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**[JOINT COMMITTEE PRINT]**

# DESCRIPTION OF CERTAIN REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2016 BUDGET PROPOSAL

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



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**114TH CONGRESS, 1ST SESSION**

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## INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), provides a description and analysis of certain revenue provisions modifying the Internal Revenue Code of 1986 (the "Code") that are included in the President's fiscal year 2016 budget proposal, as submitted to the Congress on February 2, 2015.[2] Because many of the provisions in the 2016 budget proposal are substantially similar or identical to those in the fiscal year 2015, 2014, and 2013 budget proposals, the Joint Committee staff has generally described only those provisions that did not appear in the fiscal year 2015 budget proposal or that are substantially modified from prior years' proposals.[3] The document generally follows the order of the proposals as included in the Department of the Treasury's explanation of the President's budget revenue proposals.[4] All provisions include a cite to the *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal*, which is reprinted in the back of this volume. For new provisions, there is a description of present law and the proposal (including effective date), and a discussion of policy issues related to the proposal. For modified provisions, there is a description of the modification and information directing the reader to the Joint Committee staff's description of the revenue provision as it appeared in previous budget proposals. For all other provisions, the text directs the reader to the Joint Committee staff's description of the revenue provision as it appeared in previous budget proposals.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCS-2-15), September 2015.

[2] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2016: Analytical Perspectives* (H. Doc. 114-3, Vol. III), February 2, 2015, pp. 149-204.

[3] The revenue provisions contained in the fiscal year 2013 budget proposal are described in their entirety in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012. Those provisions which were new or substantially modified in the fiscal year 2014 budget proposal are described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013. Those provisions which were new or substantially modified in the fiscal year 2015 budget proposal are described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014.

[4] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, February 2015.

## PART I ─ ADJUSTMENTS TO THE BALANCED BUDGET AND EMERGENCY DEFICIT CONTROL ACT BASELINE

### A. Permanently Extend Increased Refundability of the Child Tax Credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 751-753. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item I.A, reprinted in the back of this volume.

### B. Permanently Extend the Earned Income Tax Credit for Larger Families and Married Couples

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 753-756. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Items I.B and I.C, reprinted in the back of this volume.

### C. Permanently Extend the American Opportunity Tax Credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. The 2015 budget proposal was a modification of the President's fiscal year 2014 budget proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 2, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 34-39. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item I.D, reprinted in the back of this volume.

## PART II – REFORM U.S. INTERNATIONAL TAX SYSTEM

### A. Restrict Deductions for Excessive Interest of Members of Financial Reporting Groups

#### Description of Modification

The fiscal year 2016 budget proposal modifies the prior year's budget proposal. Both proposals apply to entities that are members of a "financial reporting group," which is defined as a group that prepares consolidated financial statements in accordance with U.S. Generally Accepted Accounting Principles ("GAAP"), International Financial Reporting Standards ("IFRS"), or another method authorized by the Secretary of Treasury under regulations. Under the original proposal--which does not apply to financial services entities--the interest expense deduction for a member of a financial reporting group is generally limited to the member's interest income plus the member's proportionate share of the financial reporting group's net interest expense computed under U.S. tax principles. The member's proportionate share is a function of its share of the group's earnings (computed by adding back net interest expense, taxes, depreciation, and amortization) as reflected in the group's financial statements. The modified proposal changes the calculation of the limitation and relies more heavily on data reported in financial statements in computing interest expense.

Under the modified proposal, a member's deduction for interest expense is generally limited if the member has net interest expense for tax purposes and the member has "excess financial statement net interest expense." Excess financial statement net interest expense equals the amount by which the member's net interest expense for financial reporting purposes, computed on a separate company basis, exceeds the member's proportionate share of the net interest expense reported on the financial reporting group's consolidated financial statements. A member's proportionate share is a function of its share of the group's earnings (computed by adding back net interest expense, taxes, depreciation, and amortization) as reflected in the group's financial statements.

When a member has excess financial statement net interest expense, the member will have excess net interest expense for tax purposes for which a current deduction is disallowed in the same proportion that the member's net interest expense for financial reporting purposes is excess financial statement net interest expense. If there is no excess financial statement net interest expense, and the member's net interest expense for financial reporting purposes is less than the member's proportionate share of the financial reporting group's net interest expense, such excess limitation is converted into a proportionate amount of excess limitation for tax purposes and can be carried forward to the three subsequent tax years.

If a U.S. member of a U.S. subgroup owns stock of one or more foreign corporations, this proposal applies before the Administration's minimum tax proposal. The U.S. subgroup's interest expense that remains deductible after application of this proposal is subject to the limitations on deductibility outlined in the Administration's minimum tax proposal.

For a description of the prior proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12),

June 2012, pp. 299-320. The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.A, reprinted in the back of this volume.

### B. Provide Tax Incentives for Locating Jobs and Business Activity in the United States and Remove Tax Deductions for Shipping Jobs Overseas

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 73-82. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.B, reprinted in the back of this volume.

### C. Repeal Delay in the Implementation of Worldwide Interest Allocation

#### Present Law

#### In general

Present law provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not, however, affect the deductibility of expenses of a domestic corporation. Rather, these rules apply principally for purposes of determining the foreign tax credit limitation, which is computed by reference to the domestic corporation's U.S. tax liability on its taxable foreign-source income in each of two limitation categories.[5]

To compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other.

In the case of interest expense, the allocation rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. For interest allocation purposes, all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets rather than gross income.[6] The term "affiliated

[5] Secs. 901 and 904. This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.

[6] Secs. 864(e)(1) and (e)(2).

group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.[7]

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation that is an includible corporation, but only if: (1) the common parent owns directly stock possessing at least 80 percent of the total voting power and at least 80 percent of the total value of at least one other includible corporation; and (2) stock meeting the same voting power and value standards with respect to each includible corporation (excluding the common parent) is directly owned by one or more other includible corporations.

The term "includible corporation" means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, domestic international sales corporations, and S corporations. Moreover, a foreign corporation generally is not an includible corporation.

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation are consistent with each other.[8] For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Banks, savings institutions, and other financial affiliates

The affiliated group for interest allocation purposes generally excludes what are referred to in the Treasury regulations as "financial corporations."[9] A financial corporation includes any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity that is not a financial institution.[10] The category of financial corporations also includes, to the extent provided in regulations, bank holding companies (including financial holding companies), subsidiaries of banks and bank holding companies (including financial holding companies), and savings

[7] Sec. 864(e)(5).

[8] One such exception is that the affiliated group for interest allocation purposes includes section 936 corporations (certain electing domestic corporations that have income from the active conduct of a trade or business in Puerto Rico or another U.S. possession) that are excluded from the consolidated group.

[9] Temp. Treas. Reg. sec. 1.861-11T(d)(4).

[10] Sec. 864(e)(5)(C) and Temp. Treas. Reg. sec. 1.861-11T(d)(4)(ii).

institutions predominantly engaged in the active conduct of a banking, financing, or similar business.[11]

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other nonfinancial members of that group. Instead, all such financial corporations that would be so affiliated are treated as a separate single corporation (the "financial group") for interest allocation purposes. The members of the group that do not constitute financial corporations are treated as members of a separate affiliated group (the "nonfinancial group").[12]

**Worldwide interest allocation**

In general

The American Jobs Creation Act of 2004 ("AJCA")[13] modified the interest expense allocation rules described above by providing a one-time election (the "worldwide affiliated group election") under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (*i.e.*, as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio that the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group,[14] over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the principles of worldwide interest allocation were applied separately to the foreign members of the group.[15]

For purposes of the new elective rules, the worldwide affiliated group means all corporations in an affiliated group as well as all controlled foreign corporations that, in the aggregate, either directly or indirectly,[16] would be members of such an affiliated group if section

[11] Sec. 864(e)(5)(D).

[12] Temp. Treas. Reg. sec. 1.861-11T(d)(4)(i).

[13] Pub. L. No. 108-357, sec. 401(a).

[14] For purposes of determining the assets of the worldwide affiliated group, neither stock in corporations within the group nor indebtedness (including receivables) between members of the group is taken into account.

[15] Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.

[16] Indirect ownership is determined under the rules of section 958(a)(2) or through applying rules similar to those of section 958(a)(2) to stock owned directly or indirectly by domestic partnerships, trusts, or estates.

1504(b)(3) did not apply (*i.e.*, in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (*i.e.*, corporations that are part of the affiliated group, as modified to include insurance companies) and certain controlled foreign corporations were attributable to a single corporation.

Financial institution group election

Taxpayers are allowed to apply the bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The rules also provide a one-time "financial institution group" election that expands the bank group. At the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the bank group, and (2) all "financial corporations." For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.[17] For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

In addition, anti-abuse rules are provided under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group. Regulatory authority is provided with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation is appropriate to carry out the purposes of these rules, to prevent assets or interest expense from being taken into account more than once, or to address changes in members of any group (through acquisitions or otherwise) treated as affiliated under these rules.

Effective date of worldwide interest allocation

The common parent of the domestic affiliated group must make the worldwide affiliated group election. It must be made for the first taxable year beginning after December 31, 2020, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2020, in which a worldwide affiliated group includes a financial corporation. Once either election is made, it applies to the common parent and all other members of the worldwide affiliated group or to all members of the financial institution group, as

[17] See Treas. Reg. sec. 1.904-4(e)(2).

applicable, for the taxable year for which the election is made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

The AJCA made the worldwide interest allocation election available for taxable years beginning after December 31, 2008, however, subsequent legislation has deferred the availability of the election until taxable years beginning after December 31, 2020.[18]

## Description of Proposal

The proposal would prospectively repeal the delay of the worldwide affiliated group election to make it available for taxable years beginning after December 31, 2015.

Effective date.−The proposal is effective upon date of enactment.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposa*l (JCX-50-15), March 6, 2015, Item II.C, reprinted in the back of this volume.

## Analysis

### Policy considerations of interest allocation

Under the minimum tax proposal described below in section II.F, a taxpayer is required to allocate and apportion interest expense among foreign-source gross income subject to tax at the full U.S. statutory rate, foreign-source gross income subject to various rates of U.S. tax under the minimum tax, and foreign-source gross income on which no U.S. tax is paid. Interest expense allocated and apportioned to foreign-source gross income that is subject to full U.S. tax

[18] As originally enacted under AJCA, the worldwide interest allocation rules were effective for taxable years beginning after December 31, 2008. However, section 3093(a) of the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 ("HERA"), delayed the implementation of the worldwide interest allocation rules for two years, until taxable years beginning after December 31, 2010. Section 15(a) of the Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92 ("WHBA") delayed the effective date from December 31, 2010 to December 31, 2017. The effective date of the worldwide interest allocation rules was once again delayed to December 31, 2020 by section 551(a) of the Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147.

It should be noted that a special phase-in rule was enacted in section 3093(b) of HERA with respect to the first taxable year to which the worldwide interest allocation rules apply. Under new section 864(f)(7), for the first year with respect to which the election applies, the amount of the taxpayer's taxable income from foreign sources is reduced by 70 percent of the excess of (i) the amount of its taxable income from foreign sources as calculated using the worldwide interest allocation rules over (ii) the amount of its taxable income from foreign sources as calculated using the present-law interest allocation rules. For that year, the amount of the taxpayer's taxable income from domestic sources is increased by a corresponding amount. Any foreign tax credits disallowed by reason of this reduction in foreign-source taxable income may be carried back or forward under the normal rules for carrybacks and carryforwards of excess foreign tax credits. This special phase-in rule that was to apply in the case of the first taxable year to which the worldwide interest allocation election applied was subsequently repealed in section 15(b) of WHBA and was never effective.

would continue to be deductible in full. However, interest expense allocated and apportioned to foreign-source gross income subject to the minimum tax would be deductible only at the applicable minimum tax rate, while no deduction would be permitted for interest expense allocated and apportioned to foreign-source gross income on which no U.S. tax is paid.

Under present law principles, the interest expense allocation rules apply to domestic corporations primarily for purposes of computing the foreign tax credit limitation. Interest expense is generally allocated and apportioned based on the taxpayer's ratio of foreign or domestic (as applicable) assets to its worldwide assets, where members of an affiliated group, excluding foreign members of the group, are treated as a single corporation for purposes of determining the apportionment ratios. The result is that the allocation under present law does not take into account the extent to which foreign members of the group may have borrowed outside the United States to finance their own operations. Instead, the present rules assume that debt incurred by U.S. group members is used disproportionately to fund the operations of foreign subsidiaries, resulting in over-allocation of interest expense to foreign source income (an effect commonly referred to as "water's edge fungibility"). These rules may cause international double taxation of foreign source income where foreign tax credits are disallowed as a result of the limitation, particularly where foreign operations and U.S. operations each maintain their own debt financing. In such case, although interest on borrowings to finance foreign operations do not reduce the current U.S. tax base, a portion of the interest expense on the U.S. borrowing is allocated to reduce foreign source taxable income for purposes of the foreign tax credit limitation. This potential for international double taxation was considered during the period leading up to enactment of the present law interest allocation rules as part of the Tax Reform Act of 1986 ("TRA '86").[19] A worldwide approach was included in the Senate bill that ultimately became part of TRA '86, but was not adopted by the conference committee.[20] It is widely believed that the water's edge approach was selected over the worldwide approach due to revenue considerations.[21]

Within the present law framework, the one-time election to apply worldwide interest allocation, once it comes into effect, allows taxable income of the domestic members of an affiliated group from sources outside the United States to be determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis, thus treating domestic and foreign corporations of the worldwide group as a single corporation. The worldwide interest allocation method is intended to alleviate the over-allocation of interest expense to foreign-source taxable income, and this method generally yields an enhanced ability to claim the foreign tax credit to alleviate double-taxation for taxpayers that currently suffer from over-allocation of interest expense against foreign source income.

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[19] Tax Reform Act of 1986, Pub. L. No. 99-514, sec.1215(a).

[20] H. Report No. 99-841, 99th Cong., 2d Sess. II-605 and II-606 (1986) (Conference Report).

[21] See, for example: Timothy Tuerff and Keith F. Sellers, "Taking Advantage of Exceptions to Asset-Based Apportionment," *Journal of International Taxation* 261, 262, footnote 4, January/February 1991. Joseph L. Andrus, "Planning Under U.S. Expense Allocation Rules," 70 *Taxes* 1008, footnote 18, December 1992.

Under this proposal to repeal the delay of the worldwide interest allocation election, the interest allocation principles of present law would continue to apply, but with an expanded purpose. Under the minimum tax proposal, interest deductions may be reduced or disallowed. Interest expense of the U.S. group would first be allocated between U.S.-source and foreign-source income. The amount of interest expense allocated to foreign-source income under these rules then would be further allocated between the three broad categories of foreign-source income on a pro rata basis, based on assets. Broadly, these foreign-source income categories include income that is subject to taxation at the full U.S. statutory tax rate, income that is entirely exempt from U.S. taxation, and income that is taxed at a variety of different tax rates under the minimum tax system.

The election to allocate interest expense on a worldwide basis would become available immediately upon transition to the minimum tax system.

**Potential complexities**

Because money is fungible, as described above, the present law regulations relevant to interest allocation generally attribute interest expense to all of a taxpayer's activities and property, regardless of any specific purpose for incurring an obligation. As such, the interest deduction is generally apportioned among all gross income in proportion to the values of the assets used by the taxpayer in generating the income. Generally, interest expense is apportioned according to the average total value of the assets producing income. The regulations permit the asset values to be determined based on the tax book value method, the alternative tax book value method, or the fair value method.

As described under the proposal *Impose a 19-percent Minimum Tax on Foreign Income*, a taxpayer will be required to allocate and apportion interest expense among foreign-source gross income subject to tax at the full U.S. statutory rate, foreign-source gross income subject to various rates of U.S. tax under the minimum tax, and foreign-source gross income on which no U.S. tax is paid. Interest expense allocated and apportioned to foreign-source gross income subject to the minimum tax would be deductible only at the applicable minimum tax rate. The determination of whether foreign operations are subject to the minimum tax is made on a country-by-country basis. Within the operations of each country, a portion of earnings is excluded from the minimum tax base as an allowance for corporate equity ("ACE"). Because an amount of per-country earnings equal to the ACE will be excluded from the minimum taxable base, the interest expense allocated to the ACE amount is non-deductible.

The Administration's proposal lacks sufficient detail describing the methodology under which interest expense will be further allocated among the assets attributable to each country between the ACE amount, which is nondeductible, and the remaining assets, which is partially deductible. As described above, interest expense is generally allocated based on assets. However, it remains unclear how this principle would be applied in the context of allocating interest expense to the ACE adjustment. Another alternative, which is potentially less complex, would be to allow the interest allocation to a country's ACE to be made on the basis of gross income, rather than assets. Under such alternative, interest expense may initially be allocated to a country based on assets, under present law principles, and then within a country, as between ACE and other assets, based on the relative amounts of ACE and non-ACE gross income.

However, under present law, allocation of interest expense on the basis of gross income is not permitted.

### D. Permanently Extend the Exception Under Subpart F for Active Financing Income

#### Present Law

Under the subpart F rules,[22] 10-percent-or-greater U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (*i.e.*, income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits ("REMICs"); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.[23]

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (so-called "active financing income").

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[22] Secs. 951-964.

[23] Prop. Treas. Reg. sec. 1.953-1(a). The proposed regulations provide that for purposes of determining subpart F income, section 953 and Prop. Reg. sections 1.953-1 through -7 are applied before section 954, and section 954 applies only to income that is not insurance income under section 953. Prop. Treas. Reg. sec. 1.953-6(g)(i).

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross-border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. In the case of insurance, temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

## Description of Proposal

The proposal permanently extends the temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business.

Effective date.−The proposal is effective for taxable years of foreign corporations beginning December 31, 2014, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.D, reprinted in the back of this volume.

## Analysis

### In general

The proposal makes permanent the present-law exceptions from current taxation of Subpart F income that were designed for active banking, securities dealing, and insurance company income. Several rationales can be offered for the proposal. The proposal could also be criticized on several grounds elaborated below.

One rationale for the proposal relates to a preference for permanent, rather than temporary, tax rules. That is, efficient operation of the Federal income system is improved by providing the certainty to taxpayers and the government of a permanent rule. Temporary rules have been justified by the thought that they may be provisional subject to seeing how well they work, or that they respond to some temporary situation in the economy. The active financing exception rules were first applicable for taxable years beginning in 1998, and have been extended (with occasional modifications) seven times, most recently expiring with the end of 2014, so their provisional nature may have faded over the 17-year period they have been in effect. Further, there is little or no evidence that any particular temporary economic situation is involved.

Another rationale for the proposal relates to tax neutrality or fairness, specifically, treating all active income similarly. If active income from transactions with unrelated persons by other businesses is entitled to deferral under the U.S. income tax rules governing international business operations of its taxpayers, then arguably, neutrality and fairness dictate that active income of these financial intermediation businesses is entitled to comparable U.S. income tax treatment. Deviation from neutrality may sometimes be considered appropriate to encourage or discourage particular economic behavior, or perhaps to take account of legislative or administrative difficulties in defining and distinguishing the income. Here, the first of these reasons does not seem apposite, though the second reason is more relevant if the theory for allowing deferral is that the income is active, not passive or mobile. By their nature, financial flows are passive for persons who are investors in the assets generating income. Moreover, global financial arrangements make financial income mobility increasingly simpler and more

widely available. For corporations involved in financial intermediation, dividends and other payments to affiliates permit international capital mobility and the relocation of income sources. On the insurance side, reinsurance transactions additionally permit international transfer of not only risks, but also, capital and income. Arguably, defining as active certain types of income that can also be passive requires careful distinctions. If the definition can be achieved, the principal of neutrality can be served.

Under present law, the benefit for taxpayers of the active financing exceptions is that they permit deferral of U.S. taxation on eligible income. Other proposed or hypothetical regimes for U.S. taxation of international businesses may have different benefits and costs for taxpayers, so the effect of an active financing exception under those regimes could be different and could necessitate or suggest that a different way to identify an active financing business might be appropriate, as further discussed below.

**Technical and policy issues under present-law rules**

Advocates have suggested modifications to the details of the rules in order to apply them more precisely to active financing income. If the rules are to be made permanent, arguably, consideration could be given to improving their accuracy and their technical operation at the same time. Both changes in business practices, and issues that were not considered at the time of original enactment, may suggest areas in which to consider modifications to the existing rules.

Some point to an increase in cross-border, regional, business activity that has made it more difficult to satisfy requirements currently applicable for a bank, financing company, securities dealer, or insurance company to be eligible for the exception. The requirements of the active financing exception that are designed to ensure a firm has a strong nexus with one country become difficult to satisfy if the firm's customer base, income, and assets spread through a region. For example, it becomes more difficult to satisfy the requirement that a bank have local substantial deposits; the requirement than a qualifying insurance company must derive more than 50 percent of its aggregate net written premiums from covering applicable home country risks; and the requirement that to be qualified banking or financing income, 30 percent or more of the corporation's or unit's gross income be from transactions with home-country customers. Reducing the percentages by which nexus is defined would make the tests easier to meet. On the other hand, weakening or eliminating nexus permits tax-driven migration of mobile financial intermediation income just as it permits business-driven migration of financial intermediation income. Without a good connection between the income and the physical conduct of the activities that make up the business, and without the addition of some other way to test the nature of foreign-earned financial income, the distinction between business income and investment income in the financial context breaks down. To permit regional cross-border overseas business to fit easily within the active financing exception, further development of distinctions between business income and investment income may be needed.

Another basis on which the current rules distinguish between financial business income and financial investment income has to do with applicable regulation. To qualify under the current rules, a bank must generally be an institution licensed to do business as a bank in the United States; a securities business must generally be registered as a securities broker or dealer (or government securities broker or dealer) under the Securities Exchange Act of 1934. Under

the current rules, a qualifying insurance company must be subject to regulation as an insurance or reinsurance company by its home country, and be licensed, authorized or regulated by the applicable insurance regulatory body for its home country to sell insurance contracts. In addition, in determining whether income derived from reserves is qualified insurance income under the exceptions, the amount of the reserve for any contract is determined in the same manner as it would be if the company were subject to tax under Subchapter L of the Code (that is, under U.S. tax rules), but may not exceed foreign statement reserves (less catastrophe and other reserve amounts). Though these standards of regulation tend to make the financial intermediaries more recognizably banks, securities brokers or dealers, or insurers similar to those in the United States, some say that the applicable foreign regulatory standards could be appropriate, at least in some cases. Businesses argue that the foreign regulatory standards govern their foreign business activities, and thus are the proper standards to apply. For example, pointing to the power of the IRS to rule that a particular foreign statement reserve for insurance risks appropriately measures income for purposes of determining qualifying insurance income, some have questioned why the IRS cannot just rule favorably on reserves on a country-by-country basis. However, there are two principal drawbacks of relying on foreign regulatory structures to determine a U.S. tax outcome. First, regulators generally choose standards for their regulatory purposes, such as maintaining solvency of financial intermediaries. Such standards have little or no relation to accurate income measurement or, necessarily, to identifying active businesses. This is true not only of foreign regulatory standards, but domestic ones too. Second, the priorities of other governments may differ from those of some U.S. regulators. For example, a primary purpose may be to promote foreign investment in their jurisdictions and only secondarily to preserve solvency, so the idea that entities compliant with those standards are likely to resemble U.S.-regulated financial intermediaries is weakened. Relatedly, any regulator can modify its standards, indirectly changing the U.S. tax rule without the participation of U.S. tax writers. These difficulties suggest that distinguishing foreign-earned business financial income from investment financial income may not be straightforward.

**Context of the proposal**

The proposal to make the active financing exceptions permanent without modification is accompanied by a proposal to impose a minimum rate of U.S. tax, generally at 19 percent or higher, on foreign income. The impetus to refine the operation of the exceptions may be reduced if the result of qualifying for the exception is that the income is taxed at a lower rate, rather than that the full amount of the tax is deferred as under present law. On the other hand, a rate differential still provides a motivation for treating income as eligible for the exception, implying that definitional flaws should nevertheless be corrected. The concept of a minimum tax suggests that mobility of income is a greater concern than previously, as tax rate differentials among countries cause mobile income to be moved from higher-rate jurisdictions to low-rate jurisdictions. If a tax benefit is provided to financial intermediaries engaged in active business, but not to investment income, then the distinction between them remains important.

