay an excise tax equal to 2.3 percent of the sales price of such device. The excise tax does not apply to eyeglasses, contact lenses, hearing aids, and any other medical device determined by the Secretary to be of a type that is generally purchased by the general public at retail for individual use.

**Provision:** Under the provision, the medical device excise tax would be repealed. The provision would apply to sales after the date of enactment.

**JCT estimate:** According to JCT, the provision would reduce revenues by \$29.5 billion over 2014-2023.

### **Sec. 7002. Modifications relating to oil spill liability trust fund.**

**Current law:** Under current law, an excise tax is imposed on crude oil (including crude oil condensates and natural gasoline) that is received at a U.S. refinery and on petroleum products that are imported into the United States. These excise tax revenues are deposited into the Oil Spill Liability Trust Fund. The excise tax rate is 8 cents per barrel through 2016 and 9 cents per barrel for 2017, but the tax expires after 2017. In 2011, the IRS issued administrative guidance concluding that tar sands are not subject to the excise tax because tar sands are not included in the definition of “crude oil” or “petroleum products” for purposes of the excise tax.

**Provision:** Under the provision, the excise tax would continue to be imposed at a rate of 9 cents per barrel for 2018 through 2023. In addition, the definitions of “crude oil” and “petroleum products” to which the excise tax applies would be modified to include crude oil condensates, natural gasoline, any bitumen or bituminous mixture, any oil derived from a bitumen or bituminous mixture, shale oil, and any oil derived from kerogen-bearing sources. The provision would be effective for oil and petroleum products received at U.S. refineries or imported into the United States during calendar quarters beginning more than 60 days after the date of enactment.

**JCT estimate:** According to JCT, the provision would increase revenues by \$1.2 billion over 2014-2023.

### **Sec. 7003. Modification relating to inland waterways trust fund financing rate.**

**Current law:** Under current law, an excise tax of 20 cents per gallon is imposed on fuel used in powering commercial cargo vessels on inland or intra-coastal waterways. These excise tax revenues are deposited into the Inland Waterways Trust Fund.

**Provision:** Under the provision, the excise tax rate would be increased to 26 cents per gallon. The provision would be effective for fuel used after 2014.

**Consideration:** In a letter dated September 24, 2013, to the Ways and Means Committee, the Waterways Council and a coalition of nearly 40 stakeholders expressed support for increasing the excise tax that supports the Inland Waterways Trust Fund to at least 26 cents per gallon, in conjunction with spending reforms included in the Water Resources Reform and Development Act, which passed the House of Representatives on October 23, 2013.

**JCT estimate:** According to JCT, the provision would increase revenues by \$0.2 billion over 2014-2023.

#### **Sec. 7004. Excise tax on systemically important financial institutions.**

**Current law:** Under current law, sections 113 and 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act define a systemically important financial institution (SIFI) as (1) any bank holding company with at least \$50 billion in total consolidated assets, or (2) any non-bank financial institution designated for SIFI treatment by the Financial Stability Oversight Council and thus subject to oversight by the Federal Reserve. SIFI status subjects a financial institution to more stringent prudential standards than apply to non-SIFIs, and such status also requires regulators and the financial institution to agree on a resolution plan to ensure an orderly process in the event that the financial institution fails or suffers financial distress. The Federal Reserve and other agencies conduct annual stress tests on SIFIs to ensure that the SIFIs have adequate capital to absorb losses that result from economic downturns.

Currently, there is no excise tax that applies to the assets of SIFIs.

**Provision:** Under the provision, every SIFI would be required to pay a quarterly excise tax of 0.035 percent of the SIFI's total consolidated assets (as reported to the Federal Reserve) in excess of \$500 billion. After calendar year 2015, the \$500 billion threshold would be indexed for increases in the gross domestic product (GDP). The provision would apply to calendar quarters beginning after 2014.

#### **Considerations:**

- Many commentators and academic studies have suggested that policies such as Dodd-Frank's SIFI designation actually contribute to the financial markets' view that certain financial institutions are "too big to fail" and may, therefore, be deserving of additional taxpayer bailouts in the future.
- The provision would address the significant implicit subsidy bestowed on big Wall Street banks and other financial institutions under Dodd-Frank. By deeming SIFIs to be "too big to fail," Dodd-Frank effectively subsidizes these big banks and financial institutions, providing them lower borrowing costs than they would face without that special designation. While tax reform cannot undo Dodd-Frank, it can and should help recapture a portion of that implicit subsidy.



- The SIFI designation applies to financial institutions with over \$50 billion in assets. To avoid affecting smaller, regional banks that were not at the center of the recent financial crisis, the provision would be carefully targeted to apply to the largest of Wall Street firms – those having more than \$500 billion in worldwide consolidated assets.
- On March 22, 2013, the Senate approved, by a unanimous vote of 99-0, a bipartisan amendment to the Senate budget resolution endorsing legislation to end subsidies and funding advantages received by “too big to fail” banks with total assets over \$500 billion. So this concept has strong bipartisan, bicameral support.

**JCT estimate:** According to JCT, the provision would increase revenues by \$86.4 billion over 2014-2023.

**Sec. 7005. Clarification of orphan drug exception to annual fee on branded prescription pharmaceutical manufacturers and importers.**

**Current law:** Under current law, an annual tax is imposed on covered entities engaged in the business of manufacturing or importing branded prescription drugs for sale to any specified government program or pursuant to coverage under any such program. Taxes collected are credited to the Medicare Part B trust fund. The aggregate annual tax imposed on all covered entities is \$2.5 billion for calendar year 2011, \$2.8 billion for calendar years 2012 and 2013, \$3 billion for calendar years 2014 through 2016, \$4 billion for calendar year 2017, \$4.1 billion for calendar year 2018, and \$2.8 billion for calendar year 2019 and thereafter. The aggregate tax is apportioned among the covered entities each year based on their relative share of branded prescription drug sales taken into account during the previous calendar year.

Branded prescription drug sales do not include sales of any drug or biological product with respect to which an orphan drug tax credit was allowed for any tax year under Code section 45C. The exception for orphan drug sales does not apply to any drug or biological product after such drug or biological product is approved by the Food and Drug Administration (FDA) for marketing for any indication other than the rare disease or condition with respect to which the section 45C credit was allowed.

**Provision:** Under the provision, eligibility for the orphan drug exemption would be expanded to include any drug or biological product that is approved or licensed by the FDA for marketing solely for one or more rare diseases or conditions, regardless of whether the section 45C credit was ever allowed. A disease or condition would be considered “rare” if either it affects less than 200,000 U.S. persons, or there is no reasonable expectation that the cost of developing and making the drug available will be recovered from sales. The provision would be effective for calendar years after 2013.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.

## **Title VIII – Deadwood and Technical Provisions**

### **Subtitle A – Repeal of Deadwood**

#### **Secs. 8001-8084. Repeal of Deadwood.**

**Current law:** Under current law, there are numerous provisions that relate to past tax years (and generally are no longer applied in computing taxes for open tax years), involve situations that were narrowly defined and unlikely to recur, or otherwise have outlived their usefulness. These types of provisions are often referred to as “deadwood” provisions.

**Provisions:** Under these provisions, current-law provisions that are deadwood would be repealed. (Note that other provisions in other titles of the discussion draft would repeal other current-law provisions that would become deadwood as a result of those other provisions.) These provisions generally would be effective on the date of enactment, although the tax treatment of any transaction occurring before that date, of any property acquired before that date, or of any item taken into account before that date, would not be affected by these provisions.

**JCT estimate:** According to JCT, the provisions would have no revenue effect over 2014-2023.

### **Subtitle B – Conforming Amendments Related to Multiple Sections**

#### **Sec. 8101. Conforming amendments related to multiple sections.**

**Current law:** Under current law, there are numerous provisions that would be affected by multiple provisions in the discussion draft and, therefore, require technical changes to conform these current-law provisions to the provisions in the discussion draft.

**Provision:** Under the provision, several conforming changes that are common to various provisions of the discussion draft would be made. The provision generally would be effective for tax years beginning after 2014.

**JCT estimate:** According to JCT, the provision would have no revenue effect over 2014-2023.