One could, however, question why business income that is inherently mobile should benefit from a lower rate than income that is inherently less mobile (such as income that is earned from physical assets located in the United States). The rate differential could cause economic inefficiency and tax-induced distortions by encouraging more capital to move to the financial sector than otherwise would without the availability of a lower rate. On the other hand,

the higher rate for less mobile income could be thought of as a detriment or deterrent for that type of income, which is attributable to the relative ease of collecting U.S. tax on it, since it cannot flee so readily. This depends, conceptually, on what the base rate is or should be and whether certain types of income should be more heavily or more lightly taxed under the U.S. domestic and international tax rules.[24] This question is not unique to active financing income, but also could be asked with respect to any other type of mobile business income.

## E. Permanently Extend the Look-Through Treatment of Payments Between Related Controlled Foreign Corporations

### Present Law

#### In general

The rules of subpart F[25] require U.S. shareholders with a 10-percent or greater interest in a CFC to include certain income of the CFC (referred to as "subpart F income") on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents, and royalties, among other types of income. There are several exceptions to these rules. For example, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, and it also does not include rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that these payments reduce the subpart F income of the payor. Subpart F income of a CFC also does not include any item of income from sources within the United States that is effectively connected with the conduct by such CFC of a trade or business within the United States ("ECI") unless the item is exempt from taxation (or is subject to a reduced rate of tax) under a bilateral income tax treaty.

#### The "CFC look-through rule"

Under the subpart F exception commonly referred to as the CFC look-through rule dividends, interest (including factoring income that is treated as equivalent to interest under section 954(c)(1)(E)), rents, and royalties received or accrued by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor treated as ECI.[26] For this

[24] This issue is discussed further in the section of this document relating to the proposal to impose a 19-percent minimum tax on foreign income, below.

[25] Secs. 951-964.

[26] Sec. 954(c)(6).

purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes.

The Secretary is authorized to prescribe regulations that are necessary or appropriate to carry out the CFC look-through rule, including such regulations as are necessary or appropriate to prevent the abuse of the purposes of such rule.

The CFC look-through rule applies to taxable years of foreign corporations beginning after December 31, 2005 and before January 1, 2015, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

## Description of Proposal

The proposal makes the CFC look-through rule permanent.

Effective date.−The proposal is effective upon date of enactment.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.E, reprinted in the back of this volume.

## Analysis

The proposal is best evaluated by reference to competing policy goals implicated by the CFC look-through rule. When the House Ways and Means Committee approved the 2005 bill that included the CFC look-through provision that was enacted into law the following year, the committee report described the rationale for the temporary provision in the following terms: "Most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries."[27] In other words, the U.S. subpart F rules were viewed as burdening a U.S. multinational company ("MNC") more heavily than the tax laws of other countries burdened home-country MNCs when an entity in an MNC group used business earnings to make a cross-border interest or royalty or other payment to another entity in the group, and the Ways and Means Committee wanted to end this perceived burden.

On the other hand, by allowing a CFC to make an untaxed, cross-border deductible payment to a related CFC, the CFC look-through rule may facilitate foreign tax reduction because a U.S. MNC might arrange intra-group payments from entities in high-tax countries to entities in low-tax countries. Commentators have long argued whether a U.S. MNC's foreign tax planning should be a concern to U.S. policy makers. The argument on one side is that the U.S. rules should not discourage foreign tax reduction, either because foreign tax reduction by itself is a matter for the foreign country, not the United States, or because when a U.S. MNC reduces its

[27] H.R. Rep. No. 109-304, Tax Relief Extension Reconciliation Act of 2005, November 17, 2005, p. 45.

foreign tax liability, the MNC may claim less of an offset of its U.S. tax liability by means of a foreign tax credit. The countervailing argument is that if a U.S. MNC with operations in multiple countries, some high-tax and some low-tax, can reduce its income in a high-tax country in which it operates without creating a corresponding U.S. income inclusion, the U.S. MNC will have more of an incentive than it otherwise would to shift the location of reported profits outside the United States, even to a high-tax country in which it operates because it can in turn shift those profits or related income streams to low-tax countries. That is, by allowing foreign tax reduction without a corresponding U.S. inclusion, the U.S. international tax rules (including the CFC look-through rule) encourage shifting of profits out of the United States.

The arguments over the CFC look-through rule parallel more general arguments related to U.S. international tax reform and reform of the cross-border taxation rules of countries around the world. Some commentators and policy makers have argued that the U.S. international tax rules impede U.S. MNCs when those MNCs are competing with MNCs resident in countries with international tax rules that are seen as more favorable than the U.S. rules to home-country MNCs. At the same time, many participants in discussions of international tax reform, including the Administration, have contended that the U.S. rules impose disproportionately little tax on the foreign income of U.S. MNCs and thereby foster shifting of income outside the United States. The Base Erosion and Profit Shifting project ("BEPS") of the Organisation for Economic Co-operation and Development ("OECD") is motivated in part by the concerns of governments of large countries with significant corporate tax collections that MNCs engage in aggressive tax planning to report profits in low- or no-tax countries and, in doing so, reduce corporate tax collections in countries in which the MNCs have substantial activities.

If the CFC look-through rule were made permanent and there were not simultaneous reform of related U.S. international tax rules, permanency would be in tension with the goal of reducing shifting of reported profits outside the United States to the extent foreign tax reduction makes this shifting more pronounced. Making the CFC look-through rule permanent also would be in tension with, or might be perceived by other governments to contradict, the objectives of other OECD member countries to reduce corporate tax base erosion in those countries.

The Administration does not suggest CFC look-through permanency by itself, however. It views CFC look-through permanency as complementary to the adoption of its proposal for a 19-percent minimum tax on foreign income because, according to the Treasury Department, the minimum tax "would provide a more appropriate policy response to concerns regarding foreign-to-foreign payments by ensuring that such payments could not be used to shift income into entities with effective tax rates below the minimum tax rate of 19 percent." Under this view, a related-party deductible payment attributable to business earnings of the paying entity should not trigger U.S. taxation if the recipient entity is subject to a sufficiently high level of taxation, either foreign or U.S., perhaps because the payment might be motivated more by business considerations than by tax planning but also because, regardless of the motivation for the payment, the 19-percent minimum tax represents the Administration's balancing of concerns about shifting of profits outside the United States with a concern not to impose disproportionately burdensome residence country taxation on U.S. multinational companies' foreign income in relation to the residence country taxation imposed by home countries of foreign competitors.

This view prompts at least two questions. If a CFC subject to a foreign tax rate of, for example, 25 percent makes a deductible payment to a related CFC that faces a tax rate lower than 25 percent but sufficiently high not to trigger U.S. taxation under the 19-percent minimum tax, to what extent is it possible to separate business considerations from tax planning as possible reasons for the payment? A practical answer might be that that sort of foreign tax reduction is of such a smaller magnitude than the foreign tax reduction permitted by the CFC look-through rule in the absence of a minimum tax that the reduction is no longer a compelling enough concern given the countervailing objective not to create a U.S. tax disincentive to common cross-border business structures entailing related-party payments. This answer raises a second question: Should a permanent CFC look-through rule, even in conjunction with a 19-percent minimum tax, give the same favorable treatment to deductible payments such as interest and royalties as to non-deductible payments such as dividends? By definition, only deductible payments raise the concern of tax base erosion. The Administration acknowledges the distinction between deductible and non-deductible cross-border payments by, among other things, excluding related-party dividend payments from the earnings subject to the 19-percent minimum tax. On the other hand, MNCs might argue that there are business reasons wholly divorced from tax planning considerations why one entity in a group might lend funds, or license the use of its property, to one or more related entities that use the funds or property in their business activities. Under this argument, intra-group, cross-border interest and royalty payments are no different from intra-group, cross-border dividend payments to the extent the payments arise out of business income of the paying entity.

### F. Impose a 19-Percent Minimum Tax on Foreign Income

#### Present Law

**In general**

The United States employs a hybrid-"worldwide" tax system, under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad.[28] Income earned directly or through a pass-through entity such as a partnership is taxed on a current basis. However, active foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally is not subject to U.S. tax until the income is distributed as a dividend to the domestic corporation. This favorable rule in turn is circumscribed by the anti-deferral rules of subpart F of the Code, which provide that a domestic parent corporation is subject to U.S. tax on a current basis with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. In order to mitigate double taxation of foreign source income, the United States allows a domestic corporation to claim a credit for foreign income taxes paid by it and by its foreign subsidiaries, subject to certain limitations. In addition, U.S. tax law imposes an exit tax when a U.S. company decides to sidestep U.S. taxation by migrating its tax residence from the United States to a foreign jurisdiction through a "corporate inversion" transaction.

[28] For convenience, the remainder of this discussion generally is phrased in terms of U.S. corporate, rather than individual, owners of foreign subsidiaries, as this is the most common fact pattern.

**Anti-deferral regimes**

Subpart F

Under the subpart F rules,[29] 10 percent-or-greater U.S. shareholders ("United States Shareholders") of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on their pro rata shares of certain income earned by the CFC, whether or not such income is distributed to the shareholders. A CFC is defined generally as a foreign corporation with respect to which United States Shareholders own more than 50 percent of the combined voting power or total value of the stock of the corporation.

Income subject to current inclusion under subpart F (before consideration of the temporary rules described below) includes, among other categories, insurance income and foreign base company income. Foreign base company income consists of foreign personal holding company income, income from certain transactions involving a related person (*e.g.*, income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized) and income attributable to certain oil and gas activities.[30]

Foreign personal holding company income generally comprises the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits ("REMICs"); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (so-called "active financing income").[31] In addition, so-called "look-through rules" temporarily provide that dividends, interest, rents, and royalties received by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to non-subpart F income of the payor. For these purposes, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC.

[29] Secs. 951-964.

[30] Sec. 954.

[31] The temporary exception from the subpart F provisions for certain active financing income, first enacted in 1997 (Taxpayer Relief Act of 1997, Pub. L. No. 105-34), has been modified and extended by the American Tax Relief Act of 2012 (Pub. L. No. 112-240) for two years to include taxable years beginning before 2014, and is currently expired.

Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes.[32]

In addition to current taxation of insurance income and foreign base company income, United States Shareholders are subject to taxation currently on income that is deemed to be distributed when a CFC increases its investment in U.S. property.[33] For this purpose and subject to certain exceptions, U.S. property includes tangible property located in the United States, stock or debt of a related U.S. person and rights to use certain intangible property in the United States.

Passive foreign investment companies

U.S. shareholders (both individuals and corporations) are effectively taxed currently on earnings of passive foreign investment companies ("PFICs"), regardless of the amount of the PFIC's stock that they own.[34] A PFIC is 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 or are held for the production of passive income.[35] Passive income generally is the same as foreign personal holding company income, as defined for subpart F purposes.[36]

The PFIC rules provides for three different methods of taxation. The first is the "excess distribution" regime pursuant to which gains from the disposition of PFIC stock and distributions that exceed prior year averages are deemed to have been earned ratably over the U.S. taxpayer's holding period and are subject to an interest charge to reflect the time value of the deferred tax payment. The excess distribution regime can be avoided if a U.S. shareholder elects to treat the PFIC as a qualified electing fund (a "QEF"). If a QEF election is made, the U.S. shareholder is taxed currently on its share of the QEF's earnings. QEF elections may be made only if the PFIC provides sufficient data to its shareholders that the PFIC's ordinary earnings and net capital gain can be determined each year. For investors in publicly traded foreign mutual funds, who may not be able to make QEF elections, there is also a mark-to-market election. In that case, the U.S. shareholder reflects its annual built-in gain or loss for the year in its taxable income.

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[32] The temporary look-through rules were most recently extended in the American Tax Relief Act of 2012 (Pub. L. No. 112-240), which extended the temporary provisions for two years to include taxable years beginning before 2014. This provision is currently expired.

[33] Sec. 956.

[34] For purposes of the PFIC rules, references to a U.S. shareholder must be distinguished from references to a United States Shareholder (as defined above). A U.S. shareholder in the context of the PFIC rules is a U.S. person that holds any number of shares of PFIC stock. In the context of subpart F, a United States Shareholder is any U.S. person that owns at least 10 percent of the total combined voting power of all classes of stock of a CFC. Sec. 951(b).

[35] Sec. 1297(a).

[36] Sec. 1297(b).

**Foreign tax credit**

Subject to certain limitations, a domestic corporation is allowed to claim a credit for foreign income taxes it pays. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or included in the domestic corporation's income under the anti-deferral rules.[37]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[38] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[39]

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each category by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category (described below), on the other.[40] In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[41] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.[42] In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations

[37] Secs. 901, 902, 960 and 1295(f).

[38] Secs. 901 and 904.

[39] Sec. 904(c).

[40] Subject to applicable limitations, deductions allocated and apportioned to foreign source gross income are deductible on a current basis irrespective of whether the related foreign income is taken into account currently or is deferred. To the extent that foreign income is deferred indefinitely or permanently, this treatment could create a situation in which there is effectively a negative tax rate because expenses that are deducted are never matched up to the corresponding ─ but untaxed ─ income they produce.

[41] Treas. Reg. sec. 1.861-8(b) and Temp. Treas. Reg. sec. 1.861-8T(c).

[42] Temp. Treas. Reg. sec. 1.861-9T and Treas. Reg. sec. 1.861-17.

generally are treated as a single corporation for purposes of determining the apportionment ratios.[43]

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.[44] These rules exclude foreign corporations from an affiliated group.[45] The American Jobs Creation Act of 2004 ("AJCA")[46] modified the interest expense allocation rules for tax years beginning after December 31, 2008.[47] The new rules permit a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis (*i.e.*, as if all domestic and foreign affiliates are a single corporation). The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign source income.

The foreign tax credit limitation is applied separately to "passive category income" and to "general category income."[48] Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. General category income includes all other income. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is high-taxed (*i.e.*, if the foreign tax rate is determined to exceed the highest rate of tax specified in Code section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a United States shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividend or other payment was made.[49] Dividends received by a 10 percent corporate

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[43] Sec. 864(e)(1) and (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

[44] Secs. 864(e)(5) and 1504.

[45] Sec. 1504(b)(3).

[46] Pub. L. No. 108-357.

[47] AJCA, sec. 401. Section 402 of the "Renewable Energy and Job Creation Act of 2008," H.R. 6049 (which passed in the House of Representatives on May 21, 2008), would temporarily delay implementation of this provision until January 1, 2018.

[48] Sec. 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Prior to AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations (also known as "10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). A number of other provisions of the Code create additional separate categories in specific circumstances. See, *e.g.*, secs. 865(h) and 901(j).

[49] Sec. 904(d)(3).

shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[50]

Application of the foreign tax credit limitation separately to passive category income (generally considered to be low-taxed income) and general category income is intended to limit cross-crediting (*i.e.*, the use of foreign taxes imposed at high foreign tax rates to reduce the residual U.S. tax on low-taxed foreign source income). However, even with these constraints, the current system allows for a significant amount of cross-crediting. For example, excess foreign taxes, such as those arising in connection with the receipt of dividends from a high-taxed CFC, are often used to offset U.S. tax on royalties received for the use of intangible property in a low-tax country.

**U.S. taxation of foreign corporations – corporate inversions**

For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any State.[51] All other corporations (that is, those incorporated under the laws of foreign countries) are treated as foreign.[52]

The anti-inversion rules limit the ability of a domestic corporation to expatriate and thus avoid taxation on its worldwide income.[53] Among other things, the general anti-inversion rules (the "toll charge rules") provide that during the 10-year period following the inversion transaction corporate-level gain recognized in connection with the inversion generally may not be offset by tax attributes such as net operating losses or foreign tax credits. These sanctions generally apply to a transaction in which, pursuant to a plan or a series of related transactions: (1) a domestic corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after

[50] Sec. 904(d)(4).

[51] Sec. 7701(a)(4).

[52] Sec. 7701(a)(5).

[53] Prior to AJCA, shareholders of the re-domiciled parent company who were U.S. persons generally would be subject to U.S. tax on the appreciation in the value of their stock of the U.S. company unless a number of conditions were satisfied, including that U.S. persons who were shareholders of the U.S. company received 50 percent or less of the total voting power and total value of the stock of the new foreign parent company in the transaction. See section 367(a)(1); Treas. Reg. sec. 1.367(a)-3(c)(1). The IRS promulgated these greater-than-50-percent rules after becoming aware of tax-motivated inversion transactions, including the publicly traded Helen of Troy cosmetic company's re-domiciliation in Bermuda. See Notice 94-46, 1994-1 C.B. 356 (April 18, 1994); T.D. 8638 (December 26, 1995). Shareholder taxation under section 367 as a result of inversion transactions remains largely the same after enactment of AJCA.

If an inversion transaction was effectuated by means of an asset acquisition, corporate-level gain generally would have been recognized under section 367(a).

For a fuller description of the possible tax consequences of a reincorporation transaction before AJCA, see Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, p. 4.

March 4, 2003; (2) the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 60 percent but less than 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction (this stock often being referred to as "stock held by reason of"); and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (that is, the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.[54]

If a transaction otherwise satisfies the requirements for applicability of the anti-inversion rules and the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction, the anti-inversion rules entirely deny the tax benefits of the inversion transaction by deeming the new foreign parent to be a domestic corporation for all Federal tax purposes.[55]

Similar rules apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.[56]

The Treasury Department has promulgated detailed guidance under section 7874. On September 22, 2014, the IRS and Treasury Department issued a notice intended to address avoidance of section 7874 and to restrict or eliminate certain tax benefits facilitated by inversion transactions.[57]

## Description of Proposal

### Per-country minimum tax

The Administration proposes to significantly change the taxation of foreign earnings of domestic C corporations by imposing a per-country minimum tax on earnings from a CFC, branch, or from the performance of services abroad. Under the proposal, the foreign earnings of a CFC or branch or from the performance of services are subject to current U.S. taxation at a rate

[54] Section 7874(a). AJCA also imposes an excise tax on certain stock compensation of some executives of companies that undertake inversion transactions. Section 4985.

[55] Sec. 7874(b).

[56] Sec. 7874(a)(2)(B)(i).

[57] Notice 2014-52, 2014 I.R.B. LEXIS 576 (September 22, 2014). Among other things, the notice describes regulations that the Treasury Department and IRS intend to issue (1) addressing some taxpayer planning to keep the percentage of the new foreign parent company stock that is held by former owners of the inverted domestic parent company (by reason of owning stock of the domestic parent) below the 80 or 60 percent threshold; (2) restricting the tax-free post-inversion use of untaxed foreign subsidiary earnings to make loans to or stock purchases from certain foreign affiliates, and (3) preventing taxpayers from avoiding U.S. taxation of pre-inversion earnings of foreign subsidiaries by engaging in post-inversion transactions that would end the controlled foreign corporation status of those subsidiaries.

(not below zero) of 19 percent less 85 percent of the per-country foreign effective tax rate (the "residual minimum tax rate"). As a result, if the per-country foreign effective tax rate is greater than or equal to 22.35 percent, the domestic corporation's foreign income is "exempt" from U.S. tax in the sense that it has no U.S. tax liability.[58]

Under the proposal, the minimum tax for a particular country is computed by multiplying the applicable residual minimum tax rate by the minimum tax base for that country. A U.S. corporation's tentative minimum tax base with respect to a country for a taxable year is the total amount of foreign earnings for the taxable year assigned to that country for purposes of determining the effective tax rate for the country.

**Allowance for corporate equity ("ACE")**

Under the proposal, the minimum tax is computed country-by-country on the tax base assigned to the country. The tax base is the tentative minimum tax base reduced by an allowance for corporate equity. The ACE deduction provides a risk-free return on equity invested in active assets within the country. Under the proposal active assets generally include assets that do not generate foreign personal holding company income (determined without regard to both the look-through rule of section 954(c)(6) and any election to disregard an entity as separate from its owner).[59] (The ACE deduction in the Administration's minimum tax proposal is sometimes referred to as the "Administration's ACE deduction" in this document.)

**Foreign effective tax rate**

The foreign effective tax rate under the proposal is computed on an aggregate basis over a 60-month period ending on the date the domestic corporation's current taxable year ends, or in the case of a CFC, that ends on the date on which the CFC's current taxable year ends. For purposes of computing the foreign effective tax rate, the foreign taxes taken into account are those taxes that, absent the proposal, would be eligible to be claimed as a foreign tax credit during the 60-month period. The foreign earnings taken into account for the 60-month period are determined using U.S. tax principles, but would include disregarded payments deductible elsewhere, such as disregarded intra-CFC interest or royalties, and would exclude dividends from related parties. These rules would be further subject to rules applicable to hybrid arrangements discussed below.

**Assignment of earnings to a foreign country**

The Administration's proposal includes rules for assigning foreign earnings and taxes to a foreign country. The basic rule assigns earnings and taxes to the country based on the tax

[58] To arrive at the 22.35 percent figure, one solves for the foreign effective tax rate such that the minimum tax liability of 19 percent less 85 percent of the foreign effective tax rate equals zero. This foreign effective rate equals 19 percent/0.85, which is approximately 22.35 percent.

[59] The CFC look-through rule, currently expired, is made permanent in the President's fiscal year 2016 budget proposal. See section II.E. of this document for a discussion.

residence determined under foreign law. The Administration provides two examples. In the first example, a CFC is incorporated in Country X, but is a tax resident of Country Y under both the Country X and Country Y place of management tests for tax residence. In this example, the CFC's earnings and associated foreign taxes are assigned to Country Y for purposes of computing the foreign effective tax rate and the minimum tax. The Administration's second example follows the first, but instead of a place of management test, Country Y uses the place of incorporation test. Country X sees the CFC as a tax resident of Country Y, but Country Y sees the CFC as a tax resident of Country X. Here the CFC is not subject to foreign tax anywhere and the CFC's earnings are subject to the full 19 percent minimum tax under the proposal.

The proposal provides that where the same earnings of a CFC are subject to tax in multiple countries, the earnings and all of the foreign taxes associated with those earnings are assigned to the highest-tax country. For example, if a CFC incorporated in high-tax Country Z has a permanent establishment in low-tax Country Q and both Country Z and Country Q tax the earnings of the permanent establishment, the earnings and both the Country Z and Country Q taxes associated with those earnings are assigned to Country Z.

**Hybrid arrangements**

In assigning earnings to countries under the proposal, both for purposes of determining the foreign effective tax rate as well as for determining the tentative minimum tax base for a particular year, special rules are implemented to restrict the use of hybrid arrangements to shift earnings from a low-tax country to a high-tax country for U.S. tax purposes without triggering tax in the high-tax country. For example, no deduction is allowed for a payment from a low-tax country to a high-tax country that is treated as a dividend eligible for a participation exemption in the high-tax country. In addition, the earnings assigned to a low-tax country are increased for a dividend payment from a high-tax country that is treated as deductible in the high-tax country.

**Taxation of distributions of foreign earnings to U.S. parent corporations**

The Administration's minimum tax is imposed on current foreign earnings regardless of whether those earnings are repatriated to the United States. All foreign earnings could be repatriated without further U.S. tax. Thus, under the proposal, U.S. tax is imposed on a CFC's earnings either immediately (either under present law subpart F rules or the minimum tax proposal) or not at all (if the income is subject to sufficient foreign tax or is exempt pursuant to the ACE).

Additionally, taxation under section 956 of CFC investments in United States property and the section 959 and related rules for treatment of previously taxed earnings would be repealed for United States shareholders that are U.S. corporations.

**Changes to present law subpart F**

The proposal retains present law subpart F. Subpart F generally continues to require a United States shareholder of a CFC to include in its gross income on a current basis, at the full U.S. tax rate (with foreign tax credits available as provided under present law), the shareholder's share of the CFC's subpart F income, but the subpart F high-tax exception is made mandatory under the proposal for United States shareholders that are U.S. corporations.

**Sale of CFC stock**

Under the proposal, no U.S. tax is imposed on the sale by a United States shareholder of stock of a CFC to the extent any gain reflects the undistributed earnings of the CFC. These undistributed earnings would generally have already been subject to tax under the subpart F rules, the minimum tax, or the 14-percent one-time tax.[60] Additionally, the proposal taxes any stock gain attributable to unrealized gain in the CFC's assets in the same manner as would apply to the future earnings from the CFC's assets. Accordingly, stock gain is subject to the minimum tax or to tax at the full U.S. rate to the extent that the gain reflects unrealized appreciation in assets that would generate earnings subject to the minimum tax or subpart F, respectively.

**Royalties and interest payments**

Like present law, the Administration's proposal taxes at the full U.S. rate the foreign-source royalty and interest payments received by a U.S. corporate taxpayer. To the extent a foreign branch of a U.S. corporation uses intangible assets owned by the U.S. parent, the branch is treated under the proposal as making royalty payments to its owner that are recognized for U.S. tax purposes.

Interest expense incurred by a U.S. corporation that is allocated and apportioned to foreign earnings on which the minimum tax is paid is deductible at the residual minimum tax rate applicable to those earnings.[61] No deduction is permitted for interest expense allocated and apportioned to foreign earnings for which no U.S. income tax is paid.

**Regulatory authority**

The Administration's proposal grants authority to the Secretary to issue regulations to carry out the purposes of the minimum tax, including regulations addressing the taxation of undistributed earnings when a U.S. corporation owns an interest in a foreign corporation that has a change in status as a CFC or non-CFC, and regulations to prevent the avoidance of the purposes of the minimum tax through outbound transfers of built-in-gain assets or CFC stock.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2015.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.F, reprinted in the back of this volume.

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[60] See the discussion of the Administration's proposal to Impose a 14-Percent One-Time Tax on Previously Untaxed Income described in Part II.G. of this document.

[61] For analysis of the allocation and apportionment of interest, see Part II.C. of the document on the Administration's proposal to Repeal Delay in the Implementation of Worldwide Interest Allocation.

## Analysis

### Introduction

Global economic development and changes in how U.S. multinational enterprises ("MNEs") conduct their business operations abroad have prompted U.S. policymakers to reevaluate the tax treatment of cross-border income. Countries outside the United States have grown increasingly important as both consumers and producers of goods and services. Income growth in developing countries has opened up new markets for U.S. MNEs to sell goods and services. Improvements in infrastructure and information technology have made it more cost-effective for U.S. MNEs to establish some business operations, such as manufacturing facilities, abroad. U.S. MNEs have grown increasingly reliant on global supply chains to produce goods more efficiently and to serve foreign markets more effectively. These developments have put pressure on U.S. international tax rules to address and accommodate more complicated fact patterns concerning how U.S. MNEs organize themselves, serve foreign markets, and structure their production networks. Moreover, as U.S. MNEs generate growing amounts of income abroad, their economic positions have become more sensitive to how their foreign-source income is taxed, which has arguably increased the attention that they devote to how international tax rules are structured.

Policymakers may be concerned that U.S. international tax rules have not kept pace with developments in the global economy. As the link between the standard of living in the United States, and the activities of both foreign businesses in the United States and U.S. MNEs abroad, has arguably grown stronger, it may be the case that reform of the U.S. international tax system can have a significant impact on national welfare. In recent years, some policymakers have put forth legislative proposals to reform the tax treatment of cross-border income. Members of the U.S. Congress, including former Senate Finance Committee Chairman Ron Wyden, former Senate Finance Committee Chairman Max Baucus, Senator Mike Enzi, and former House Ways and Means Chairman Dave Camp, have made public or have introduced legislation to reform the U.S. international tax rules.[62] These reform proposals replace deferred U.S. taxation of the business earnings of foreign subsidiaries of U.S. companies with either full current U.S. taxation of foreign subsidiary earnings or a mix of current U.S. taxation of the earnings and exemption from U.S. taxation.[63]

The Administration's fiscal year 2016 budget proposes reforms to the U.S. international tax system that have similarities with some of these legislative proposals. A key component of the Administration's international tax reform plan is the proposal to establish 19 percent per-

[62] See: Bipartisan Tax Fairness and Simplification Act of 2011, S. 727 (112th Cong., 1st Sess., April 5, 2011) ("former Chairman Wyden's proposal"); United States Jobs Creation and International Tax Reform Act of 2012, S. 2091 (112th Cong., 2d Sess., Feb. 9, 2012), ("Senator Enzi's proposal"); former Chairman Baucus's staff discussion draft, Nov. 19, 2013 ("former Chairman Baucus's discussion draft" (or Option Y and/or Option Z thereof); The Tax Reform Act of 2014, H.R. 1 (113th Cong., 2d Sess., Dec. 10, 2014), ("TRA 2014").

[63] For analysis and comparison of these legislative proposals and discussion drafts, see: Joint Committee on Taxation, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises* (JCX-90-14), July 21, 2014.

country minimum tax with an ACE, thereby providing a mix of current taxation and exemption from U.S. taxation of CFC earnings. Like the legislative proposals mentioned previously, the Administration's minimum tax proposal—and its international tax reform plan as a whole—generally does not revisit, or resolve, some of the questions that are potentially fundamental to the design of the U.S. international tax system, including: (1) how income should be sourced, (2) how related-party transactions should be priced, and (3) how reliant U.S. international tax rules should be on the concept of residence. Nonetheless, even with its limited scope, the Administration's minimum tax proposal may have a large impact on the global pattern of investment and employment by U.S. MNEs, and the academic and policy literature concerning international taxation can shed light on some, but not all, issues involved in evaluating the proposal, including the ways in which the proposal impacts the economic behavior of U.S. MNEs as well as whether it creates the appropriate incentives to promote domestic employment and investment.

To analyze the Administration's minimum tax proposal, it is useful to start with two numerical examples of how it operates to illustrate some of the incentives it creates for U.S. MNEs and how it may affect the ability of U.S. MNEs to compete with foreign corporations in overseas markets. The first example (referred to as "Example 1" throughout the document) highlights how the proposal affects the decision of a U.S. MNE to invest in the United States or abroad. The second example ("Example 2") discusses the effect of the proposal on a U.S. MNE's ability to compete with foreign companies in overseas markets. Both of these examples illustrate how the impact of the Administration's minimum tax on the behavior of U.S. MNEs is not clear-cut and depends on assumptions made about the tax and economic environment in which the U.S. MNE operates. The examples also provide points of reference in evaluating certain design features of the minimum tax and serve as the foundation for the analysis in the rest of the document.

## Numerical examples

### Example 1: U.S. MNE choice between domestic and foreign investment

Consider a U.S. MNE choosing the location of an equity-funded $1,000 investment that is expected to earn a 10 percent pre-tax return each year.[64] Assume the U.S. MNE is deciding between making that investment in the United States, where its return is taxed at a 28 percent corporate rate, or through its CFC in Country A, where the effective rate of tax on those earnings is 15 percent.[65] For simplicity, assume the U.S. MNE is evaluating the investments on the basis

[64] It is assumed that the earnings generated by the investment do not constitute foreign personal holding company income. The type of investment made by the U.S. MNE may differ depending on the location of the investment, and may serve different business purposes (*e.g.*, a manufacturing plant in one country and an office space for engineers in another country). This example merely assumes that whatever investment is made earns a 10 percent return each year.

[65] This example uses a 28 percent U.S. corporate tax rate, rather than the (maximum) rate of 35 percent under present law, because the Administration's overall tax reform plan contemplates a 28 percent maximum U.S. corporate tax rate. See White House and the Department of the Treasury, "The President's Framework for Business Tax Reform," February 2012. The foreign effective rate of tax that is used for purposes of the minimum tax

of their after-tax return in the first year only and is not considering the liquidation value of its equity investment or how and where those earnings are reinvested.[66] All earnings from the U.S. investment are sourced to the United States, while all earnings from the Country A investment are sourced to Country A. Further assume that, for purposes of the ACE, the risk-free rate of return is two percent, and that the value of the equity investment is $1,000.[67]

The U.S. investment yields a pre-tax return of $100 each year (0.10 * $1,000). The tax due on these earnings is $28 (0.28 * $100 = $28), so that the after-tax return on the U.S. investment is $72.

In contrast, while the Country A investment yields the same pre-tax return of $100, it earns a greater after-tax return of $82.55 (accounting for both U.S. and foreign taxes paid), thereby making investment in Country A more attractive than investment in the United States. To arrive at this figure, first compute the Country A tax liability, which is $15 (0.15 * $100). The U.S. minimum tax liability equals 19 percent multiplied by the tentative minimum tax base (the "tentative minimum tax liability"), less 85 percent of the U.S. MNE's Country A tax liability.[68] The tentative minimum tax base equals $100 less the ACE deduction of $20 (the $1,000 equity investment multiplied by the risk-free rate of two percent), or $80. Therefore, the tentative minimum tax liability is 0.19 * $80 = $15.20. The U.S. minimum tax liability equals the tentative minimum tax liability of $15.20 less 85 percent of foreign taxes paid, or $15.20 – (0.85 * $15) = $2.45. As a result, the total U.S. and Country A tax liability on the U.S. MNE's earnings equals $15 + $2.45 = $17.45. The after-tax return on the Country A investment is therefore $100 – $17.45 = $82.55, which exceeds the after-tax return of $72 on the U.S. investment. The lower tax burden on the Country A investment, compared to the U.S. investment, arises because of (1) the lower effective tax rate in Country A and (2) the ACE deduction.

Interpretation of results

The above calculations show that the U.S. MNE prefers the Country A investment when the U.S. investment and Country A investment each yield the same pre-tax rate of return of 10 percent. However, it is not necessary for the pre-tax rates of return to be equal for this result to hold, and the U.S. MNE prefers to invest in Country A even if the Country A investment yields a

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calculation in the Administration's proposal is a five-year average. For simplicity, this example assumes that the five-year average rate is known to be 15 percent.

[66] The qualitative results of this example do not generally depend on these factors as long as comparable assumptions are made for each investment.

[67] The Administration's proposal does not fully specify how U.S. corporations should calculate the value of their equity invested in active assets for purposes of the ACE deduction. This issue is discussed below.

[68] The Administration's proposal calculates the U.S. minimum tax liability in terms of the residual minimum tax rate for a particular country. In the context of this example, computing the U.S. MNE's minimum tax liability using the foreign taxes paid to Country A yields the same result. For expositional purposes, U.S. minimum tax liability calculations in this document are usually expressed in terms of foreign taxes paid.

lower pre-tax return than the U.S. investment. This result can be seen in two ways. If the U.S. investment yields a pre-tax return of 10 percent, the U.S. MNE prefers the Country A investment as long as the Country A investment yields a pre-tax rate of return of at least 8.67 percent.[69] Alternatively, if the Country A investment yields a pre-tax rate of return of 10 percent, the U.S. investment must yield a pre-tax rate of return of at least 11.47 percent for the U.S. investment to be favored.[70] The economic implication is that the U.S. MNE may prefer the foreign investment even if it is less productive than the U.S. investment, which leads to an inefficient allocation of resources on the part of the U.S. MNE as well as lower investment in the United States.

The example may also be used to evaluate the interpretive significance (or lack thereof) of the 19 percent rate that the Administration has set at its minimum tax rate. While the 19 percent rate is used to compute a U.S. MNE's tax liability on its foreign-source income, it does not generally refer to the minimum foreign tax, minimum U.S. tax, or minimum combined U.S. and foreign tax that a U.S. MNE is expected to pay. As mentioned previously in the description of the Administration's proposal, in the absence of the ACE deduction, the U.S. MNE's investment in Country A faces no U.S. minimum tax liability as long as it is subject to an effective tax rate of at least 22.35 percent, meaning that the 19 minimum tax rate is not the minimum foreign effective tax rate at which no further U.S. minimum tax is due. In other words, in the absence of the ACE deduction, the 19 percent minimum tax rate is lower than the foreign effective tax rate at which no U.S. tax is owed (22.35 percent). With the ACE deduction in the Example 1, the U.S. MNE's earnings from the $1,000 investment are subject to no U.S. tax liability as long as the foreign effective tax rate is no lower than 17.88 percent.[71] In this case, the 19 percent minimum tax rate exceeds the minimum foreign effective tax rate at which no U.S. tax is owed (17.88 percent). Moreover, if the foreign effective tax rate were zero, the ACE deduction may lower the rate of the corporation's U.S. tax liability below 19 percent. As a

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[69] At a pre-tax rate of return of 8.67 percent, the Country A investment yields a $72.08 after-tax return, which is greater than the $72 after-tax return on the U.S. investment (which has a 10 percent pre-tax rate of return).

[70] At a pre-tax rate of return of 11.47 percent, the U.S. investment yields an after-tax return of $82.58, which is greater than the $82.55 after-tax return of the Country A investment (which has a 10 percent pre-tax rate of return).

[71] The tentative minimum tax liability is $15.20 in Example 1. To solve for the minimum foreign effective tax rate at which no U.S. tax is owed, divide this amount by 85 percent (= $17.88). A tentative minimum tax liability of $17.88 represents 17.88 percent of the $100 in earnings generated by the Country A investment.

Alternatively, one can arrive at a minimum foreign effective tax rate of 17.88 percent by multiplying 22.35 percent by 80 percent. 22.35 percent is the minimum foreign effective tax rate at which no U.S. tax is owed when the ACE deduction is zero. There is an ACE deduction in this example, and to account for it, recall that the tentative minimum tax base equals the earnings on the investment ($100) reduced by the ACE deduction of $20. The resulting tentative minimum tax base of $80 is 80 percent of the $100 generated by the investment.

To confirm that this is the minimum foreign effective tax rate at which no U.S. tax is owed, if the effective tax rate in Country A were 17.88 percent, taxes paid to Country A equal $17.88. The tentative minimum tax liability is 19 percent multiplied by $80, or $15.20. The U.S. minimum tax liability is the tentative minimum tax liability of $15.20 less 85 percent of foreign taxes paid, or $15.20 – 0.85*($17.88) = $0.

result, it is possible under the Administration's minimum tax proposal for a U.S. MNE to pay tax at a combined U.S. and foreign tax rate below 19 percent.

Example 2: U.S. MNE competing with foreign corporation for purchase of an asset

Consider a U.S. MNE bidding against a foreign multinational ("ForCo") for an asset located in Country A. The asset is short-lived and generates $1,000 in active income (sourced to Country A) in its first year and produces no income afterwards; it has no liquidation value. As in Example 1, the effective tax rate in Country A is 15 percent and that the risk-free rate of return used for calculating the ACE deduction is two percent.[72] Assume that required after-tax rate of return (the "hurdle rate") for both the U.S. MNE and ForCo is 10 percent. In other words, the U.S. MNE and ForCo only pursue those investments that yield at least a 10 percent after-tax rate of return. Furthermore, assume that the home country of ForCo exempts all its Country A earnings from home-country tax. To simplify calculations, assume that the value of equity invested in the asset for purposes of the ACE is its purchase price, and that the investment can be fully expensed (at a value equal to the purchase price) for purposes of computing a corporation's Country A tax liability.[73] This example is more stylized than example 1 because the calculations involved are more complicated.

ForCo is willing to pay up to $894.73 for the asset. To confirm that this figure is correct, note that ForCo requires an after-tax rate of return of at least 10 percent. The after-tax return is the amount of income that the investment generates ($1,000), less the purchase price of the asset and taxes due on the income. ForCo is willing to purchase the asset as long as the after-tax return, divided by the purchase price of the asset, is at least 10 percent. If ForCo acquires the asset for $894.73, its net income in Country A is $105.27 ($1,000 – $894.73). The Country A tax on these earnings is $15.79 (0.15 * $105.27); this is the total tax paid on these earnings because income sourced to Country A is exempt from tax in ForCo's home country. Therefore, the after-tax return on the income is $105.27 – $15.79 = $89.48, and $89.48 divided by $894.73 is approximately 10 percent, ForCo's required after-tax rate of return.[74]

After performing similar calculations as above, but taking into account the minimum tax due on the U.S. MNE's investment, the maximum that the U.S. MNE is willing to bid for the asset is $888.57, which is lower than what ForCo is willing to pay (suggesting that ForCo will

[72] The foreign effective rate that is used for purposes of the minimum tax calculation in the Administration's proposal is a five-year average. For simplicity, this example assumes that the five-year average rate is known to be 15 percent.

[73] As noted in example 1, above, the Administration's proposal does not fully specify how U.S. corporations should calculate the value of their equity invested in active assets for purposes of the ACE deduction. This issue is discussed below.

[74] To arrive at this figure algebraically, one solves for the value of the purchase price of the asset (denoted by $p$) such that the after-tax return (which equals $\$1{,}000 - p - (0.15)*(\$1{,}000 - p)$) on investment in the asset divided by the purchase price $p$ equals 0.10.

acquire the asset).[75] At any purchase price greater than this amount, the U.S. MNE's investment yields a rate of return below 10 percent. For example, if the U.S. MNE bid $894.73 for the asset—the maximum ForCo is willing to bid—the after-tax rate of return on the investment is 9.39 percent, which is below U.S. MNE's hurdle rate. The investment earns a lower after-tax return in U.S. MNE's hands because, unlike ForCO, U.S. MNE pays home-country tax on its Country A earnings in addition to its Country A tax liability.

Interpretation of results and their sensitivity

The U.S. MNE is at a competitive tax disadvantage relative to ForCo in bidding for the asset in the sense that ForCo is willing to pay more for it despite having the same hurdle rate as the U.S. MNE. If the asset goes to the highest bidder, than ForCo will acquire the asset instead of the U.S. MNE. However, this result hinges on the important assumption that the asset generates the same pre-tax return of $1,000 in the hands of both the U.S. MNE and ForCo. Corporations are generally not identical; there are differences between them that affect how they perform, such as their management quality, existing portfolio of assets (financial and non-financial, tangible and intangible), and workforce. Therefore, even within a highly stylized example such as this one, it may be unrealistic to expect that the Country A asset generates the same pre-tax return for both the U.S. MNE and ForCo if there are significant differences between the corporations. If the U.S. MNE and ForCo are bidding for a company in Country A, for example, that company may generate greater profits in the hands of the U.S. MNE, instead of ForCo, if the U.S. MNE manages the company better or if the products offered by the company fit better with the U.S. MNE's product line than ForCo. In the context of Example 2, if the Country A asset generates a higher pre-tax return under the U.S. MNE's control, then the U.S. MNE may be willing to pay more for the asset than ForCo. For example, if the asset earned a pre-tax return of $1,050 in the hands of the U.S. MNE (instead of the previous assumption of $1,000), then the U.S. MNE is willing to pay up to $933.00 for the asset, which is greater than the maximum of $894.73 that ForCo is willing to pay. This variation of Example 2 highlights how foreign assets may be more valuable overall under the control of a particular U.S. MNE even if they are more valuable from a tax perspective under the control of a foreign corporation.

The ability of ForCo to outbid the U.S. MNE also depends on the foreign effective rate in Country A. If the effective tax rate in Country A is 22.35 percent or greater, the U.S. MNE owes no U.S. tax on its Country A investment, and is therefore in the same competitive tax position as ForCo, whose home country exempts its Country A income from taxation. In this case, the maximum that the U.S. MNE is willing to pay for the Country A asset equals the maximum that ForCo is willing to pay, and the U.S. MNE is not at a competitive tax disadvantage in bidding for the Country A asset.

[75] To arrive at the figure of $888.57, one solves for value of the purchase price of the asset such that the after-tax return on investment in the asset, divided by the asset's purchase price, is at least 10 percent. Taking into account the minimum tax due on the U.S. MNE's return from investment in the asset makes the calculation more complicated than the calculation for the maximum price that ForCo is willing to pay for the asset. (The ACE deduction, for example, is a function of the purchase price itself.)

## Neutrality conditions

### Introduction

Traditional economic analysis of international tax rules has focused largely, but not exclusively, on the two margins studied in the numerical examples above: (1) the comparative tax treatment of domestic and foreign investments made by U.S. MNEs, and (2) the comparative tax treatment of investments made in a particular overseas market by a U.S. MNE and a foreign corporation. As described in more detail below, neutrality principles centering on these margins have been developed to assess the extent to which U.S. international tax rules promote an efficient allocation of capital. While their usefulness for policy development has been questioned, they serve as useful starting points for broader economic analysis of international tax rules in general and the Administration's minimum tax proposal in particular.

### Neutrality conditions and their limits

In the business context, taxes are generally thought to distort economic activity to the extent that they change economic behavior in ways that result in inefficient levels or patterns of investment. Analysts have settled on a number of general principles when it comes to evaluating whether tax rules promote economic efficiency in the purely domestic, closed-economy context. One general principle is that the pattern of aggregate investment may be more economically efficient if taxes are neutral with respect the type of investment being made, or more specifically, if effective marginal rates of taxation are the same across investments. If effective marginal rates of taxation vary by the type of investment made (because of different cost recovery rules or investment incentives), that may result in an inefficient allocation of resources and lead to lower levels of production. More resources flow to lightly-taxed sectors than would be the case if taxes were neutral with respect to types of investment, and fewer resources are devoted to more highly-taxed sectors. This will generally lead to lower levels of productive efficiency in the economy and reduce national welfare.

In the cross-border, open-economy context, there is significantly less consensus on the principles that should be used to evaluate international tax policy. A number of neutrality conditions—the most prominent of which are capital export neutrality and capital import neutrality—have been proposed to evaluate whether the international tax system promotes global (and not necessarily national) welfare. As efficiency criteria or general guides to the development of international tax policy, their usefulness has been questioned by a number of commentators. Their validity relies on special (and not necessarily realistic) assumptions concerning the substitutability of domestic and foreign investment, how investments are made (*e.g.*, greenfield investments or acquisitions of existing companies), and the existence of intangible capital.[76] Moreover, it is unclear if principles used to evaluate whether international

[76] For a discussion of the usefulness of the neutrality conditions and the assumptions under which they can be used as efficiency criteria, see American Bar Association Task Force on International Tax Reform, "Report of the ABA Task Force on International Tax Reform," *Tax Law Review*, vol. 59, no. 3, 2005-2006, pp. 652-812; Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," John W. Diamond and George R. Zodrow (eds.), *Fundamental Tax Reform: Issue, Choices, and Implications*, the MIT Press, 2008, pp. 319-354; Daniel N. Shaviro, *Fixing U.S. International Taxation*, Oxford

tax rules promote global welfare should be used by policymakers when designing their national tax systems, since policymakers may be more concerned with national, as opposed to global, welfare. Nonetheless, these neutrality principles are useful places to start when considering how to evaluate the international tax rules that a country adopts, and their limitations may shed light on what other principles may be more useful for analysis.

Capital export neutrality refers to a condition under which the overall effective tax rate on the return to investments made by a resident in any given country is the same regardless of where the investment is made. In other words, the decision made by a resident to invest at home or abroad is not influenced by tax considerations. As applied to U.S. international tax rules, this condition is met if the return to foreign and domestic investments made by U.S. investors are taxed currently at the same rate (*i.e.*, worldwide taxation without deferral) with unlimited foreign tax credits. Example 1 illustrates how the Administration's minimum tax proposal does not satisfy capital export neutrality because income from foreign investments made by U.S. MNEs may face a lower tax burden than income earned from a similar U.S. investment.

Capital import neutrality refers to a condition under which the overall effective tax rate on the return to investments made in any given country is the same regardless of the residence of the investor. As applied to U.S. international tax rules, this condition is met if foreign investments made by U.S. investors in any given country face the same overall tax burden as investments made by any other investor in that country. If the other investors are residents of that country or residents in countries that exempt foreign-source income from taxation, then capital import neutrality is satisfied if the United States exempts the foreign-source income of U.S. residents from taxation. Example 2 highlights how the Administration's minimum tax proposal does not satisfy capital import neutrality, since the returns to investments made in a particular overseas market may be taxed differently depending on whether the investment is made by a U.S. MNE or a foreign corporation (which may affect the degree to which foreign assets are owned by foreign corporations instead of U.S. MNEs).

Although the Administration's proposal satisfies neither capital export neutrality or capital import neutrality, that may not be important to policymakers. To the extent that U.S. policymakers are primarily concerned with promoting national welfare when designing tax policy, it is unclear whether promoting a globally efficient pattern of investment should be a policy goal.[77] For example, if it is the case that global economic welfare is increased if more investment moves outside the United States, because that capital is more productively deployed elsewhere, and that change in investment results in decreases in U.S. employment and growth, it is unclear if U.S. policy should promote that outward flow of investment. In other words, if investment is less productive in the United States than elsewhere, but that investment increases employment and growth in the United States relative to the case where that investment is made

University Press, 2014; and David A. Weisbach, "The Use of Neutralities in International Tax Policy," *National Tax Journal*, vol. 68, no. 3, September 2015, pp. 635-652.

[77] In public remarks, Treasury officials have explained that the proposal partly reflects a policy objective that is a compromise between capital export neutrality and capital import neutrality. See David D. Stewart, "U.S. Plans to Release New Model Tax Treaty as Draft," March 2, 2015.

elsewhere, national welfare may increase if that investment is made in the United States even if that action reduces global welfare. U.S. policymakers may prefer this result even though global welfare is reduced, since national welfare has increased. While the usefulness of the neutrality conditions as guides to the design of U.S. tax policy is limited because they cannot generally be used as efficiency criteria in the national context, they do highlight the general question of whether foreign or domestic investments should be taxed at the same rate, or whether overseas investments made by U.S. corporations should be taxed as the same or lower rate as similar investments made by their foreign competitors.

## Domestic employment and investment

### Introduction

U.S. policymakers are often concerned with promoting economic growth and the general economic well-being of the U.S. population, both of which are influenced significantly by the level of investment and employment in the United States. Therefore, policymakers may be more concerned with how the U.S. system of taxing cross-border income affects domestic investment and employment than the extent to which it promotes an efficient pattern of global investment.

Domestic investment and employment arises from a number of sources, including the activities of U.S. MNEs and other U.S. businesses as well as the U.S. activities of foreign multinationals. In turn, their investment decisions in the United States may be based on a number of factors, including: the quality of the U.S. workforce and the cost of labor; their expected sales growth both in the United States and abroad *(i.e.*, the demand for their goods and services); the location of both their customers and their input suppliers; taxes; and the economic benefits of locating activities in particular areas, such as a geographic region *(e.g.*, Silicon Valley), because, for example, of existing research networks and proximity to universities.

In the cross-border context, concerns about the competitiveness of the U.S. tax system have centered on policy objectives that include: (1) fostering the growth of U.S. MNEs abroad, (2) encouraging domestic investment by U.S. and foreign businesses, and (3) promoting U.S. ownership, as opposed to foreign ownership, of U.S. and foreign-sited assets. These particular policy objectives may be important to policymakers for a number of economic reasons described below, and may at times be in conflict with each other.

### Fostering the growth of U.S. MNEs abroad

The overseas growth of U.S. MNEs may be measured along a number of dimensions, including (1) sales to foreign markets and (2) overseas investment and employment. Policymakers may be interested in promoting the growth of U.S. MNEs because of the positive impact this may have on domestic investment and employment. However, the channel through which increased foreign sales impacts domestic investment and employment may differ from the channel through which increased foreign investment and employment affects the U.S. operations of a U.S. MNE. Therefore, their effects may differ and it may be useful to analyze the effects separately.

An increase in overseas sale made by a U.S. MNE, unaccompanied by changes in foreign investment and employment, may lead to greater domestic investment and employment.[78] For example, a company may increase employment at a U.S. manufacturing plant, or build new U.S. facilities, if sales of its U.S.-made goods increase abroad. Likewise, an opportunity to expand into a new foreign market may increase the resources that a company puts into its U.S.-based marketing and management activities as it aims to gain a foothold in that market. To the extent that a U.S. company relies on its domestic operations to serve foreign markets, increased sales overseas should increase domestic investment and employment. In addition, an increase in earnings may increase the value of the U.S. MNE, the benefits of which could accrue primarily to U.S. shareholders given the documented "home bias" in portfolio investments (*i.e.*, the disproportionate share of local equities that investors hold in their portfolio relative to what theories of the benefits of international diversification would predict).[79] Income gains by U.S. shareholders may be important to the extent that a goal of U.S. policymakers is to improve the standard of living in the United States.

In contrast to overseas sales growth, it is less clear whether increased foreign investment and employment, by themselves, have a positive impact on domestic investment and employment. For example, a U.S. MNE may move its U.S.-based manufacturing operations overseas to take advantage of lower labor costs, thereby reducing domestic investment and employment. U.S. shareholders may still benefit in this case if the earnings (and value) of the U.S. MNE have increased. However, the welfare loss from reduced domestic employment and investment may exceed whatever welfare gain accrues to U.S. shareholders. It may also be the case that foreign investment and employment complements domestic investment and employment. For example, increased foreign investment and employment may be a precursor to increased overseas sales and profits, which may provide a U.S. MNE with funds to make more domestic investments and expand its domestic workforce.

Example 1 shows that under the Administration's minimum tax proposal, the U.S. MNE may have an incentive, from a tax perspective, to invest abroad rather than in the United States. The economic impact of such an incentive is unclear because there is inconclusive evidence on whether foreign investment and employment complements, or substitutes for, domestic investment and employment. One study finds that expansion of a company's domestic economic activity is associated with expansion in the activity of its foreign affiliates.[80] However, this can occur if a company develops a new product and expands its sales force both in the United States and overseas.[81] In this case, domestic investment and employment growth coincides with, but is

[78] This particular claim concerns sales and is distinct from the claim that foreign investment and employment is a substitute for, or complement to, domestic investment and employment.

[79] The degree of home bias for developed countries has been declining over time. For a review of the literature on home bias in portfolio holdings, see Nicolas Coeurdacier and Hélène Rey, "Home Bias in Open Economy Financial Macroeconomics," *Journal of Economic Literature*, vol. 51, no. 1, March 2013, pp. 63-115.

[80] Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, vol. 1, no. 1, February 2009, pp. 181-203.

[81] The authors of the study recognize this problem and attempt to correct for it in their analysis.

not caused by, foreign investment and employment growth. Another study finds that, on average, increases in domestic employment by U.S. MNEs are associated with increases in employment of their foreign affiliates.[82] However, this result holds only for affiliates in high-income countries. For affiliates in low-income countries, where labor costs may be lower than in the United States, the authors found that foreign employment growth is associated with reductions in U.S. employment. If the domestic effect of increasing foreign investment and employment in a given country depends on some characteristic of that country (*e.g.*, its per-capita income), that may suggest that the tax treatment of foreign-source income should, in theory, depend on the country in which that income is earned, and that an exemption system that applies uniformly across countries may promote domestic employment and investment less effectively (if at all) than an exemption system whose application varies by country in some way. For example, if it is the case that foreign employment and investment in high-income, but not low-income, countries complements domestic employment and investment, and high-income countries tend to have higher effective tax rates on business income, then proposals that exempt income earned in high-tax countries may be better targeted at increasing domestic employment and investment than proposals that exempt income earned in both high-tax and low-tax countries. The Administration's minimum tax proposal accomplishes this to some extent by imposing no U.S. tax liability on U.S. MNE earnings in jurisdictions where the foreign effective tax rate is 22.35 percent or greater (or less if there is an ACE deduction).

Encouraging domestic investment by U.S. businesses and foreign businesses

Higher levels of domestic investment by U.S. and foreign businesses may contribute to U.S. economic growth and job creation. For example, when a U.S. business makes a new investment, such as constructing a new factory or research facility, it may need to hire workers as part of the investment. The investments they make may also increase the productivity of the operations of the U.S. business which may promote overall economic growth in the United States and potentially raise wages (to the extent that workers' wages rise as their productivity rises). These same economic effects are not restricted to domestic investments by U.S. businesses and could be brought about by domestic investments made by foreign businesses.

Promoting U.S. ownership of U.S. and foreign assets

Some policymakers may prefer that ownership of U.S. and foreign assets resides with U.S. persons instead of foreign persons. With regards to foreign assets, U.S. ownership may confer a number of benefits on the U.S. economy. Foreign assets may serve as a platform for overseas expansion and growth, potentially increasing domestic employment and investment. In addition, when a U.S. company acquires a foreign company, it may also be acquiring intangibles (such as intellectual property and managerial know-how) that complement its existing U.S. operations and enhance their effectiveness. Moreover, income generated from the asset will be part of the U.S. income tax base rather than the income tax base of another country, at least under present law.

[82] Ann E. Harrison, Margaret S. McMillan, and Clair Null, "U.S. Multinational Activity Abroad and U.S. Jobs: Substitutes or Complements," *Industrial Relations*, vol. 46, no. 2, April 2007, pp. 347-365.

Relative to situations involving U.S. ownership of a foreign asset, it is less clear how, as a general matter, U.S. ownership of a U.S. asset benefits the U.S. economy more than foreign ownership of a U.S. asset. Some may argue that a foreign-owned U.S. company may hire fewer U.S. workers, or invest less in the United States, than would be the case if that company had a U.S. parent. However, to the extent that the parent—U.S. or foreign—of the U.S. company is charged with maximizing shareholder value, it should make employment and investment decisions based on what maximizes profits, and without further regard to where those economic activities take place (at least to a first approximation). In other words, both the potential U.S. and foreign parents will hire the most qualified workers, and make the most productive investments, regardless of nationality or location. However, if the potential U.S. parent and foreign parent have operational differences, these differences could influence U.S. investment and employment. For example, when a foreign company acquires a U.S. company, the headquarters operations of the U.S. company may move outside the United States if operations are managed more effectively where the foreign parent's central management is located, which may often be outside the United States. This may result in direct employment losses in the United States as well as some of the local economic benefits that accompany headquarters operations, including involvement in philanthropic activities.[83] There is little research on the magnitude or existence of these local economic benefits, however.

A foreign company that starts a new venture in the United States by making new investments ("greenfield investments") instead of acquiring an existing company may benefit the U.S. economy by increasing employment and investment. This positive economic impact may come at the expense of U.S. businesses, though. For example, the foreign company's U.S. venture may be competing directly with a U.S. company for control of a market for a particular product. If the foreign company's U.S. venture succeeds in controlling the market at the expense of its U.S.-based competitor because its products are more attractive and the company is managed more efficiently, for example, net investment and employment in the United States may still increase. However, what could have been a U.S.-headquartered company controlling a market segment is now a foreign-headquartered company. If policymakers are concerned about this scenario, though, that concern may be in conflict with the goal of encouraging U.S. investment by foreign corporations.

The U.S. economic impact in the second hypothetical example—where a foreign person makes a new investment in the United States—contrasts with that of the first hypothetical example, where a foreign company acquired an existing U.S. company. In both cases, a foreign-headquartered company owns a U.S. asset that could have been owned by a U.S.-headquartered company. However, there is a positive U.S. economic impact in the example where a foreign company makes a new investment, while there is a negative U.S. economic impact in the example where a foreign company acquires an existing U.S. company and moves its headquarters overseas. These examples, and the U.S. economic impact described, are hypothetical, but they illustrate that the distinction between foreign ownership of an existing U.S. asset versus a new U.S. asset may be important for the economic analysis. However, there is

[83] David Card, Kevin F. Hallock, and Enrico Moretti, "The Geography of Giving: The Effect of Corporate Headquarters on Local Charities," *Journal of Public Economics*, vol. 94, nos. 3-4, April 2010, pp. 222-234.

little empirical evidence on the extent to which these hypothetical examples reflect existing investment patterns, and if so, whether, on balance, U.S. ownership of U.S. assets provides greater economic benefits to the United States than foreign ownership of U.S. assets.

A general consideration to take into account is whether a U.S. asset is more productive under foreign ownership than U.S. ownership for purely economic reasons. A foreign company, for example, may have a stronger overseas presence (in the relevant markets) than prospective U.S. acquirers of a U.S. company, and may facilitate the global expansion of the U.S. company more effectively. The economic case for promoting U.S. ownership of the U.S. company in this situation is unclear. However, if the U.S. company is more productive under U.S. ownership, but for tax reasons is more valuable in the hands of a foreign owner, there may be a stronger case for designing tax rules to promote U.S. ownership of these assets.

Some may contend that the Administration's proposal exacerbates the existing tax disadvantage that U.S. MNEs face, and in the process, increases the tax savings that could result when the multinational changes its tax residence, such as through a foreign acquisition or through an inversion transaction. This may result in more foreign ownership of U.S. assets, as well as less U.S. ownership of foreign assets, as shown in Example 2. The magnitude of such a geographic shift in ownership is unclear, as is the potential economic effect. The magnitude is unclear as tax considerations are only one of a number of factors that influences the decision to purchase an asset, as the discussion in Example 2 illustrates. Moreover, to the extent that a U.S. MNE is earning profits in jurisdictions where its foreign effective rate is greater than 22.35 percent (which is lower than the median statutory corporate rate in the OECD), it will not be at a tax disadvantage relative to local competitors because it will owe no U.S. tax. Indeed, some may argue that the 19 percent minimum tax rate is too low, and that raising the rate will increase tax revenue with minimal effect on the foreign operations, or international competitiveness, of U.S. MNEs.

**The lockout effect**

Introduction

The Administration's minimum tax proposal addresses one of the principal concerns with the current system—the "lockout effect"—by taxing income currently or not at all. The lockout effect is a colloquial reference to the possibility that the overseas earnings of U.S. MNEs are being "locked out" and not reinvested in the United States because U.S. MNEs have a tax incentive, created by deferral, to reinvest foreign earnings rather than repatriate them. This may occur if U.S. MNEs choose to make foreign investments, rather than domestic investments, because the ability to elect to defer payment of residual U.S. tax liability on the returns to the foreign investments may make those foreign investments more attractive on an after-tax basis, even if they yield the same pre-tax return as a domestic investment. The lockout effect disappears if repatriation of overseas earnings has no tax consequence.

Researchers have estimated significant efficiency costs associated with the actions companies undertake to accumulate earnings offshore in order to postpone payment of residual U.S. tax. These costs reflect the costs of tax planning; foregone domestic investment

opportunities; an inefficiently large number of acquisitions of foreign companies that result from tax-motivated decisions of companies to keep earnings offshore; and other factors.[84]

The "lockout effect" under the Administration's minimum tax proposal

The Administration's minimum tax proposal, in conjunction with the Administration's proposal for a one-time tax of 14 percent on previously untaxed foreign income, eliminates the lockout effect.[85] Colloquially, Administration's minimum tax eliminates the lockout effect on "new earnings," while the one-time tax of 14 percent on previously untaxed foreign income eliminates the lockout effect on "old earnings."

The Administration's minimum tax eliminates the lockout effect on new earnings because income is either exempt from tax or taxed currently. Income subject to a foreign effective tax rate of at least 22.35 percent, or income shielded by the ACE deduction, is exempt from U.S. tax. All other income bears some residual, and final, U.S. tax. By eliminating lockout, the Administration's proposal may promote U.S. economic activity as companies may increase domestic employment and investment or payouts to shareholders, who may be primarily U.S. residents.

The Administration's minimum tax operates outside the structure of subpart F. While a CFC's subpart F income is limited to its current earnings and profits, there is no comparable limit in the Administration's proposal. Since the foreign effective tax rate used for purposes of the minimum tax calculation is a five-year average, it may be significantly higher than the foreign effective rate on income attributable to the operations of the U.S. MNE in a particular country in any one year. This may arise, for example, when income earned by a U.S. MNE's CFCs is highly taxed in a particular country in the current year, but subject to little or no tax in the previous four years. As a result, the U.S. tax liability on the income of CFCs in a particular country under the minimum tax may exceed the income of the CFCs. This may create possible liquidity problems for the U.S. MNE and may argue for adopting some form of limitation on a U.S. MNE's minimum tax liability in the Administration's minimum tax proposal. However, some may point out that the liquidity problem is mitigated to the extent that the U.S. MNE has a significant amount of accumulated after-tax earnings from its operations in a foreign country because the income from those operations has been subject to little or no tax in prior years.

Design issues and economic considerations

In the cross-border context, there is no standard way of designing a U.S. "minimum tax" system because any such system can reflect a range policy decisions made on key design

[84] A calculation of the efficiency cost of the lockout effect can be found in Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," *National Tax Journal*, vol. 66, no. 3, September 2013, pp. 671-712. Further discussion can be found in Rosanne Altshuler, Stephen Shay, and Eric Toder, "Lessons the United States Can Learn from Other Countries' Territorial Systems for Taxing Income of Multinational Corporations," Tax Policy Center, January 21, 2015.

[85] For a description and analysis of the Administration's proposal to impose a one-time tax of 14 percent on previously untaxed foreign income, see section II.G. of this document.

features. These features include: (1) whether the minimum tax refers to the overall tax burden on the return on foreign investment, the U.S. tax burden, or the host-country tax burden; (2) the type of income that is subject to the minimum tax; (3) whether the minimum tax is computed at the global level, the country level, the CFC level, or another level; and (4) how double-taxation is relieved. The Administration's proposal reflects a choice to impose the minimum tax burden on a country-by-country basis on non-subpart F income, with double-taxation relieved by allowing for a corporation's minimum tax liability in a given country to be reduced by 85 percent of its foreign effective tax rate in that country.

**Allowance for corporate equity**

Introduction

The ACE deduction that forms part of the Administration's minimum tax proposal can be traced to more general work done by economists on designing a corporate tax system that does not distort the investment behavior of firms.[86] As part of that work, some economists have proposed a general system ("ACE system") under which corporations can deduct an allowance for corporate equity that equals the historical value of shareholders' equity multiplied by a nominal interest rate that reflects the opportunity cost of equity finance.[87] For a shareholder, the opportunity cost of equity finance is the rate of return on his next-best investment opportunity (*i.e.*, the rate of return that a shareholder foregoes by investing in the corporation). In other words, the opportunity cost of equity finance is the rate of return, or hurdle rate, that a shareholder requires in order to invest in the corporation instead of pursue its next-best investment. Under certain assumptions, the ACE system is neutral with respect to the level of investment, the form it takes (*i.e.*, type of asset), and the way in which it is financed (*i.e.*, with the use of debt or equity).[88]

The ACE deduction in the context of an ACE system is distinct from the ACE deduction in the Administration's minimum tax proposal. They are both used to calculate a return that should be exempt from home country tax. However, while the Administration's ACE deduction is intended to represent "a return on the actual activities undertaken in a foreign country," the ACE deduction in an ACE system is meant to promote neutral tax treatment of investment and is

[86] For a review of this work, see Alan J. Auerbach, Michael P. Devereux, and Helen Simpson, "Taxing Corporate Income," in James Mirrlees, Stuart Adam, Timothy Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba (eds.), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press, 2010, pp. 837-893.

[87] See Robin Boadway and Neil Bruce, "A General Proposition on the Design of a Neutral Business Tax," *Journal of Public Economics*, vol. 24, no. 2, 1984, pp. 231-239; Institute for Fiscal Studies Capital Taxes Group, "Equity for Companies: A Corporate Tax for the 1990s," Institute for Fiscal Studies, April 1991; and Stephen R. Bond and Michael P. Devereux, "On the Design of a Neutral Business Tax Under Uncertainty," *Journal of Public Economics*, vol. 58, no. 1, 1995, pp. 57-71. A summary of the ACE system and its economic effects can be found in Michael P. Devereux, "Issues in the Design of Taxes on Corporate Profit," *National Tax Journal*, vol. 65, no. 3, September 2012, pp. 709-730.

[88] *Ibid*. These assumptions include a constant tax rate and symmetric tax treatment of gains and losses.

a general feature of how corporate income is taxed domestically.[89] As a result, the Administration's ACE deduction is calculated differently from an ACE deduction in an ACE system, and theoretical results concerning the design of the ACE deduction in an ACE system are not generally applicable to the design of the Administration's ACE deduction. However, to facilitate economic analysis of the Administration's ACE deduction and how it should be designed, it is instructive to examine how the ACE deduction operates in the context of the ACE system.

ACE deduction in an ACE system

The base for the allowance for corporate equity in an ACE system is the closing value of shareholders' equity in the current tax year and is calculated as follows:[90]

| | | |
|---|---|---|
| Opening value of shareholders' equity: | | |
| | + | Equity allowance given in the prior tax year |
| | + | Taxable profits (net of the equity allowance) in the prior tax year |
| | + | Dividends from other companies |
| | + | Net new equity issues |
| | – | Tax payable on taxable profits in the previous tax year |
| | – | Dividends paid |
| | – | Net new acquisitions of shares in other companies |
| Closing value of shareholders' equity in the current tax year | = | Opening value of shareholders' equity in the next tax year |

The ACE deduction equals the ACE base multiplied by a nominal interest rate that reflects the opportunity cost of equity finance. Assuming a constant tax rate and symmetric tax treatment of gains and losses, the nominal interest rate that promotes neutrality with respect to

[89] A limited number of countries, including Belgium and Italy, have adopted some form of allowance for corporate equity as part of their general corporate tax system. It is sometimes referred to as a notional interest deduction. The tax treatment of foreign-source income in an ACE system presents certain complications described in Rachel Griffith, James Hines, and Peter Birch Sorensen, "International Capital Taxation," in James Mirrlees, Stuart Adam, Timothy Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba (eds.), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press, 2010, pp. 914-996.

[90] Note that acquisitions of shares in other companies is excluded from the ACE base to avoid "double counting" (*i.e.*, the same equity cannot be included in the ACE base of two corporations). This particular presentation of the formula for the ACE base draws on Graeme S. Cooper, "Implementing an Allowance for Corporate Equity," *Australian Tax Forum*, vol. 27, 2012, pp. 241-271, and is equivalent to the conventional calculation as described in Institute for Fiscal Studies Capital Taxes Group, "Equity for Companies: A Corporate Tax for the 1990s," Institute for Fiscal Studies, April 1991.

investment is the nominal risk-free rate, even if the investment itself is risky.[91] The optimality of applying the nominal risk-free rate, instead of a rate that includes a risk premium, partly rests on the symmetric tax treatment of gains and losses: since the firm receives the ACE deduction with certainty (*e.g.*, in loss years), the appropriate nominal interest rate should also be one that reflects a certain payment.[92] If the rate used for calculating the ACE deduction were greater than the nominal risk-free rate, a corporation would be biased toward financing investment through equity instead of debt.

One theoretical feature of the ACE system is that investment is neutral with respect to tax depreciation schedules.[93] Any benefit that a corporation receives from a more generous (*i.e.*, more accelerated) cost recovery schedule is offset by a reduction in the present value of its ACE deductions. For example, assume that, for a particular corporation, $1 of depreciation allowance is accelerated from the second year of an asset's life to its first year. The acceleration reduces the corporation's tax liability in the first year, increasing its after-tax profits. However, the corporation's tax liability in the second year increases directly (because of the lower depreciation allowance) and indirectly because its ACE deduction decreases. (From the formula for the ACE deduction in the second year, a larger depreciation allowance in the first year results in a decrease in taxable profits in the first year that exceeds the decline in taxes paid in the first year, lowering the ACE deduction overall for the second year.) Theoretically, it can be shown that the increase in the present value of depreciation allowances resulting from the acceleration of $1 of depreciation allowance into the first year is offset by a reduction in the present value of ACE deductions.[94]

ACE deduction in the Administration's minimum tax proposal

While a number of countries have adopted an allowance for corporate equity as part of their general corporate tax system, the Administration does not do so and instead uses the allowance as a way to calculate a return to "actual activities undertaken in a foreign country." The Administration's minimum tax proposal does not fully detail how the ACE deduction should be calculated but does describe its general structure. Under the Administration's minimum tax proposal, the ACE deduction equals a risk-free rate of return multiplied by the value of equity invested in "active assets," which generally encompasses only those assets that do not generate foreign personal holding company income. According to the Administration's budget proposal, the policy goal is to exempt that portion of income attributable to "actual activities undertaken in a foreign country." By doing so, the Administration's proposal may partly address the concern

[91] See and Stephen R. Bond and Michael P. Devereux, "On the Design of a Neutral Business Tax Under Uncertainty," *Journal of Public Economics*, vol. 58, no. 1, 1995, pp. 57-71.

[92] For a discussion and proof of this result, see Stephen R. Bond and Michael P. Devereux, "Generalized R-Based and S-Based Taxes Under Uncertainty," *Journal of Public Economics*, vol. 87, nos. 5-6, pp. 1291-1311.

[93] See and Stephen R. Bond and Michael P. Devereux, "On the Design of a Neutral Business Tax Under Uncertainty," *Journal of Public Economics*, vol. 58, no. 1, 1995, pp. 57-71.

[94] *Ibid*.

that U.S. corporations are at a competitive tax disadvantage relative to foreign corporations whose home countries exempt their foreign-source income.

Conceptual issues

The Administration's minimum tax proposal relies on the ACE deduction to calculate the return to actual activities, but there are other methods of calculating this return that have different economic implications. For example, one can allow corporations to expense investments made in foreign countries, which effectively exempts (from U.S. tax) the required return on that investment (sometimes referred to as a "normal" return). The Tax Reform Act of 2014 ("TRA 2014") proposed another method of calculating a required return that equaled the CFC's adjusted tax basis in depreciable property multiplied by 10 percent.[95] These two methods do not exhaust alternatives to the allowance for corporate equity for calculating a return that should be exempt from tax, or at least receive favorable tax treatment. For example, Option Z in former Chairman Baucus's international tax reform discussion draft relies on a less formulaic, and more qualitative definition of the "active foreign market income" that is eligible for a reduced rate under the system it establishes.[96] Administrative simplicity, however, may favor a formulaic approach versus a non-formulaic approach to calculating a normal return. A question arises concerning the extent to which the various formulaic methods of calculating or deriving a required return—the Administration's ACE deduction, immediate expensing, or a 10-percent return on depreciable property—accurately reflects a return to actual activities undertaken in a foreign country.

For example, assume that a CFC invests in a research facility (including the underlying land) where a drug compound is discovered, and for which it receives royalty payments from related parties for use of that compound. Both expensing and the allowance for a return on tangible property provides for some required return to investment in the research facility, although not a return to the investment in land. However, it is unclear whether the equity invested in the research facility or the land would be included as part of the allowance for corporate equity, since the principal source of income generated by the research facility consists of foreign personal holding company income (in this case, royalties).[97] To the extent that the operations of the research facility represent actual activities undertaken in a foreign country, the category of assets eligible for the Administration's ACE deduction may be under-inclusive if the value of equity invested in the research facility is excluded from the ACE base.

However, if the research facility were instead a manufacturing facility that produced goods for sale abroad, both the equity invested in the manufacturing facility, and the land on which it sits, are included in the Administration's ACE deduction, while only the investment

[95] See sec. 4211 of TRA 2014.

[96] See sec. 1 of Option Z of former Chairman Baucus's discussion draft.

[97] Royalties are not considered foreign personal holding company income if they meet the active royalty exception of section 954(c)(2)(A). However, since the royalties in this example are received from related parties, they do not qualify for the active royalty exception.

(whether debt- or equity-financed) in the manufacturing facility can be expensed or is allowed a return under the other methods of calculating a required return (expensing or an allowance for a 10-percent return on depreciable property). In this case, more assets are potentially included in calculating the Administration's ACE deduction than under the other methods, because the ACE deduction is not limited to those assets that are depreciable or that can be expensed (including land, inventory, and certain intangibles).

For any asset that is eligible for the ACE deduction, only a portion of the value of the asset may be included in the base for the allowance for corporate equity if the acquisition of these assets is largely financed by debt. It is unclear if the source of an investment's financing should determine whether the return on that investment reflects actual activities undertaken in a foreign country or if exemption should generally depend on a CFC or branch's capital structure. The Administration's minimum tax proposal reflects both of these principles by virtue of how the ACE deduction is calculated. In contrast, methods of calculating a required return that allow for immediate expensing, or allow for a 10 percent return on depreciable property, generally do not depend on how an investment is financed, although these methods could be modified to depend on the source of investment. However, since debt financing generates interest expense deductions that themselves shield income from the minimum tax, excluding from the ACE base the portion of the value of an asset that is financed with debt accomplishes the policy objective of not allocating deductions to income that is exempt from tax.

Design issues

The above example also highlights a key difference between the Administration's ACE deduction and the ACE deduction in an ACE system. The ACE base in an ACE system is calculated based on shareholders' total equity and does not depend on how that equity is invested, or whether the return to that investment is considered active income or passive income (such as dividends, interest, rents, and royalties). In contrast, equity invested in active assets—which generally do not include assets that generate dividends, interest, rents, and royalties—is generally excluded from the Administration's ACE base. To the extent that it is difficult to determine whether an asset generates active income or passive income (as the research facility example above demonstrates), the Administration's ACE deduction is more complicated to calculate than the ACE deduction in an ACE system, where it is not necessary to track the form in which shareholders' equity is deployed. (The policy goals of the Administration's ACE deduction and the ACE deduction in an ACE system differ, however.) Additionally, the Administration's minimum tax proposal does not describe how a corporation should compute its ACE deduction when one of its CFCs hold equity in another CFC—equity may be "double-counted" in this case. In an ACE system, such equity is excluded from the ACE base.

Even when it is determined that an asset is an active asset, the Administration's proposal does not specify how to calculate the value of equity invested in that active asset. For example, the value of these active assets may be based on their historical cost, fair market value, adjusted tax basis, or other method of valuation, and it is unclear if equity itself is computed using tax or financial accounting principles. Calculating the Administration's ACE base using the historical cost of active assets may allow for administrative simplicity to the extent that historical cost is known and easily tracked, but doing so is likely to overestimate the return to actual activities, which is what the ACE deduction is meant to approximate in the Administration's minimum tax

proposal. Active assets generally depreciate and become less productive over time. Therefore, the return on these assets generally declines over time. However, calculating the Administration's ACE deduction using the historical cost of active assets assigns the same return to "actual activities," as reflected in the use of the active asset, at the beginning of the asset's useful life as near the end of its useful life. In other words, an asset's historical cost is fixed over time, and using the historical cost of an active asset to calculate the Administration's ACE deduction may rely on an incorrect assumption, which is that the return on that asset is constant over time (at least until the asset is disposed of). Using the fair market value of assets—which generally tracks the income-producing capacity of an asset—may better reflect the Administration's policy goal of exempting the return to actual activities undertaken in a foreign country. However, determining the fair market value of assets may present administrative difficulties. This valuation is not currently done for tax purposes, and the fair market value may be difficult to determine for assets with a limited resale market (although this latter problem is mitigated by the definition of active assets). Calculating the Administration's ACE deduction based on an asset's adjusted tax basis may be a more administratively simple (but potentially inaccurate) way of accounting for the general decline in the economic value of an asset. However, it is a more accurate way of calculating the economic value of an asset than using its historical cost, which is fixed over time.

Once the value of equity invested in active assets is determined for purposes of the Administration's minimum tax proposal, a risk-free rate is applied to determine the ACE deduction. However, the risk-free rate may be inappropriate. The optimality of using the risk-free rate when calculating the ACE deduction in an ACE system hinges on the assumption that gains and losses are treated symmetrically for tax purposes. If that assumption does not hold, as is the case in the U.S. tax system, then applying the risk-free rate to the Administration's ACE base may not be optimal. When there is asymmetric tax treatment of gains and losses, using a higher interest rate that allows for a risk premium may be more appropriate, since the downside risk of a company's investment is no longer shared with the government. The ability to carry forward unused ACE deductions may allow for more symmetric tax treatment of gains and losses, but the Administration does not specify whether that can be done in its minimum tax proposal.

The Administration's ACE deduction also depends on a number of other proposals in the Administration's overall international tax reform package, including making permanent the (currently expired) active financing exception ("AFE").[98] Under the active financing exception, certain qualified banking, finance, or insurance income that would otherwise be considered foreign personal holding company income would be excluded from foreign personal holding company income. A permanent active financing exception, in the context of the Administration's minimum tax proposal, would provide companies with a risk-free return on equity invested in assets generating AFE income. To the extent that the rate of return on gross assets held by financial companies is lower than that of non-financial companies, and more generally, to the extent that rates of return differ across industries and countries, it is unclear if a

[98] The President's fiscal year 2016 budget proposal makes AFE permanent. See section II.D. of this document for a discussion.

uniform rate of return should be used in determining the allowance for corporate equity. In particular, it may be the case the rate of return applied to assets generating AFE income for purposes of the ACE should be lower than the rate of return applied to other active assets, since the required rates of return on assets generating AFE income may be lower than the required rate of return on other active assets. However, financial companies are typically more highly leveraged than non-financial companies, so the value of the gross assets included in the allowance for corporate equity may be reduced significantly by debt. In this case, the reduction in the ACE deduction resulting from excluding the debt-financed portion of assets generating AFE income may offset the use of a required rate of return that is otherwise higher than optimal.

**Other components of Administration's proposal**

Foreign effective tax rate calculation

The Administration's proposal taxes foreign earnings using a residual minimum tax rate. This tax rate is computed by subtracting 85 percent of the per-country foreign effective tax rate from the proposal's minimum 19 percent tax rate. The foreign effective tax rate is computed on an aggregate basis with respect to all foreign earnings and the associated foreign taxes assigned to a country. The foreign effective tax rate is determined over a rolling 60-month time period that ends on the domestic corporation's taxable year end or for the CFC on the date on which the CFC's current taxable year ends.

The concepts of earnings and foreign taxes are generally computed using U.S. tax principles under the proposal. However, where the earnings and taxes are assigned is based on the tax residence under foreign law. The proposal attempts to mitigate some of the concerns raised related to the use of foreign taxes and U.S. earnings to determine the effective tax rate, and thus, taxability of foreign income. Other proposals have done these computations on a single year at a single entity level. Timing differences, net operating losses, and group losses or consolidated tax filings in other countries could significantly affect the computation of the foreign effective tax rate. By averaging the foreign tax rate computation over a rolling 60-month period, some of the timing differences and net operating effects on the tax rate computation are mitigated. Computing the tax rate by combining all of the foreign earnings in a single country mitigates some of the group loss and consolidated return concerns. However, without specific adjustments for net operating losses or allowing averaging over the life of operations within a country, there could still be fluctuations in the foreign effective tax rate from year to year. The Administration may argue that some cut-off in the computation of effective tax rates is necessary for the administration of the proposal, and that a 60-month time period is a reasonable period of time within which many temporary differences will turn.

Another argument some use against using the foreign tax rate as a limitation is that the U.S. taxpayer is indifferent between paying tax in the foreign jurisdiction or in the United States. The Administration's proposal addresses this concern by limiting the reduction against the 19 percent minimum tax by only 85 percent of the foreign taxes paid. This adjustment raises the cost of paying foreign taxes and puts some burden on the taxpayer to reduce the foreign taxes paid.

Country-by-country calculation

Under the proposal, the computation of foreign effective tax rates and the computation of the residual minimum tax rate are done country-by-country at the domestic shareholder level. Each shareholder combines the earnings and taxes from each CFC, branch or service income within each individual country. While computing the tax rates at the country level may mitigate some of the issues raised in countries that allow group losses or group consolidated returns, it may also add complexity to the computation of U.S. taxes.

The Administration's proposal seems to require U.S. taxes to be computed separately for each country. Each country will have a separate residual minimum tax rate, and interest will be allocated to each country in accordance with current U.S. interest allocation rules. Some may argue that for a multinational corporation operating in dozens of countries, the result will be dozens of residual minimum tax rates, and dozens of individual interest allocations in order to compute the minimum tax country-by-country. Proponents may argue that the U.S. international tax system is already very complex requiring the computation and maintenance of even more earnings and profits and tax pools at the level of each CFC.

Expense allocation

The Administration's minimum tax proposal modifies present-law rules for allocating interest expense incurred by the U.S. parent in support of its foreign operations and accomplishes the policy objective of matching the value of interest expense deductions with the residual minimum tax rate applied to the earnings supported by those expenses. As under present law, interest expense of the U.S. group would first be allocated between U.S.-source and foreign-source income. However, the amount of interest expense allocated to foreign-source income under these rules then would be further allocated between the three broad categories of foreign-source income on a pro rata basis, based on assets. Broadly, these foreign-source income categories include income that is subject to taxation at the full U.S. statutory tax rate, income that is entirely exempt from U.S. taxation, and income that is taxed at a variety of different tax rates under the minimum tax system. Relative to present law, the ability to allocate interest based upon worldwide allocation may reduce the total amount of disallowed interest expense, which otherwise may not be deductible in any jurisdiction.

The first category is for income that is taxed at the full U.S. statutory tax rate, and includes foreign-source royalty and interest income received directly by the U.S. group as well as foreign-source income that is generated through the subpart F mechanism, such as the various types of foreign base company income of present law. Under the proposal, this category of foreign-source income that is subject to tax at full U.S. rates would still be eligible for offset by foreign tax credits. Accordingly, the interest allocated to this category would operate to compute the foreign tax credit limitation, but would remain fully deductible. The inclusion of branch income in the determination of the minimum tax base means that the deductibility of interest expense used to support branch operations is more limited than under present law, where those expenses are fully deductible. This may be appropriate because branch income may be subject to a lower tax rate under the Administration's minimum tax proposal.

The second category is for income that is not at all taxed, and includes foreign subsidiary earnings that were already subject to a local tax at a rate equal or exceeding 22.35 percent, thus yielding zero residual U.S. minimum tax. In addition, any foreign subsidiary earnings that are exempt from U.S. taxation based on the allowance for corporate equity would also be included in this category of foreign-source income that is not subject to further U.S. taxation. This would necessarily require that an interest allocation be made to the income exempt under the allowance for corporate equity on a per-country basis, as described below, in order to determine the interest expense disallowance with respect to earnings up to the allowance for corporate equity, which is exempt from the U.S. minimum tax, and therefore subject to interest expense disallowance. Disallowing interest deductions in this case supports the policy objective of not allowing expenses to be deducted against income that is exempt from tax. (Not doing so may result in negative tax rates on that income.)

The third category of foreign-source income includes income that is earned by foreign subsidiaries and which is subject to the 19-percent minimum tax based on a residual tax rate on a per-country basis. Interest allocated to this category would be deductible at the rate at which the residual minimum tax was applied; not doing so may result in negative tax rates on that income and would be inconsistent with the principles of matching the value of deductions with the tax rate applicable to the income that is supported by the expenses being deducted. This would necessarily require that interest expense allocated to foreign earnings that are subject to the minimum tax be further allocated within this category to each country, in order to compute the interest expense disallowance on a per-country basis. Moreover, once the per-country interest allocation is determined, the interest must be further allocated within each country to earnings up to the allowance for corporate equity, which, as mentioned, results in complete disallowance of interest expense, and to the remainder of the earnings within the country, which results in partial expense disallowance.

By establishing these three categories, the Administration's minimum tax proposal decreases the value of interest deductions incurred by the U.S. parent in support of foreign operations in countries where it is subject to the minimum tax, thereby reducing the incentive for the U.S. parent to borrow. In addition to serving the policy goal of matching the value of deductions with the tax rate applicable to the income supported by the expenses being deducted, the Administration's minimum tax proposal may also serve the policy goal of discouraging U.S. corporations from borrowing in the United States, instead of elsewhere, because interest deductions are more valuable in the United States given its relatively high statutory corporate tax rate. Moreover, the proposal, by reducing the incentive for the U.S. parent to borrow in support of its foreign operations, increases the relative incentive for its foreign subsidiaries to borrow, thereby reducing the tax base of the foreign countries in which they are operating. Some may argue, however, that lowering the corporate tax rate is a more effective way of discouraging U.S. parents from borrowing in the United States to support their foreign operations.

The rules for allocating expenses other than interest (*e.g.*, research, overhead, etc.), however, do not align with the policy objective of matching the value of deductions with the tax rate applicable to the income supported by the expenses being deducted. As a result, the Administration's minimum tax proposal subsidizes some domestic activity used to generate income subject to the lower residual minimum tax rate or exempt from tax altogether. Such subsidization may be consistent with the policy goal of promoting domestic employment and

investment even though it is inconsistent with the policy goal of matching the deductibility of expenses with the tax rate applicable to the earnings supported by those expenses.

CFC-branch parity

The Administration's minimum tax applies to earnings from a CFC, branch, or from the performance of services abroad. The parity of CFCs and branches in this respect contrasts with present law, where active income earned by CFCs can be tax deferred while active income earned by branches is subject to tax currently (after allowance of a credit for foreign tax paid on branch income). CFC-branch parity may be appropriate in the context of the Administration's minimum tax proposal to the extent that a U.S. MNE's minimum tax liability in a particular country is meant to reflect the degree to which the overall operations of the U.S. MNE are being taxed in that country, whether those operations occur through CFCs or branches. On the other hand, a number of complications and transition questions related to treating branches as CFCs would need to be addressed. These issues include, among others, deemed transactions for U.S. tax purposes for activities within the same legal entity (the U.S. parent corporation). In the absence of special transition rules and upon enactment of the Administration's minimum tax proposal, a branch of a domestic corporation would be treated as transferring its assets to a newly formed foreign corporation, with one result being possible U.S. tax liability for the domestic corporation if the assets deemed transferred have appreciated in value while held by the branch.

## G. Impose a 14-Percent One-Time Tax on Previously Untaxed Foreign Income

### Present Law

**Background**

Domestic corporations generally are taxed on their worldwide income, including income earned from the direct conduct of a foreign business by the domestic corporation (by means of direct sales, licensing or branch operations in the foreign jurisdiction) or through a pass-through entity such as a partnership. Income earned indirectly by domestic corporations from the foreign operations conducted by their foreign corporate subsidiaries is generally not subject to U.S. tax until the income is distributed to the domestic parent corporation. Thus, the U.S. tax on foreign earnings of foreign corporate subsidiaries is said to be "deferred." This result is circumscribed by the anti-deferral regimes of the Code.

**Anti-deferral regime of Subpart F**

The anti-deferral regime known as subpart F departs from the general rules by requiring that certain U.S. shareholders' proportionate shares of the earnings of certain foreign corporations be subject to U.S. income tax on a current basis, even if the earnings are not distributed to the shareholders. Subpart F provides special rules for a controlled foreign corporation ("CFC") and each "U.S. shareholder." A CFC is a foreign corporation in which more than 50 percent of the corporation's stock (measured by vote or value) is owned by U.S. persons (directly, indirectly, or constructively) who own at least 10 percent of the stock

(measured by vote only).[99] Only a U.S. person who owns at least 10 percent of the stock of a CFC is a U.S. shareholder within the meaning of subpart F. A U.S. shareholder is subject to current U.S. taxation on its pro rata share of certain earnings and profits ("E&P") of the CFC that constitute either subpart F income or includible investments in U.S. property.[100] Where the foreign country in which the CFC is tax-resident for foreign tax purposes imposes an income tax on the income of the CFC, a foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income,[101] in which case the net U.S. tax owed is the difference between the U.S. tax otherwise applicable to the income and the foreign tax imposed on the income.

Subpart F income

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another and consists of foreign base company income,[102] insurance income,[103] and certain income relating to international boycotts and other violations of public policy.[104]

There are several exceptions to the broad definition of subpart F income. First, under the same-country exception, dividends and interest (which generally are foreign personal holding company income, one category of subpart F income) received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized may be excluded from subpart F income. In addition, rents and royalties (which are also generally foreign personal holding company income) received by a CFC from a related corporation for the use of property within the country in which the CFC is organized are not included in subpart F income.[105] The same-country exception is not available to the extent that the payments reduce the subpart F income of the payor. A second exception from foreign base company income and insurance income is available for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate

[99] Secs. 951(b), 957, and 958.

[100] Sec. 951(a).

[101] Secs. 901, 902, 960.

[102] Sec. 954. Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.

[103] Sec. 953.

[104] Sec. 952(a)(3)-(5).

[105] Sec. 954(c)(3).

greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).[106]

In addition to the above exceptions, there are two exceptions that have expired and remain applicable only for taxable years of a CFC beginning after 2004 and before 2015, and the taxable years of the U.S. shareholders with or within which such taxable years of the CFC ends. The first, known as the "CFC look-through" rule, excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent not attributable or properly allocable to the payor's subpart F income or to the payor's income that is effectively connected with the conduct of a U.S. trade or business.[107] The other exception, often referred to as the active finance exception, applies to income derived in the active conduct of banking, financing, or insurance business[108] and requires, among other things, that the CFC be predominantly engaged in such business and conduct substantial activity with respect to such business.

Other inclusions under subpart F: investments in U.S. property

To stop taxpayers from avoiding U.S. tax by repatriating untaxed CFC earnings through non-dividend payments such as loans to the U.S. parent company, subpart F also requires that 10-percent U.S. shareholders of a CFC include in income their pro rata shares of a CFC's untaxed earnings invested in certain items of U.S. property.[109] This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.[110] Exceptions to the definition of U.S. property, include U.S. bank deposits, certain export property, and certain trade or business obligations.[111]

Adjustment of tax attributes to reflect subpart F inclusions

Subpart F includes rules for the computation of earnings and profits and for basis adjustments to avoid taxing earnings that have been previously taxed under subpart F. Ordering rules provide that distributions from a CFC are treated as coming first out of earnings and profits of the CFC that have been previously taxed under section 956 as investments in U.S. property, then under subpart F, and then out of other earnings and profits.[112] Other rules ensure that

[106] Sec. 954(b)(4).

[107] Sec. 954(c)(6).

[108] Sec. 954(h), (i).

[109] Secs. 951(a)(1)(B), 956.

[110] Sec. 956(c)(1).

[111] Sec. 956(c)(2).

[112] Sec. 959(c).

previously taxed earnings and profits are not taxed again when actually distributed to a 10-percent U.S. shareholder of a CFC, whether the previous exclusion was based on subpart F income or as a result of increased investments in U.S. property.[113] A 10-percent U.S. shareholder's basis in the stock of a CFC is increased by the amount of the shareholder's subpart F inclusions in respect of the CFC stock and is decreased by the amount of any distributions received from the CFC that are excluded from the shareholder's income as previously taxed income.[114]

**Foreign tax credit**

Subject to certain limitations, U.S. taxpayers are allowed to claim credit for foreign income taxes they pay. The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles) to mitigate double taxation of foreign-source income without allowing an offset against U.S. tax on U.S.-source income.[115] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. The foreign tax credit limitation applies separately to each of two categories of foreign-source income: passive (such as portfolio interest and dividend income) and general (all other income).[116]

A 10-percent corporate U.S. shareholder is generally allowed a deemed-paid, or indirect, credit for foreign taxes based on the proportion of taxes paid by a foreign corporation on the earnings and profits it distributes relative to its accumulated earnings and profits.[117] This is called a deemed-paid credit to reflect the fact that the foreign income tax is actually paid by the foreign subsidiary but is allowed as a credit to a 10-percent corporate U.S. shareholder. Similarly, under subpart F, a domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is also allowed a deemed-paid credit for foreign income taxes paid by the foreign corporation when the related income is included in the domestic corporation's income under the anti-deferral rules.[118] If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the

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[113] Sec. 959(a)(2).

[114] Secs. 961(a), 961(b).

[115] Secs. 901, 904.

[116] Sec. 904(d). In certain instances, passive income is treated as general category income (for example, income earned by a qualifying financial services entity or income that is taxed at a foreign tax rate determined to exceed the highest rate of tax specified in Code section 1 or 11, as applicable). Dividends, subpart F inclusions, interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made. A number of other provisions of the Code create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, *e.g.*, secs. 865(h), 901(j), 904(d)(6), 904(h)(10).

[117] Sec. 902.

[118] Sec. 960, 1291(g).

taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[119]

A foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[120]

**Temporary dividends-received deduction for repatriated foreign earnings**

Section 965 provided a one-time deduction of 85 percent for certain dividends received by a U.S. corporation from its CFCs. At the taxpayer's election, this deduction was available for dividends received either during the taxpayer's first taxable year beginning on or after October 22, 2004, or during the taxpayer's last taxable year beginning before such date. The dividend amount eligible for the temporary deduction was subject to several limitations and was accompanied by a proportional disallowance of credit for foreign taxes paid with respect to dividends for which the deduction was allowed.[121] The amount of dividends eligible for the 85 percent deduction could not exceed the amount by which the cash dividends exceeded the taxpayer's average repatriation level calculated for a three-year base period preceding the year of the deduction. A separate limitation capped the eligible dividends to the greater of $500 million or the amount identified on the taxpayer's recent audited financial statements as earnings invested indefinitely outside the United States. Increases in related party indebtedness in the year further limited the availability of the deduction. The dividends were required to be invested in the United States in accordance with a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.[122]

**Financial accounting and reporting of CFC earnings under U.S. generally accepted accounting principles ("GAAP")**

Under U.S. GAAP principles, the earnings of a foreign subsidiary are generally included in the consolidated financial statements of the U.S. parent during the period in which they are earned. However, for U.S. tax purposes, tax is deferred for earnings that are not distributed to the U.S. parent or otherwise includible, such as under subpart F. These undistributed earnings of a foreign subsidiary that are included in financial statement consolidated income but which are deferred from U.S. taxation represent a temporary difference for which a tax liability and associated tax expense is currently accrued, unless the relevant tax laws provide a means by which the investment in the subsidiary can be recovered tax-free.[123] It is generally presumed for

[119] Sec. 904(c).

[120] Sec. 909.

[121] Sec. 965(d)(1).

[122] Sec. 965(b)(4).

[123] Accounting Standards Codification ("ASC") 740-30-25-3.

U.S. GAAP purposes that all undistributed earnings of a foreign subsidiary will be repatriated to the U.S. parent entity.

A firm may overcome the presumption that it will repatriate all undistributed earnings of a foreign subsidiary to the U.S. parent company by providing evidence of specific plans for reinvestment of the undistributed earnings that demonstrate that remittance of the earnings will be postponed indefinitely and by demonstrating that the U.S. parent company has adequate cash flows from other sources and will not require remittances from the foreign subsidiary. These criteria required to overcome the presumption are sometimes referred to as the "indefinite reversal criteria."[124]

When a parent entity makes an assertion regarding its intent to indefinitely reinvest foreign earnings, and has demonstrated its ability to do so, it is required to disclose the gross amount of foreign earnings in the footnotes of its financial statements. The parent entity is also required to disclose the nature of events that would give rise to taxation of the earnings in the parent jurisdiction, as well as an estimate of the tax liability associated with the foreign earnings or a statement that providing a reasonable estimate of the tax liability is impractical.

Each multinational firm decides how to report its indefinite reinvestment based on its facts. Some firms assert indefinite reinvestment of all untaxed (that is, non-subpart F) foreign earnings. Other firms assert indefinite reinvestment of some, but not all, of their foreign earnings. In neither case does the assertion of indefinite reinvestment of such profits permit firm conclusions about whether or not the firm has incurred residual tax. Actual distribution of historic earnings in the form of taxable dividends in any given period may be less than the amount of earnings in respect of which they have accrued a U.S. tax liability for financial statement purposes. The decision to accrue a U.S. tax liability on foreign earnings does not require that such earnings be repatriated in the current year. Some firms may not assert indefinite reinvestment of any foreign earnings and therefore accrue a U.S. tax liability with respect to all these earnings irrespective of the amount of their actual repatriations. Because U.S. GAAP rules related to recognition of income and tax amounts in relation to undistributed foreign earnings are not based on whether a firm actually repatriates these earnings, financial statements do not allow clear inferences about the amount of a firm's actual repatriations.

The decision to assert indefinite reinvestment with respect to foreign earnings is also not synonymous with actual inability to use the earnings in the United States. Firms may make an indefinite reinvestment assertion for financial statement purposes, even while using the earnings in the United States, whether on a temporary basis or otherwise, so long as the use of the earnings does not give rise to a current taxable inclusion for U.S. tax purposes.[125] Certain planning techniques have been identified in which a series of short-term CFC loans to the U.S.

[124] ASC 740-30-25-17.

[125] Section 956(c)(2) enumerates investments or transactions in the United States that are not considered to be investments in U.S. property for purposes of triggering the inclusion under section 956(a).

parent are used in attempts to avoid a taxable inclusion without conflicting with the assertion regarding indefinite reinvestment.[126]

If a parent entity has asserted indefinite reinvestment of foreign earnings, it must record in its financial statements a tax liability in respect of undistributed earnings if it subsequently plans to or actually repatriates these earnings.

## Description of Proposal

The proposal imposes a tax of 14 percent on all deferred earnings and profits of CFCs accumulated for taxable years beginning before January 1, 2016. A credit is allowed for the foreign taxes associated with the deferred earnings, multiplied by the ratio of the proposed tax rate (14 percent) to the maximum U.S. corporate tax rate in 2015 (35 percent), or 40 percent. The one-time tax is payable ratably over five years. The proposal is contingent upon enactment of the related proposal for a minimum tax.

Revenues from the proposal are intended to pay for a surface transportation reauthorization proposal and any shortfalls between revenue and surface transportation spending under present law for fiscal year 2016.[127]

Effective date.—The proposal is effective on date of enactment.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.G, reprinted in the back of this volume.

## Analysis

The Administration presents the 14 percent tax on deferred income as a transition rule to be enacted together with its proposed 19-percent minimum tax, rather than a proposal to be considered in the absence of comprehensive reform of U.S. rules on international taxation. The existence of large amounts of untaxed foreign earnings attributable to periods prior to the effective date of the reformed regime presents a question of how such earnings should be treated: under present law rules, under the reform regime rules or via a transition rule. Reform proposals have varied in how best to address this issue, or even whether to address it. The transition rules

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[126] A detailed case study of the technique is included in exhibits from the September 20, 2012 hearing of the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Homeland Security and Government Affairs, "Offshore Profit-Shifting and the U.S. Tax Code − Part I (Microsoft and Hewlett-Packard)." Senate Hearing 112-781 (September 20, 2012). The exhibits are available at http://www.hsgac.senate.gov/download/?id=7B9717AF-592F-48BE-815B-FD8D38A71663.

[127] *Budget of the U.S. Government, FY2016* (ISBN No. 978-0-16-092678-5 at pp 25-28; available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/budget.pdf) includes a six year, $478 billion surface transportation reauthorization proposal. That proposal and its associated outlays are outside the scope of an analysis of tax policy and will not be discussed herein.

included in previous international reform proposals range from mandating a current, full inclusion of all untaxed earnings to permitting continued, elective deferral indefinitely.[128] This discussion describes policy considerations relevant to transition relief and evaluates the Administration's proposal in light of those considerations. Several aspects of the proposed transition tax requiring further clarification are also identified, as well as possible economic effects.

**Policy considerations underlying transition rules**

When substantive tax rules change, transition rules that mitigate losses that some taxpayers would otherwise realize as a result of the reform are frequently included. Transition rules are also used to mitigate potential economic windfalls that may result. Whether mitigation of either losses or windfalls is advisable is the subject of a large body of commentary reflecting a range of considerations in determining whether a transitional rule is warranted.[129] These considerations include retroactivity of a provision, the extent to which it supports reliance on the tax laws, its effect on efficient investment consistent with the underlying policy goals of the substantive law, and simplification. More recent commentary counsels that the decision whether to provide a special transition rule may best be considered on an *ad hoc* basis, because the policies underlying the shape of a transition rule are not exogenous to the policy underlying the substantive tax rule change.[130]

Retroactive effect

Inclusion of transition relief in tax legislation can be viewed as part of a general aversion to *ex post facto* law-making[131] as contrary to the rule of law.[132] In determining whether or not a

[128] United States Jobs Creation and International Tax Reform Act of 2012, S. 2091 (112th Cong., 2d Sess., Feb. 9, 2012), ("Senator Enzi's proposal" or "Enzi proposal"); Chairman Baucus's staff discussion draft, Nov. 19, 2013 ("Chairman Baucus's proposal" or "Baucus draft") available at http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14; and Tax Reform Act of 2014, H.R. 1 (113th Cong., 2d Sess., Dec. 10, 2014) ("TRA 2014" or "Camp 2014").

[129] For an overview of academic literature on tax transition policy, refer to Heather M. Field, "Taxpayer Choice In Legal Transitions," 29 *Virginia Tax Review* 505 (Winter 2010); David M. Hasen, "Legal Transitions And The Problem Of Reliance," 1 *Columbia Journal of Tax Law* 120, (Spring 2010); "Conference: Legal Transitions: Is There An Ideal Way To Deal With The Non-Ideal World Of Legal Change, 13 *Journal of Contemporary Legal Issues* 279 (University of San Diego School of Law 2003).

[130] Doran, Michael, "Legislative Compromise and Tax Transition Policy," 74 *University of Chicago Law Review* 545 (Spring 2007).

[131] The U.S. Constitution prohibits enacting *ex post facto* laws that punish behavior that was innocent prior to the effective date of the law, whether by the U.S. Congress (Art. I, Sec. 9, cl. 3) or the States (Art. I, Sec. 10, cl.1). The prohibition in the Constitution is not itself applicable to tax laws, except to the extent that the legislation deals with criminal sanctions.

[132] Charles Sampford, *Retrospectivity and the Rule of Law*, (Oxford 2006). The author traces the first English use of the term "rule of law" to the mid-17th century, and describes it as an "evocative but impossible ideal: 'the rule [or government] of law[s], not the rule of men.'" *Ibid*., page 40. He argues that rule of law requires that

statute has retroactive effect, one may consider the extent to which that statute changes the legal status, character or consequences of pre-enactment transactions.[133] Tax statutes that are not explicitly retroactive (*i.e.*, they do not change the tax outcome of a pre-enactment taxable year) may nonetheless have a retrospective effect on the value of a prior transaction, for example by changing the deductibility of an ongoing expense related to an investment that predates the law. Since 1996, the Code limits the authority of the Secretary to issue regulations with retroactive effect, except to prevent abuse or when notice of the expected substance of the regulations had previously been published on or before the effective date.[134]

Encouraging reliance on law

Closely related to the consideration of retroactive effect is the policy interest in encouraging reliance on the tax laws. The routine inclusion of transition rules has been questioned by those who argue that such rules promote reliance on the old laws at the expense of encouraging behavior consistent with the policies underlying the new laws and may lead to results worse than would occur without a transition rule. Examples of transitional rules that encourage reliance on the law are those that preserve the anticipated advantages of pre-reform transactions by allowing the transactions to continue to receive the same tax treatment as if the law had not changed. Such rules, often referred to as "grandfather" provisions, generally limit the retroactive effect of a new law by altering effective dates on specified acquisitions or investments, while allowing the new rules to determine the treatment of later similar transactions.[135] The rationale for such rules is presumably that the pre-enactment acquisition or investment may have been undertaken based on the expected tax treatment under the law at the time of the transaction. Inclusion of a rule that mitigates the burden resulting from the change reflects a determination that such expectations should be respected. Respect for reliance on prior law may foster comparable reliance on the new tax rules, by reducing investor uncertainty and perceived risk in future investments.

Efficiency

Taxes may distort economic behavior and lead to an inefficient allocation of a given level of resources by altering the returns to economic activity pursued by individuals and firms (*e.g.*, creating a wedge between pre- and after-tax returns).[136] Taxes on wage income, for example,

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legislation be prospective, and further posits that whether or not legislation is prospective or retroactive is not answerable by either/or tests but can is a matter of degree.

[133] Stephen R. Munzer, "A Theory of Retroactive Legislation," 61 *Texas Law Review* 425, 441-45 (1982).

[134] Sec. 7805(b); Pub. Law 104-168, sec. 1101(a). Before amendment, retroactive effect of regulations was presumed, unless the Secretary exercised discretion to limit retroactive effect. *Automobile Club of Michigan v. Commissioner of Internal Revenue*, 353 U.S. 180 (1957), reh'g den. 353 U.S. 989 (1957).

[135] Michael J. Graetz, "Legal Transitions: The Case of Retroactivity in Income Tax Revision," *126 University of Pennsylvania Law Review 47, 54-57 (1977).*

[136] A more comprehensive discussion of tax policy and economic efficiency can be found in Alan J. Auerbach and James R. Hines, "Taxation and Economic Efficiency," in Alan J. Auerbach and Martin Feldstein (eds.), *Handbook of Public Economics*, vol. 3, pp. 1347-1421.

reduce the after-tax return to labor and may lead individuals to work less, reducing economic output. In addition, differential tax treatment of investments made in different types of property, such as those arising from special cost recovery provisions, may result in an inefficient pattern of investment that reduces overall economic output; too much investment may flow to more lightly taxed sectors and too little investment may flow to more heavily taxed sectors. Changes in tax laws may increase uncertainty regarding tax policy. Because greater uncertainty in turn increases investment risk, uncertainty regarding tax policy may distort economic behavior.

Simplification

If a system as reformed represents a broad departure from the prior rules, measures that simplify the implementation of the new system may be desirable. In such cases, a transition rule that eliminates the need to maintain separate accounting under two systems of possibly conflicting rules, or shortens the period during which such duplicative tracking is required, may ease complexities that arise during a transition period. Because transition rules can in themselves generate complexity,[137] the simplest rule may be to not provide a transition rule.[138] If the reform does not depart greatly from the preexisting legal rules, then simplification is less important as a rationale for a transition rule.

**Transition policy considerations applied to the proposed one-time 14-percent tax**

The 14-percent tax on previously untaxed foreign earnings is a transition measure for the Administration proposal for a new system of international tax. In the absence of any transition rule upon implementation of the proposed minimum tax and subpart F reforms, the deferred foreign earnings that would have been repatriated and incurred residual U.S. tax, even in the absence of international tax reform, may avoid taxation permanently, resulting in an unanticipated windfall.[139] In contrast, a rule that required full inclusion of the previously deferred earnings at full tax rates before transition to a new international tax system may be viewed as an abrogation of expectations, raising the cost of having relied upon present law rules that allow companies to determine whether to repatriate earnings and incur a residual U.S. liability, and possibly causing cash-flow disruption or economic hardship. Concerns that the transition could cause economic hardship can be alleviated in a number of ways, including reducing the rate of tax applicable to prior earnings, permitting installment payments, and waiving interest on installment payments.

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[137] Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," JCS-02-05 (Jan. 27, 2005) at p. 195, citing, *e.g.*, Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations," *National Tax Journal*, Vol. LIV, No. 4, (December 2001) (illustrating that moving to a dividend exemption system could provide an opportunity for simplification, but that many of the sources of complexity encountered under present law would remain).

[138] Foster, J.D., "Practice and Principles of Tax Reform Transition, Background," Paper No. 23, Tax Foundation, March 1998.

[139] Shaviro, Dan blog - Start Making Sense − Obama 14% transition tax - (Feb. 2, 2015). Available at http://danshaviro.blogspot.com/2015/02/obama-administration-international-tax_2.html.

Mandatory or elective repatriation

One of the initial choices in designing a rule for a transitional deemed repatriation rule is whether it is should be mandatory or elective. To the extent that a reduced rate on repatriation is elective, it may be viewed as a tax holiday,[140] assuming that the reduced tax rate is available only temporarily. A mandatory inclusion of all untaxed earnings, at the full U.S. tax rate, as a policy matter, is consistent with considerations of simplification and economic efficiency. By having taxed all previously untaxed earnings at the outset of the reform regime, implementation of the new regime may be achieved more quickly, without the need for dual recordkeeping.

Economic efficiency is encouraged because the incentive to delay repatriation to avoid taxation on those earnings is removed. Under present law, to the extent that a firm's managers are concerned with increases in the firm's reported U.S. tax expense, and the corresponding decrease in the firm's earnings per share, managers may delay the repatriation of foreign earnings. Some commentators therefore have observed that the financial accounting rules provide an incentive to delay repatriations. In addition, the U.S. residual tax when earnings are repatriated may also discourage firms from paying dividends from foreign subsidiaries to U.S. parent companies. To the extent that a mandatory transition rule results in all historic earnings considered to be previously taxed income and the new regime taxes income either currently or not at all, the tax motivation in deciding whether to repatriate earnings is moot.

On the other hand, reliance on tax laws may be undermined if a mandatory deemed repatriation without regard to whether the earnings are actually distributed is viewed as a penalty for taxpayers that have justifiably relied on present law to defer tax on undistributed foreign earnings. Similarly, to the extent that a portion of the earnings could realistically have been expected never to incur a residual U.S. tax because they were in fact permanently reinvested abroad, the imposition of a transition tax has a retrospective aspect.

The increased current tax burden from requiring full inclusion of pre-effective date earnings may be mitigated by providing a preferential tax rate on pre-effective date earnings, or by allowing taxpayers to spread the tax payment out over several years. Both former Chairman Baucus and former Chairman Camp proposed mandatory repatriation of preexisting deferred earnings and profits, without regard to whether an actual distribution was made, and permitted payment of the transition tax in installments over a period of up to eight years. The mechanism for the mandatory inclusion of pre-effective date foreign earnings in both proposals is subpart F.

An elective repatriation was included in Senator Enzi's proposal for taxpayers who are willing to delay benefits of the proposed reforms. In that proposal, the taxpayer burden of lost simplification was borne only by those who chose to forgo the elective repatriation opportunity, who would also be entitled to continue to rely on present law with respect to the pre-enactment

[140] Chye-Ching Huang, and Brandon DeBot, "Transition Tax on Overseas Profits Versus Repatriation Holiday and Understanding the Differences," Center on Budget and Policy Priorities (April 10, 2015). Available at http://www.cbpp.org/files/4-10-15tax.pdf.

earnings.[141] Under Senator Enzi's proposal, all present law rules remain in effect with respect to the previously deferred earnings with respect to which no election was made, and any distributions are made first from the deferred earnings not previously taxed, thus delaying the benefits of the substantive reform to the electing taxpayer until its deferred earnings were distributed. The goal of simplification of administration of the law is also delayed under this structure.

Rate of tax

The reform proposals that include a transition rule for previously deferred profits differ on the amount of residual U.S. tax to be imposed; all differ from that of the Administration proposal of 14 percent. To the extent that the rates are less than a taxpayer could reasonably expect to incur absent the proposed reform, the rates may create a windfall; if higher than the probable residual U.S. tax that would have been incurred, they may present an increased burden that undermines expectations and reliance on the law, retrospectively.

The transition rules provided the following exemptions and reduced rates:

| **Proposal** | **Repatriation** | **Amount of Exemption** | **Rate of Tax** |
|---|---|---|---|
| Administration FY2016 | Mandatory | 60 percent | 14 percent |
| Baucus draft | Mandatory | The deduction or exemption amount is described as the applicable percentage needed to result in a 20-percent effective tax rate. | 20 percent |
| Camp draft (H.R. 1 113th) | Mandatory | 75 percent foreign cash/<br>90 percent all other foreign assets | 8.75 percent<br>3.5 percent |
| Enzi proposal (S. 2091 112th) | Elective, whether actual or deemed | 70 percent of up to 100 percent deferred earnings | 10.5 percent |

As the table above demonstrates, there is a range of rates that various policy makers have considered appropriate to mitigate the effect of the transition to a new set of rules, and all reflect a substantial reduction from the current top corporate tax rate of 35 percent. None are accompanied by a stated rationale for the rate chosen. The rate of 14 percent chosen by the Administration is 40 percent of the maximum U.S. corporate tax rate under present law,

[141] Under that proposal, a corporate 10-percent U.S. shareholder may elect a one-time 70-percent deduction for eligible amounts received from a CFC from pre-effective date earnings. Eligible amounts include both cash repatriated in the form of dividends and amounts that a taxpayer elects to treat as subpart F income ("deemed repatriation"). The 70-percent deduction election is not available for earnings of noncontrolled section 902 corporations that the U.S. shareholder elects to treat as CFCs.

reflecting an exemption of 60 percent of the deferred earnings. If further mitigation were found to be warranted to achieve the overall reform goal, the rate may vary. It is not clear that variance in the transition tax necessarily follows from any departure from the proposed 19 percent minimum tax, but such variance may be necessary in order to meet any desired objective concerning revenue gain or loss.

In the Camp draft, foreign assets that are held in liquid form are differentiated from other assets in order to determine the applicable deduction, resulting in a higher rate of tax. The higher rate on cash or cash equivalents may be based on concerns about ability to pay and reluctance to compel liquidation of hard foreign investments to satisfy the transition tax. The differential rates may also, in part, reflect the view that the accumulation of cash assets is less desirable activity under present law than investment of those assets in active business operations (whether at home or abroad) and therefore less deserving of mitigation. The policy goals of imposing a minimum tax on foreign active income include the desire to remove incentives to avoid repatriation of foreign earnings and would be consistent with adoption of a two-tier tax based on whether the deferred profits are maintained as foreign cash assets. However, those policies may not be furthered by the two-tier rate to the extent that the cash assets are already invested in the United States in forms that do not trigger income inclusions as investments in U.S. property under section 956. In addition, the added complexity of classification of assets, especially insofar as the cash needs of companies vary by industry, may counsel against such a differential.

Tax attributes not absorbed in transition

Although the description of the transition tax is silent on possible carryforward of credits or losses that are not absorbed by the transition, the description of the proposal for a 19-percent minimum tax contemplates that after January 1, 2016, foreign tax credits are to be computed only on the basis of current earnings and taxes. Concern that reliance on tax law is undermined if tax attributes are not carried forward may arise and lead to support for a transition rule that 'grandfathers' such attributes, in whole or in part. On the other hand, simplification may favor a default rule about treatment of excess credits or losses both at transition and in future years. Foreign tax credits are the principal tax attribute that may be stranded upon transition to a new set of international tax rules, although the treatment of overall foreign losses is also unclear. If credits may be carried forward, whether the characterization of the credit for purposes of assignment to an income category for limitation purposes is retained may depend on whether the substantive tax reform includes changes to the limitation categories, and whether such changes are undermined by allowing (or requiring) a parallel system for pre-transition tax attributes.

**Aspects of the proposal that require further clarification**

Scope of the transition tax

In describing the mandatory, deemed repatriation, the Administration refers to imposition of a tax on the earnings of CFCs, but does not explain who is to be taxed. It is not obvious that the tax extends to all U.S. shareholders within the meaning of subpart F. For example, the Baucus proposal imposes the transition tax only on each corporate U.S. shareholder of a CFC, who must include its pro rata share of the accumulated deferred foreign income in gross income. In contrast, the Camp proposal applies to all U.S. shareholders of a CFC as well as U.S. persons

owning an interest equal to or greater than 10-percent interest in any other 10-percent owned foreign corporation.

If the structure of subpart F remains in place and the deemed repatriation is structured as a subpart F inclusion, the deemed repatriation would result in income to all U.S. shareholders within the meaning of subpart F, not only to a domestic corporate U.S. shareholder. In contrast, the minimum tax proposal is a tax imposed only on domestic corporations and their CFCs. Furthermore, other changes to subpart F contemplated as part of the minimum tax implementation affect only corporations, such as the repeal of the rules requiring income recognition when earnings are invested in U.S. property.

One basis for determining whether to include non-corporate shareholders in any deemed repatriation is whether that inclusion is consistent with the substance of the minimum tax proposal and its goals. That requires looking at how the proposed changes to subpart F may differentiate between corporate and individual U.S. shareholders and the basis for any distinctions. That is, reconsideration of the breadth of the transition rule may be warranted because there is no new set of international tax rules to which these shareholders are transitioning. On the other hand, exclusion of individuals from bearing the transition tax may add unnecessary complexity that itself may undermine reform goals.

Computation of base on which the tax is asserted

Several questions about the appropriate base for imposition of the 14-percent tax are unanswered in the proposal. First, it is not clear whether earnings that accrued pre-1987 are included. Those who favor a presumption that the earnings to be repatriated were all accrued after 1986 contend that earnings accumulated pre-1987 are not reliably tracked. They also argue that such a rule is consistent with the general goal of simplification. However, critics may argue that such a presumption is not warranted in the case of longstanding firms who may get an unintended windfall if such earnings are not considered. In addition, the proposal is silent as to the treatment of actual dividend distributions in the last taxable year immediately prior to enactment. Special ordering rules may be needed to avoid double taxation with respect to such distributions. Some may suggest that the transition rule apply only to earnings that are undistributed as of a certain date, but such a limitation risks creation of unintended opportunities to avoid the tax by timing transactions.

**Economic effects of a deemed repatriation in transition to minimum tax regime**

Many analysts describe the present law system permitting deferral of tax payment on active business income as creating a "lockout effect." The "lockout effect" is a colloquial reference to the possibility that the overseas earnings of U.S. multinationals are not reinvested in the United States because U.S. multinationals have a tax incentive, created by deferral, to reinvest foreign earnings rather than repatriate them. This may occur if U.S. multinationals choose to make foreign investments, rather than domestic investments, because the ability to defer payment of residual U.S. tax liability on the returns to the foreign investments may make those foreign investments more attractive on an after-tax basis, even if they yield the same pre-tax return as a domestic investment. The one-time mandatory 14-percent tax on historic foreign earnings removes further tax costs to repatriating those earnings and "unlocks" them for use by

U.S. multinationals to make investments in the United States or distribute earnings to shareholders, among other uses.[142]

### H. Limit Shifting of Income Through Intangible Property Transfers

The fiscal year 2016 budget proposal is substantially similar to an earlier proposal first offered for fiscal year 2013, as modified in the budget proposal for fiscal year 2015. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 17-18. That proposal was a modification of a fiscal year 2013 budget proposal, which is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 354-371. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.H, reprinted in the back of this volume.

### I. Disallow the Deduction for Excess Non-Taxed Reinsurance Premiums Paid to Affiliates

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 372-389. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.I, reprinted in the back of this volume.

### J. Modify Tax Rules for Dual Capacity Taxpayers

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 403-410. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.J, reprinted in the back of this volume.

### K. Tax Gain from the Sale of a Partnership Interest on Look-Through Basis

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget*

[142] However, cash assets may already be invested in the United States in forms that do not trigger income inclusions as investments in U.S. property under section 956.

*Proposal* (JCS-2-12), June 2012, pp. 411-416. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.K, reprinted in the back of this volume.

## L. Modify Sections 338(h)(16) and 902 to Limit Credits When Non-Double Taxation Exists

### Description of Modification

This proposal combines two prior-year proposals into a single proposal, as described below. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.L, reprinted in the back of this volume.

The proposal to extend section 338(h)(16) to certain asset acquisitions is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 423-425.

The proposal to remove foreign taxes from a section 902 corporation's foreign tax pool when earnings are eliminated is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 426-431.

## M. Close Loopholes Under Subpart F

This proposal combines two separate prior-year proposals that expand subpart F and two new proposals that modify the thresholds for application of subpart F into a single proposal. The two new proposals and relevant present law are described and analyzed below. The estimated budget effect of the combined proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal (JCX-50-15), March 6, 2015, Item II.M, reprinted in the back of this volume.

### Present Law

#### Background

If a foreign corporation is a controlled foreign corporation ("CFC") for an uninterrupted period of 30 days or more during a taxable year ("30-day rule"), every person who is a United States shareholder of the corporation, and who owns stock in the corporation on the last day of such CFC's taxable year, must currently include in its gross income its pro-rata share of the subpart F income earned by the CFC during that year.[143] In addition, a United States shareholder

[143] Sec. 951(a)(1)(A)(i).

of a CFC is required to include in gross income on a current basis its pro rata share of the CFC's earnings and profits invested in United States property as determined under section 956.[144]

**United States shareholder**

A United States shareholder means, with respect to a foreign corporation, a U.S. person[145] that owns or is considered as owning under applicable constructive ownership rules, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation.[146] Generally, ownership includes stock owned directly plus a proportionate amount of stock owned through certain other foreign entities.[147] Additionally, the rules of attribution contain constructive ownership rules that attribute stock on the basis of the value of shares owned. The constructive ownership rules that apply for purposes of identifying the existence of a United States shareholder generally refer to the constructive ownership rules of section 318, with certain modifications.[148]

**Controlled foreign corporation**

A foreign corporation is a CFC if more than 50 percent of the total combined voting power of all classes of stock of the corporation or total value of the stock of the corporation is owned by United States shareholders on any day during a taxable year of the corporation. As with the determination of the existence of United States shareholders, for purposes of determining the status of a foreign corporation as a CFC, direct, indirect, and constructive ownership rules are applied.[149]

**Constructive ownership**

With respect to foreign corporations, constructive ownership rules apply for purposes of, among other things, the determination of whether a U.S. person is a United States shareholder and whether a foreign corporation is a CFC.[150] In general, a person must satisfy an ownership threshold before stock of a corporation that the person owns is considered to be owned by (is "attributed to") the corporation. That is, attribution to corporations occurs only if 50 percent or more, by value, of the stock of a corporation is owned, directly or indirectly, by or for any person.[151] The general ownership attribution rules of section 318 are modified for purposes of

[144] Secs. 951(a)(1)(B) and 956.

[145] As defined in sec. 957(c).

[146] Sec. 951(b).

[147] Sec. 958(a)(2).

[148] Sec. 958(b).

[149] Sec. 957(a).

[150] Sec. 958(b).

[151] Sec. 318(a)(3)(C) and Treas. Reg. section 1.958-2(d)(1)(iii).

U.S. shareholder and CFC determinations. Among other modifications, stock owned by a foreign person, even a person who satisfies the 50-percent ownership threshold, is not attributed to U.S. persons, including domestic corporations (in other words, there is no "downward attribution" of stock from a foreign person to a U.S. person). Therefore, a domestic corporation that is wholly-owned by a foreign parent corporation is not treated as owning stock in other foreign corporations owned by the foreign parent.[152]

As a result, if a foreign person is a partner in a U.S. partnership, a beneficiary of a U.S. trust, or a shareholder of a domestic corporation, and if the foreign person also owns (directly or indirectly) stock of a foreign corporation, then, for purposes of determining whether such partnership, trust, or corporation is a United States shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC, the partnership, trust, or corporation is not considered to own the stock of the foreign corporation owned by the foreign person. For example, if a domestic corporation is a wholly-owned subsidiary of a foreign parent corporation, and each of the domestic corporation and the foreign parent corporation directly owns 50 percent (vote and value) of the stock of another foreign corporation, the domestic corporation is considered to own only 50 percent (vote and value) of the stock of such other foreign corporation and is not considered to own the stock that is owned by the foreign parent corporation for purposes of determining whether the domestic corporation is a United States shareholder of the foreign corporation.

**Subpart F income**

Generally, subpart F income includes certain passive and other highly mobile income. Specifically, subpart F income includes, among other things, foreign base company income,[153] which, in turn, includes foreign personal holding company income, foreign base company sales income, and foreign base company services income.[154]

Foreign personal holding company income

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits ("REMICs"); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts. Some dividends, interest, rents, and royalties are excluded from foreign personal holding company income under same-country and look-through exceptions.[155]

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[152] Sec. 958(b)(4) and Treas. Reg. section 1.958-2(d)(1)(iii).

[153] Sec. 952(a)(2).

[154] Sec. 954(a).

[155] For example, there is an exception for rents and royalties derived in active business. Sec. 954(e)(2).

Foreign base company sales income

Foreign base company sales income generally consists of income derived by a CFC in connection with: (1) the purchase of personal property from a related person and its sale to any person; (2) the sale of personal property to any person on behalf of a related person; (3) the purchase of personal property from any person and its sale to a related person; or (4) the purchase of personal property from any person on behalf of a related person. In each of the situations described in items (1) through (4), the property must be both manufactured outside the CFC's country of incorporation and sold for use outside of that same country for the income from its sale to be considered foreign base company sales income.[156] Certain exceptions to this general rule may apply. For example, income from sales of property involving a related person may be excluded from foreign base company sales income if the "manufacturing exception" applies.[157]

Foreign base company services income

Foreign base company services income generally consists of income from services performed outside the CFC's country of incorporation for or on behalf of a related person,[158] including cases where substantial assistance contributing to the performance of services by a CFC has been furnished by a related person or persons.[159] Substantial assistance consists of assistance furnished (directly or indirectly) by a related U.S. person or persons to the CFC, but generally only if the assistance satisfies an objective cost test. For purposes of the objective cost test, the term "assistance" includes, but is not limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies provided directly or indirectly by a related U.S. person to a CFC. The objective cost test is satisfied if the cost to the CFC of the assistance furnished by the related U.S. person or persons equals or exceeds 80 percent of the total cost to the CFC of performing the services.[160]

## Description of Proposal

The proposal modifies the thresholds for applying subpart F in two ways.

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[156] Sec. 954(d)(1).

[157] Treas. Reg. section 1.954-3(a)(4).

[158] Sec. 954(e).

[159] Treas. Reg. section 1.954-4(b)(1)(iv).

[160] Notice 2007-13, 2007-5 C.B. 410. Prior to the issuance of Notice 2007-13, the substantial assistance rules also included a subjective principal element test. Under the subjective principal element test, assistance in the form of direction, supervision, services or know-how were considered substantial if the assistance provided the CFC with skills which where were a principal element in producing the income from the performance of such services by the CFC.

Amend CFC attribution rules

The proposal amends the ownership attribution rules of section 958(b) so that certain stock of a foreign corporation owned by a foreign person is attributed to a related U.S. person for purposes of determining whether the related United States person is a United States shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC In other words, the proposal provides "downward attribution" from a foreign person to a related U.S. person in circumstances in which present law does not so provide. The pro rata share of a CFC's subpart F income that a United States shareholder is required to include in gross income, however, continues to be determined based on direct or indirect ownership of the CFC, without application of the new downward attribution rule.

Eliminate the 30-day grace period before subpart F inclusions

The proposal also provides that a United States shareholder of a CFC must include in its gross income its pro rata share of the CFC's subpart F income even if the CFC is not a CFC for an uninterrupted period of at least 30 days in a taxable year.

Effective date.−The proposals are effective for taxable years beginning after December 31, 2015.

## Analysis

### Proposal to amend CFC attribution rules

The proposal reflects a concern that when a U.S.-parented group is acquired by a foreign corporation, the new foreign parent, or another non-CFC foreign affiliate of the foreign parent, may acquire a sufficient amount of the stock of one or more foreign subsidiaries of the former U.S.-parented group to cause such foreign subsidiaries to cease to be CFCs. Subsequently, the group can avoid the application of subpart F with respect to the foreign subsidiaries that are no longer CFCs, even though those foreign entities remain as much as 50-percent directly owned by one or more United States shareholders. This type of transaction, resulting in "de-control" of a CFC, could be achieved under present law while also avoiding the recognition of gross income for U.S. income tax purposes with respect to the loss of control. For example, the new foreign parent, or another non-CFC foreign affiliate, could issue a note or transfer property to a CFC in exchange for stock representing at least 50 percent of the voting power and value of the CFC. As a result, subpart F would no longer apply to the United States shareholder's continued ownership interest in the former CFC, even though the worldwide group retains control of the entity and is therefore in a position to use it to shift passive and other highly mobile income from the former U.S. group contrary to the purposes of subpart F.

De-control is a result that the U.S. shareholders could not achieve without the existence of an ultimate foreign parent, regardless of the type of transaction that caused the former U.S.-parented group to become foreign-parented. That is because with a U.S. parent, stock in foreign affiliates held directly, indirectly, or constructively is aggregated, without exception, for purposes of testing for the existence of a U.S. shareholder and a CFC. In contrast to a U.S.-parented group, a foreign-parented group may de-control a foreign subsidiary of a U.S. affiliate, even while retaining control within the broader affiliated group, since downward attribution is

not required in this context. The ability to avoid the application of subpart F with respect to a former CFC of the U.S. group may enable further erosion of the U.S tax base, if, for example, deductible payments are made from a U.S. subsidiary within the group to the former CFC.

After mounting concern regarding the impact of inversion transactions,[161] the Treasury Department and the Internal Revenue Service issued guidance[162] reflecting these concerns and stated their intent to issue regulations to address certain post-inversion avoidance transactions. One set of transactions at issue involves, in connection with post-inversion planning steps, the ability to access the previously-untaxed undistributed earnings of a CFC without an income inclusion to a U.S. shareholder of the CFC so as to continue indefinite deferral of such earnings from U.S. taxation. In another set of transactions, also commonly employed by inverted groups, steps are taken to dilute and reduce a U.S. shareholders' direct and indirect ownership in a foreign subsidiary, while increasing ownership in the hands of an ultimate foreign parent, where the result is that the foreign subsidiary ceases to be a CFC for U.S. income tax purposes. The guidance describes regulations that the Treasury Department and the IRS intend to issue that will address those transactions in a manner that generally would either (i) cause a current income inclusion, or (ii) prevent such transactions from terminating the CFC status of foreign subsidiaries or substantially dilute U.S. shareholders' interest in those foreign subsidiaries. The guidance applies to avoidance transactions, as defined therein, that occur on or after the date of its issuance, but only if the inversion transaction is completed on or after the date the guidance was issued. The guidance does not apply to foreign-parented groups that did not undergo an inversion transaction within the meaning of the Code.

This proposal is intended to impose restrictions with respect to de-control transactions to all foreign-parented groups, regardless of the existence or timing of an inversion transaction. The proposal is designed to bring within the purview of subpart F certain affiliated entities that are not considered to be CFCs under present law as a result of the applicable ownership attribution rules of sec. 958(b). Specifically, present law does not require downward attribution to a U.S. person of foreign entity stock held by certain foreign affiliates. Present law may not require downward attribution of stock from a foreign person to a U.S. person in this context, as this would cause entities that are not controlled, directly or indirectly, by U.S. persons to be considered CFCs and be subject to the anti-deferral rules of subpart F. This proposal would introduce the potential for current taxation under subpart F, even though the U.S. person cannot control the amount and timing of dividend payments and therefore the duration of tax deferral.

The targeted scenario is a sandwich structure involving U.S. shareholders under an ultimate foreign parent. For example, foreign parent owns a domestic corporation which in turn owns a foreign subsidiary. The sandwich structure could have arisen for a variety of historical reasons, whether as a result of acquisition of the domestic parent by a foreign group or through organic growth of the domestic subsidiary into foreign markets. The proposal does not

[161] As defined in sec. 7874.

[162] Notice 2014-52, I.R.B. 2014-42, September 22, 2014.

distinguish between the types of historic transactions that resulted in sandwich structures, and equally applies to all such corporate structures.

The guidance targeted transactions of inverted groups on a prospective basis in two ways, by treating an obligation of an ultimate foreign parent of a U.S. shareholder as an investment in U.S. property and by negating an intended de-control through recharacterization of the transaction steps, thereby retaining the possibility for recognition of gross income in relation to the historical earnings and profits of the CFC. Those results, however, were limited to inversion transactions. In contrast, the approach in the Administration's proposal is to treat entities that are affiliated by virtue of common ownership under a foreign parent as related persons for purposes of applying the constructive ownership rules of subpart F. This is a significant expansion to the scope of subpart F. On the other hand, the proposal is less onerous than the approach in the guidance, since the amount of the subpart F inclusion in the proposal is limited to the pro rata share attributable to the U.S. shareholder based on actual ownership percentages.

The proposal appears to have application to all foreign-parented multinational structures after the proposed date of enactment, without any grandfathering exception for pre-existing structures. Accordingly, multinational groups that are outside of the purview of subpart F under present law, in applicable fact patterns, could be subject to the anti-deferral rules of subpart F under the proposal.

Although the proposal is effective prospectively, because it would also apply to existing corporate structures, it could be viewed as being retroactive in effect since it applies to past investment decisions. For example, the proposal applies to foreign-parented groups that may have entered the U.S. market many years ago through acquisition of a U.S. multinational group and have already initiated transactions to integrate the acquired group into the structure of the overseas parent. In cases where the U.S. entity still retains a minority interest in foreign-controlled affiliates, subpart F would apply prospectively.

Affected taxpayers may respond by accelerating the extraction of foreign assets from underneath the U.S. group or by further diluting the U.S. ownership percentage, thus minimizing the potential subpart F inclusion.

**Proposal to eliminate the 30-day grace period before subpart F inclusions**

With respect to foreign corporations, the present law rules of subpart F apply to those foreign corporations that are CFCs for an uninterrupted period of 30 days during any taxable year. The proposal eliminates the 30-day requirement, thereby broadening the scope of subpart F so that its rules apply to foreign corporations that are CFCs at any point during the taxable year.

The existing categories of subpart F income, and the threshold requirements for applying subpart F, rely on technical distinctions that may be manipulated or circumvented contrary to subpart F's policy of requiring current U.S. taxation of passive and other highly mobile income earned by foreign corporations controlled by U.S. taxpayers. For example, taxpayers may avoid the 30-day rule by intentionally generating significant subpart F income during short taxable years of less than 30 days.

## N. Restrict the Use of Hybrid Arrangements that Create Stateless Income

### Description of Modification

This proposal combines two separate prior-year proposals into a single proposal. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.N, reprinted in the back of this volume.

The proposal to restrict the use of hybrid arrangements that create stateless income is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 49-58.

The proposal to limit the application of exceptions under subpart F for certain transactions that use foreign reverse hybrids to create stateless income is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal, except that it now describes the foreign reverse hybrid subject to the proposal as one owned by one or more U.S. persons, rather than a hybrid held directly by a U.S. owner, which could have been interpreted to limit the proposed rule to hybrids with only one owner. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 58-66.

## O. Limit the Ability of Domestic Entities to Expatriate

### Description and Analysis of Modification

The fiscal year 2016 proposal modifies the prior year's budget proposal by narrowing the scope of acquisitions to which the management-and-control provision applies to situations in which, immediately before the acquisition, the fair market value of the stock of the domestic entity is greater than the fair market value of the stock of the foreign acquiring corporation. The fiscal year 2016 proposal also clarifies that the management-and-control test is applied by reference to the location of the primary management and control of the entire expanded affiliated group that includes the foreign acquiring corporation, not solely to the management and control of the foreign acquiring corporation.

This narrowing of the scope of the management-and-control provision addresses the possibility that the prior year's management-and-control test might have treated a foreign acquiring corporation with management activities in the United States as a domestic corporation even if the foreign acquirer were many times larger than its domestic target corporation and its foreign operations were correspondingly a much greater portion of its overall operations than were its U.S. operations. The change to the management-and-control provision does not address other questions such as (1) whether a management-and-control test can be sufficiently well defined as to produce a clear location of tax residence on annually or over a series of years and (2) why the location of a company's management should determine the company's residence for tax purposes after certain cross-border acquisitions but not otherwise.

The fiscal year 2016 proposal also expands the scope of acquisitions subject to the anti-inversion rules of section 7874 so that, if the requirements for applicability of section 7874 were otherwise satisfied, an inversion could occur if there were an acquisition of, among other possibilities, substantially all of the U.S. trade or business assets of a foreign partnership. This expansion to acquisitions involving foreign partnerships is, like the prior year budget proposal's expansion to acquisitions of non-trade or business assets of a domestic partnership, intended to stop avoidance of the anti-inversion rules through the use of legal entities not within the scope of the language of the rules. One question is why the rule for acquisitions of foreign partnerships is defined by reference to U.S. trade or business assets rather than by reference to all trade or business assets, U.S. or foreign. The rule for an acquisition involving a domestic corporation or domestic partnership does not distinguish between U.S. and foreign trade or business assets.

This proposal modifies a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 66-80. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.O, reprinted in the back of this volume.

## PART III – SIMPLIFICATION AND TAX RELIEF FOR SMALL BUSINESSES

### A. Extend Increased Expensing for Small Businesses

#### Description of Modification

The President's fiscal year 2016 budget proposal modifies the President's fiscal year 2015 budget proposal by increasing the permanent maximum amount a taxpayer may expense from $500,000 to $1,000,000 for qualifying property placed in service in taxable years beginning after 2015. The remainder of the proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. The President's fiscal year 2015 budget proposal was a modification of the President's fiscal year 2014 budget proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 8, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 741-744. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item III.A, reprinted in the back of this volume.

### B. Expand Simplified Accounting for Small Business and Establish a Uniform Definition of Small Business for Accounting Methods

#### Description and Analysis of Modification

#### Present Law

**Limitation on use of cash method of accounting**

Taxpayers using the cash receipts and disbursements method of accounting (the "cash method") generally recognize items of income when actually or constructively received and items of expense when paid. Taxpayers using an accrual method of accounting generally accrue items of income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[163] Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all events have occurred that fix the obligation to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[164] An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.[165]

[163] See, *e.g.*, sec. 451.

[164] See, *e.g.*, sec. 461.

[165] See, *e.g.*, sec.166.

A C corporation, a partnership that has a C corporation as a partner, or a tax-exempt trust or corporation with unrelated business income generally may not use the cash method of accounting. Exceptions are made for farming businesses, qualified personal service corporations, and the aforementioned entities to the extent their average annual gross receipts do not exceed $5 million for all prior years (including the prior taxable years of any predecessor of the entity) (the "gross receipts test"). The cash method of accounting may not be used by any tax shelter. In addition, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor.[166] Such taxpayers generally are required to keep inventories and use an accrual method of accounting with respect to inventory items.[167]

A farming business is defined as a trade or business of farming, including operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, timber, or ornamental trees.[168] Such farming businesses are not precluded from using the cash method regardless of whether they meet the gross receipts test.[169]

A qualified personal service corporation is a corporation: (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates, or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether they meet the gross receipts test.

Accrual method taxpayers are not required to include in income that portion of any amounts to be received for the performance of services in the fields of health, law, engineering, architecture, accounting actuarial science, performing arts, or consulting, that, on the basis of experience, will not be collected (the "nonaccrual experience method").[170] The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

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[166] Treas. Reg. secs. 1.446-1(c)(2) and 1.471-1.

[167] Sec. 471; *Ibid*.

[168] Sec. 448(d)(1).

[169] However, section 447 generally requires a farming C corporation (and any farming partnership if a corporation is a partner in such partnership) to use an accrual method of accounting. Section 447 does not apply to nursery or sod farms, to the raising or harvesting of trees (other than fruit and nut trees), nor to farming C corporations meeting a gross receipts test with a $1 million threshold. For family farm C corporations, the threshold under the gross receipts test is $25 million. For farmers, nurserymen, and florists not required by section 447 to capitalize preproductive period expenses, section 352 of the Revenue Act of 1978 (Pub. L. No. 95-600) provides that such taxpayers are not required to inventory growing crops.

[170] Sec. 448(d)(5).

**Accounting for inventories**

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer.[171] Treasury regulations also provide that in any case in which it is necessary to use an inventory, the accrual method must be used with regard to purchases and sales.[172] However, an exception is provided for taxpayers whose average annual gross receipts do not exceed $1 million.[173] A second exception is provided for taxpayers in certain industries whose average annual gross receipts do not exceed $10 million and that are not otherwise prohibited from using the cash method under section 448.[174] Such taxpayers may account for inventory as materials and supplies that are not incidental (*i.e.*, "non-incidental materials and supplies") under Treasury Regulation section 1.162-3.[175]

In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the first-in, first-out ("FIFO") method, which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the last-in, first-out ("LIFO") method, which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

**Capitalization and inclusion of certain expenses in inventory costs**

The uniform capitalization ("UNICAP") rules, which were enacted as part of the Tax Reform Act of 1986,[176] require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.[177] For real or personal property acquired by the

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[171] Sec. 471(a) and Treas. Reg. sec. 1.471-1.

[172] Treas. Reg. sec. 1.446-1(c)(2).

[173] Rev. Proc. 2001-10, 2001-1 C.B. 272 (December 6, 2000).

[174] Rev. Proc. 2002-28, 2002-1 C.B. 815 (April 12, 2002).

[175] Under Treas. Reg. sec. 1.162-3(a)(1), a deduction is generally permitted for the cost of non-incidental materials and supplies in the taxable year in which they are first used or are consumed in the taxpayer's operations.

[176] Sec. 803(a) of Pub. L. No. 99-514 (1986).

[177] Sec. 263A.

taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

Section 263A provides a number of exceptions to the general uniform capitalization requirements. One such exception exists for taxpayers who acquire property for resale and have $10 million or less of average annual gross receipts for the preceding three-taxable year period;[178] such taxpayers are not required to include additional section 263A costs in inventory costs.

Another exception exists for taxpayers who raise, harvest, or grow trees.[179] Under this exception, section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the UNICAP rules do not apply to any animal or to any plant having a preproductive period of two years or less, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under section 447 or 448(a)(3)).[180]

Freelance authors, photographers, and artists also are exempt from section 263A for any qualified creative expenses.[181] Qualified creative expenses are defined as amounts paid or incurred by an individual in the trade or business of being a writer, photographer, or artist. However, such term does not include any expense related to printing, photographic plates, motion picture files, video tapes, or similar items.

## Description of Proposal

The proposal expands the universe of taxpayers that may use the cash method of accounting. Under the proposal, the cash method of accounting may be used by taxpayers other than tax shelters that satisfy the gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed $25 million for the three prior taxable-year period to use the cash receipts and disbursements method. The amount is indexed for inflation for taxable years beginning after 2016.

The proposal retains the exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations. Thus, qualified

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[178] Sec. 263A(b)(2)(B). No statutory exception is available for small taxpayers who produce property subject to section 263A. However, a *de minimis* rule under Treasury regulations treats producers that use the simplified production method and incur total indirect costs of $200,000 or less in a taxable year as having no additional indirect costs beyond those normally capitalized for financial accounting purposes. Treas. Reg. sec. 1.263A-2(b)(3)(iv).

[179] Sec. 263A(c)(5).

[180] Sec. 263A(d).

[181] Sec. 263A(h).

personal service corporations, partnerships without C corporation partners, S corporations, and other passthrough entities are allowed to use the cash method without regard to whether they meet the gross receipts test, so long as the use of such method clearly reflects income.[182] However, the proposal eliminates the exceptions from the required use of the accrual method for farming C corporations such that farming C corporations will be precluded from using the cash method unless they meet the $25 million gross receipts test.

The proposal also exempts certain taxpayers from the requirement to keep inventories. Specifically, taxpayers that meet the gross receipts test are not required to account for inventories under section 471, but rather may use a method of accounting for inventories that either (i) conforms to the taxpayer's financial accounting treatment of inventories, or (ii) clearly reflects income (*e.g.*, such as treating inventories as non-incidental materials and supplies).

In addition, the proposal expands the exception for small taxpayers from the uniform capitalization rules. Under this proposal, a taxpayer that meets the $25 million gross receipts test is exempted from the application of section 263A with respect to costs incurred to produce real or personal property (including property produced for the taxpayer under contract) for use by the taxpayer in the taxpayer's trade or business. The proposal retains the exemptions from UNICAP that are not based on a taxpayer's gross receipts.

Under the proposal, a taxpayer who fails the $25 million gross receipts test would not be eligible for any of the aforementioned exceptions (*i.e.*, from the accrual method, an inventory method, or UNICAP) for the current taxable year and subsequent four taxable years.

The President's fiscal year 2015 budget proposal was a modification of the President's fiscal year 2014 budget proposal. The 2015 modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 241, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 188-189. The President's budget proposals for fiscal years 2014 and 2015 contained proposals to exclude small taxpayers (*i.e.*, those with $10 million or less of average annual gross receipts) from the uniform capitalization rules, but did not expand the availability of the cash method of accounting nor exempt small taxpayers from having to use an inventory method under section 471 (or similar Code provision).

Effective date.−The proposal is effective for taxable years beginning after December 31, 2015.

The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item III.B, reprinted in the back of this volume.

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[182] Consistent with present law, the cash method generally may not be used by taxpayers who do not meet the gross receipts test if the purchase, production, or sale of merchandise is an income-producing factor.

## Analysis

### Overall method of accounting

The purpose of an accrual method of accounting is to match income and expenses in the correct year.[183] An accrual method of accounting generally provides a more accurate measure of economic income than does the cash method of accounting.[184] However, an accrual method of accounting may be more complicated than the cash method of accounting.[185] It may also be the case that the cash method of accounting addresses liquidity concerns of small businesses in that it measures income when the taxpayer is most likely to have the cash to pay any tax. The proposal seeks to alleviate the complexity of an accrual method of accounting for taxpayers whose average annual gross receipts do not exceed $25 million.

For relatively small amounts of income and expenses, the differences in income determined under the cash method and the accrual method may be small, such that each clearly reflects the income of the taxpayer. If the differences are small, any additional accuracy achieved in the measurement of income by an accrual method of accounting may not be worth the additional complexity or liquidity constraints that may come by forsaking the use of the cash method of accounting. As the amounts increase, some may argue that it is less clear that the use of a cash method of accounting clearly reflects income for the taxpayer. Also, the benefits of additional accuracy may justify the higher costs of compliance which may result from the use of the accrual method of accounting.

For some taxpayers covered by the proposal, there may be no additional cost of using an accrual method of accounting. Taxpayers may be required to maintain records in accordance with generally accepted accounting principles, for example, for reporting financial results to owners or for purposes of applying for loans with financial institutions. Generally accepted accounting principles require the use of an accrual method of accounting for most entities. For these taxpayers, there is no additional cost of keeping tax records on an accrual basis. The likelihood of following such principles likely increases with firm size. Firms between the present-law $5 million gross receipts threshold and the proposed $25 million gross receipts threshold may assign little administrative benefit to being able to use a cash method of accounting for tax purposes if they use an accrual method of accounting for other purposes.

In addition to the considerations described above, there may be compliance and tax avoidance concerns with the cash method of accounting. The cash method of accounting may

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[183] Internal Revenue Service, "Accounting Periods and Methods", Publication 538, Rev. December 2012, p. 10.

[184] The cash method of accounting recognizes items of income and expense based on the taxable year in which funds are received or disbursed, which may result in the recognition of items of income and expense without regard to the taxable year in which the economic events giving rise to the items occurred and a potential mismatching of income with related expenses.

[185] The primary advantages of the cash method of accounting are its relative simplicity and generally minimal recordkeeping.

allow taxpayers to shift the recognition of items of income and expense for tax purposes that would not be permissible under an accrual method of accounting. For example, if a taxpayer expects to be in a higher marginal tax bracket next year relative to the current year, it may seek to accelerate the receipt of income into the current year and defer the payment of expenses into next year to take advantage of the expected change in marginal tax rate. This is one reason that present law prohibits larger taxpayers and tax shelters from using the cash method of accounting.[186]

**Accounting for inventories and inventoriable costs**

The purpose of inventory accounting is to match the costs of items purchased (or manufactured) at different times with the proceeds of items sold during the year in order to determine taxable income for the year and determine the cost for tax purposes of the inventory on hand at the end of one year and start of the next. The proposal generally simplifies bookkeeping for taxpayers whose average annual gross receipts do not exceed $25 million by eliminating the need for such taxpayers to maintain complex inventory records in order to determine the cost of goods sold during the taxable year. Under the proposal, the ability of a qualifying small taxpayer to use an inventory method that is either consistent with its financial accounting treatment or that clearly reflects income generally will be practical and an administrative convenience for such taxpayer.

The uniform capitalization rules are also relatively complex, and the proposal seeks to alleviate compliance burdens for qualifying small taxpayers by expanding the scope of properties that are exempted from section 263A. Moreover, the proposal generally will increase cash flow for such taxpayers by allowing them to expense certain additional costs incurred to produce real or personal property, thereby freeing resources to pursue other activities or investments. Alternatively, the deduction of costs of producing, acquiring, or carrying property that otherwise should be capitalized into the basis of the property and recovered when the property is sold or used by the taxpayer in its trade or business may result in a mismatching of expenses with the related income as well as a deferral of Federal income taxes. Small taxpayers may benefit from the time value of such deferral of taxes. However, the economic distortion potentially caused by small taxpayers may not be large enough to warrant the application of unduly burdensome rules. In addition, the expensing of such costs may be more consistent with financial accounting treatment.[187]

Some may argue that by expanding the exception from section 263A (*i.e.*, to those with $25 million or less of gross receipts), the exceptions for those who raise, harvest, or grow trees and those who incur qualified creative expenses are not needed (as the $25 million exception would exclude small taxpayers otherwise relying on this exception). For those taxpayers with more than $25 million in gross receipts, it could be reasoned that they have sufficient

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[186] See, *e.g.*, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514)* (JCS-10-87), May 4, 1987, pp. 474 - 475.

[187] Compared to financial statement reporting requirements, the uniform capitalization rules tend to allow fewer costs to be expensed and require additional costs to be capitalized or included in inventories.

administrative resources to counter the compliance burden and, thus, industry-focused exceptions are not warranted.

### C. Eliminate Capital Gains Taxation on Investments in Small Business Stock

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 133-134. That proposal was modified in the President's fiscal year 2015 budget proposal. For a description of that modification, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 8. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item III.C, reprinted in the back of this volume.

### D. Increase the Limitations for Deductible New Business Expenditures and Consolidate Provisions for Start-Up and Organizational Expenditures

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 8-11. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item III.D, reprinted in the back of this volume.

### E. Expand and Simplify the Tax Credit Provided to Qualified Small Employers for Non-Elective Contributions to Employee Health Insurance

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 138-145. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item III.E, reprinted in the back of this volume.

## PART IV – INCENTIVES FOR MANUFACTURING, RESEARCH, AND CLEAN ENERGY

### A. Enhance and Make Permanent Research Incentives

#### Description of Modification

The President's fiscal year 2016 budget proposal modifies last year's proposal to permanently extend the research credit. Like the President's fiscal year 2015 proposal, the 2016 proposal would make the research credit a permanent feature of the Code. However, for expenditures paid or incurred after 2015, the 2016 proposal makes several modifications relative to the 2015 proposal. First, the current proposal repeals the traditional 20 percent research credit calculation method. In addition, the current proposal increases the rate of the alternative simplified credit to 18 percent (*i.e.*, the research credit is equal to 18 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years), but does not reduce such rate if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.[188]

The current proposal also allows the research credit to offset alternative minimum tax liability.

The current proposal also changes the special rules in the research credit to allow, in certain cases, for contract research expenses to include 75 (instead of 65) percent of payments to qualified non-profit organizations (*e.g.*, educational institutions).

In addition, the current proposal repeals the special rule for pass-through entities which limits the pass-through of the research credit to each owner's tax on income allocable to its ownership interest.

Finally, the current proposal repeals the requirement that an individual owner of a pass-through entity who does not materially participate in such business must capitalize and amortize section 174(a) research and experimental expenditures over 10 years when calculating alternative minimum tax liability.

This proposal is a modification of the President's fiscal year 2015 budget proposal, which in turn was a modification of the President's fiscal year 2013 budget proposal. The 2015 modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 3, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 97-116. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IV.A., reprinted in the back of this volume.

[188] Last year's proposal increased the alternative simplified credit rate to 17 percent.

## B. Extend and Modify Certain Employment Tax Credits, Including Incentives for Hiring Veterans

### 1. Permanently extend and modify the work opportunity tax credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 3-6. That proposal modified a proposal found in the President's fiscal year 2013 budget proposal. For a description of that 2013 budget proposal, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 112th Congress* (JCS-2-13), February 2013, p. 151. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IV.B.1, reprinted in the back of this volume.

### 2. Permanently extend and modify the Indian employment credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 3-6. That proposal modified a proposal found in the President's fiscal year 2014 budget proposal. For a description of that 2014 budget proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 4. A general description and analysis of the proposal can be found in described in Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 112th Congress* (JCS-2-13), February 2013, p. 144. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IV.B.2, reprinted in the back of this volume.

## C. Modify and Permanently Extend the Renewable Electricity Production Tax Credit

### Description of Modification

The fiscal year 2015 budget proposal extends the present law renewable electricity production credit for facilities through 2015. For facilities the construction of which begins after December 31, 2015, the proposal permanently extends the credit and makes it refundable. The credit is also made available to otherwise eligible renewable electricity consumed directly by the producer, rather than sold to an unrelated third party, to the extent that the production can be independently verified. Solar facilities composed of property that currently qualifies for the energy investment tax credit are made eligible for the renewable electricity production tax credit for construction beginning after 2015. The proposal also expands to the renewable electricity production tax credit to individuals who install residential energy efficient property on a dwelling unit. The present law investment credit for this property would be allowed to expire.

Finally, the proposal permanently extends the present law energy investment credits and credit rates available for energy property. Specifically, the proposal permanently extends the 30-percent investment credit for solar, fuel cell, and small wind property and the 10-percent credit for geothermal, microturbine, and combined heat and power property, along with the election to claim the investment credit in lieu of the renewable electricity production credit for property used in qualified facilities eligible for the production credit.

There are two principal modifications relative to the fiscal year 2015 budget proposal. The first is the extension of the production credit to individuals who install residential energy efficient property on a dwelling unit. The second is the permanent extension of the present law energy investment credits and credit rates.

This proposal modifies a proposal found in the President's fiscal year 2015 budget proposal. For a description of that 2015 budget proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 6-7. That proposal modified the President's fiscal year 2014 budget proposal. For a description of that 2014 budget proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 5. The original proposal is provided in the President's fiscal year 2013 budget proposal and is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 124-132. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IV.C, reprinted in the back of this volume.

### D. Modify and Permanently Extend the Deduction for Energy Efficient Commercial Building Property

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 7. That proposal modified a proposal contained in the President's fiscal year 2014 budget proposal. For a description of that 2014 budget proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 6. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IV.D, reprinted in the back of this volume.

### E. Provide a Carbon Dioxide Investment and Sequestration Tax Credit

#### Present Law

A credit of $10 per metric ton is available for qualified carbon dioxide that is captured by the taxpayer at a qualified facility, used by such taxpayer as a tertiary injectant (including carbon

dioxide augmented waterflooding and immiscible carbon dioxide displacement) in a qualified enhanced oil or natural gas recovery project and disposed of by such taxpayer in secure geological storage.[189] In addition, a credit of $20 per metric ton is available for qualified carbon dioxide captured by a taxpayer at a qualified facility and disposed of by such taxpayer in secure geological storage without being used as a tertiary injectant. Both credit amounts are adjusted for inflation after 2009.

Secure geological storage includes storage at deep saline formations, oil and gas reservoirs, and unminable coal seams. The Secretary, in consultation with the Administrator of the Environmental Protection Agency the Secretary of Energy, and the Secretary of the Interior, is required to establish regulations for determining adequate security measures for the secure geological storage of carbon dioxide such that the carbon dioxide does not escape into the atmosphere.

Qualified carbon dioxide is defined as carbon dioxide captured from an industrial source that (1) would otherwise be released into the atmosphere as an industrial emission of greenhouse gas, and (2) is measured at the source of capture and verified at the point or points of injection. Qualified carbon dioxide includes the initial deposit of captured carbon dioxide used as a tertiary injectant but does not include carbon dioxide that is recaptured, recycled, and re-injected as part of an enhanced oil or natural gas recovery project process. A qualified enhanced oil or natural gas recovery project is a project that would otherwise meet the definition of an enhanced oil recovery project under section 43, if natural gas projects were included within that definition.

A qualified facility means any industrial facility (1) which is owned by the taxpayer, (2) at which carbon capture equipment is placed in service, and (3) which captures not less than 500,000 metric tons of carbon dioxide during the taxable year. The credit applies only with respect to qualified carbon dioxide captured and sequestered or injected in the United States[190] or one of its possessions.[191]

Except as provided in regulations, credits are attributable to the person that captures and physically or contractually ensures the disposal, or use as a tertiary injectant, of the qualified carbon dioxide. Credits are subject to recapture, as provided by regulation, with respect to any qualified carbon dioxide that ceases to be recaptured, disposed of, or used as a tertiary injectant in a manner consistent with the rules of the provision.

The credit is part of the general business credit. The credit sunsets at the end of the calendar year in which the Secretary, in consultation with the Administrator of the Environmental Protection Agency, certifies that 75 million metric tons of qualified carbon dioxide have been captured and sequestered.

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[189] Sec. 45Q.

[190] Sec. 638(1).

[191] Sec. 638(2).

## Description of Proposal

The proposal establishes two new carbon dioxide sequestration credits. The first is an allocated, refundable investment credit for qualified carbon dioxide capture and sequestration property. The second is a refundable credit based on the amount of carbon dioxide permanently sequestered.

Effective date.–The proposal is effective after the date of enactment.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item II.A, reprinted in the back of this volume.

### Investment credit for carbon dioxide capture and sequestration property

The proposal establishes a new allocated, refundable investment tax credit for qualified carbon dioxide capture and sequestration property. Up to $2 billion in credits may be allocated. The credit rate is 30 percent of the installed cost of eligible property for which an allocation has been made.

Credits are available for both new and retrofitted electric generating units. Qualified property placed in service at new facilities must capture more than 75 percent of carbon dioxide emissions. Retrofits must capture more than 75 percent of the carbon dioxide emissions from the set of existing electric generating units to which the investment is applied. In addition, retrofits must apply to plant units that have capacities greater than 250 megawatts and that capture and store more than one million metric tons of carbon dioxide per year.

Eligible property includes carbon dioxide transportation and storage infrastructure, including pipelines, wells, and monitoring systems. Applications for credit allocations are due 18 months after enactment. Taxpayers may apply an investment credit to part or all of the qualified investment in the project.

In allocating credits, the Secretary must consider (1) the credit per ton of net sequestration capability and (2) the expected contribution of the technology and the type of plant to which that technology is applied to the long-run economic viability of carbon sequestration from fossil fuel combustion. No more than 60 percent of the total credits may be allocated to either new projects or to retrofits. In addition, no more than 40 percent of the total credits may be allocated to any one of the following technology categories: (1) liquid solvents, (2) solid sorbents, (3) gas-separation membranes, (4) warm gas clean-up, (5) oxygen fired combustion systems, and (6) hybrid systems. A minimum of 70 percent of the credits would be required to flow to projects fueled by greater than 75 percent coal.

### Carbon dioxide sequestration credit

The proposal establishes a new refundable carbon dioxide sequestration credit. The credit amount is $50 per metric ton of carbon dioxide permanently sequestered and not beneficially reused (for example, in an enhanced oil recovery operation) and $10 per metric ton

for carbon dioxide that is permanently sequestered and beneficially reused. The credit is indexed for inflation and available for a maximum of 20 years of production per facility.

## Analysis

Economists generally agree that it would be more efficient to address pollution through a direct tax on the pollution-causing activities than through the indirect approach of targeted tax credits for certain technologies. By the direct tax approach, the establishment of the economically efficient prices on pollutants, through taxes, would result in the socially optimal level of pollution. To achieve this result, the tax would be set to equal the cost to society of the incremental pollution. The imposition of a direct tax on the pollution-causing activity would indirectly lead to the adoption of the types of technologies favored in the tax code, but only if these technologies were in fact the most efficient technologies.

Nonetheless, many provisions of current law provide targeted tax credits for investment in, or expenditures on, certain assets that reduce, directly or indirectly, the consumption of conventional fuels and the attendant negative externalities. The design of these tax benefits is directly relevant to how close these tax benefits come, individually and collectively, to achieving their intended objectives in a cost effective and efficient manner. Ideally, their design would be coordinated to try to mimic the more economically efficient outcome that a broad based tax would provide.

The proposal has two stated goals: (1) reduce current greenhouse gas emissions from fossil fuel combustion and (2) invest in carbon dioxide capture and sequestration technologies to help facilitate technological improvements that will be important for reducing the costs of controlling future greenhouse gas emissions. The proposal seeks to accomplish these goals by incentivizing investments in carbon capture and sequestration property, as well as awarding tax credits per ton of carbon dioxide actually sequestered. While the proposed incentives will have an impact on carbon dioxide capture and sequestration, it is less clear whether the design of the incentives will accomplish the proposal's stated goals in a cost effective and efficient manner.

Focusing on the first goal of reducing current greenhouse gas emissions, both the investment and sequestration credit elements of the proposal include restrictions that make them inefficient. For example, in the case of the investment credit, 70 percent of credits must flow to projects that are at least 75 percent fueled by coal. This limitation is in addition to a requirement that the Secretary, in making credit allocations, consider the credit per ton of net sequestration capability. Preferencing coal over natural gas or other fossil fuels in this fashion creates an inefficiency to the detriment of the stated goal of reducing current greenhouse gas emissions. Similarly, the sequestration credit increases fivefold (from $10 per ton to $50 per ton) if the permanently sequestered carbon dioxide was not beneficially reused prior to sequestration. This difference is inefficient to the extent it discourages projects that beneficially reuse carbon dioxide.

The inefficient design of the proposal carries over to the second stated goal of encouraging technological improvements that will reduce the cost of controlling future greenhouse gas emissions. The proposed investment credit creates six technology categories and restricts the number of credits that can flow to any one category. This limitation is in addition to

a requirement that the Secretary, in making allocations, consider the expected contribution of the technology and the type of plant to which that technology is applied to the long-run economic viability of carbon sequestration from fossil fuel combustion. Thus, a project expected to make a greater technological contribution could be denied an allocation in favor of an inferior one that falls within a different technological category.

Finally, the proposal adopts both an investment credit for sequestration technology, and a separate credit for sequestration itself. This raises the question of why both types of credit are needed. If the government's goal is to subsidize sequestration, the sequestration credit alone would be the most direct, efficient, and technologically neutral way to accomplish this. The investment credit alone also subsidizes sequestration, but does so indirectly by subsidizing the capital necessary for sequestration, and thus favors more capital intensive projects. In contrast, the sequestration credit indirectly subsidizes the capital investments necessary for sequestration, but will not favor specific capital investments. The proposed investment tax credit intentionally subsidizes specific technologies by the restrictions placed on the amount of the credit that can go to a specific technology category. In this sense, the investment credit subsidizes technology choices that the market would not otherwise undertake. This in general is considered economically inefficient, unless the market outcome leads to inefficient investment choices. One possible argument in favor of the investment credit restrictions is that there are technologies that are too risky for market investors, but which have the potential to have a large payoff for society at large if the technology proves successful. If the government goal is to promote specific technologies, it is not clear why these projects should benefit from the sequestration credit as well. Consideration should be given to restricting the sequestration credit to projects that did not receive an investment credit, and raising the cap on the investment credit if that is necessary to encourage the adoption of the desired technologies.

### F. Provide Additional Tax Credits for Investment in Qualified Property Used in a Qualifying Advanced Energy Manufacturing Project

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 125. That proposal modified a proposal contained in the President's fiscal year 2014 budget proposal. For a description of that 2014 budget proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 59. The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 15-18. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IV.F, reprinted in the back of this volume.

### G. Provide New Manufacturing Communities Tax Credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation,

*Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 83-87. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IV.G, reprinted in the back of this volume.

### H. Extend the Tax Credit for Second Generation Biofuel Production

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 127-129. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IV.H, reprinted in the back of this volume.

## PART V ─ INCENTIVES TO PROMOTE REGIONAL GROWTH

### A. Modify and Permanently Extend the New Markets Tax Credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. That proposal was a modification of the President's fiscal year 2013 budget proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 15, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 146-151. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item V.A, reprinted in the back of this volume.

### B. Reform and Expand the Low-Income Housing Tax Credit

#### 1. Allow States to convert private activity bond volume cap into low-income housing tax credits

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. That proposal was a modification of the President's fiscal year 2014 budget proposal. For a description of the 2015 modification, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 12-13. The President's fiscal year 2014 budget proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 18-20. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item V.B.1, reprinted in the back of this volume.

#### 2. Encourage mixed income occupancy by allowing low-income housing tax credit-supported projects to elect a criterion employing a restriction on average income

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 186-188. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item V.B.2, reprinted in the back of this volume.

#### 3. Change formulas for 70 percent PV and 30 percent PV low-income housing tax credits

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. That proposal was a modification of the President's fiscal year 2013 proposal. The modified proposal is described in Joint Committee on Taxation, *Description of*

*Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 21-22, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 195-197. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item V.B.3, reprinted in the back of this volume.

**4. Add preservation of Federally assisted affordable housing to allocation criteria**

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. That proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 22. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item V.B.4, reprinted in the back of this volume.

**5. Remove the qualified Census tract population cap**

**Present Law**

**In general**

The low-income housing tax credit ("LIHTC") may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels.[192] The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building. Eligible basis is generally adjusted basis at the close of the first taxable year of the credit period.

**Present value credit**

The calculation of the applicable percentage is designed to produce a credit equal to: (1) 70 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is not Federally subsidized (the "70-percent credit"); or (2) 30 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is Federally subsidized and existing housing that is substantially rehabilitated (the "30-percent credit"). For example, in a zero-interest-rate environment, a building eligible for a 70-percent credit has an annual applicable percentage of seven percent for each of the ten years of the credit period. As interest rates rise, the seven-percent applicable percentage also rises to preserve the present value of the credit.

[192] Sec. 42.

Where existing housing is substantially rehabilitated, the existing housing is eligible for the 30-percent credit and the qualified rehabilitation expenses (if not Federally subsidized) are eligible for the 70-percent credit.

**Enhanced credit for certain buildings**

Generally, certain buildings (*i.e.*, those located in qualified census tracts, those located in difficult development areas, and those buildings designated by the State housing credit agency as requiring the enhanced credit for such buildings to be financially feasible) are eligible for an enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credits are increased to a 91-percent and 39-percent credit, respectively. The mechanism for this increase is through an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building.

A qualified census tract means any census tract in which 50 percent or more of the households have an income which is less than 60 percent of the area median gross income for such year or which has a poverty rate of at least 25 percent. A difficult development area is any area designated by the Secretary of Housing and Urban Development as an area that has high construction, land, and utility costs relative to area median gross income.

Further requirements limit the area that can be qualified census tracts and difficult development areas. The portions of each metropolitan statistical area, or nonmetropolitan statistical area (together, "MSAs"), designated as qualified census tracts cannot exceed an aggregate area having 20 percent of the population of each such statistical area. A comparable rule applies to portions of each such statistical area that are designated as difficult development areas. Buildings designated by the State housing credit agency as requiring the enhanced credit for such buildings to be financially feasible are not subject to either the limitation that applies to qualified census tracts or the limitation applicable to difficult development areas.

## Description of Proposal

The proposal removes the limitation on the portion of an MSA that may be designated as qualified census tracts. That is, qualified census tracts may include an area having more than 20 percent of the population of the MSA, provided the census tracts otherwise meet the income or poverty requirements.

Effective date.−The proposal is effective for buildings that receive allocations of low-income housing tax credits or volume cap after the date of enactment.

The estimated budget effect of this proposal can be found at *Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item V.B.5, reprinted in the back of this volume.

## Analysis

The proposal allows more buildings to qualify for the enhanced 91-percent and 39-percent credits by removing the limit on the portion of a metropolitan statistical area that may be

designated as qualified census tracts. Approximately 90 of 375 metropolitan statistical areas are limited by present law, including six of the ten most populous MSAs.[193] If additional basis is eligible for 91-percent (or 39-percent) credits in these areas, fewer 70-percent credits (or 30-percent credits in States in which the private activity bond cap is fully utilized) are available for projects in other areas. The proposal reconsiders the tradeoffs between providing deeper subsidies for low-income housing in poor areas and providing subsidies in more geographic areas.

A separate question arises as to whether the proposal is necessary. Under present law, State housing credit agencies may designate a project as requiring the 91-percent or 39-percent credits to be financial feasible without limitation by population or geography.

**6. Implement requirement that low-income housing tax credit supported housing protect victims of domestic abuse**

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 14-16. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item V.B.6, reprinted in the back of this volume.

[193] See Department of Housing and Urban Development, "Qualified Census Tract Table Generator - QCT Designation Data," available at http://qct.huduser.org/tables/data_request.odb and JCT staff calculations. Ninety of the 375 MSAs have designated qualified census tracts that include an area having at least 19.5 percent of the population of the MSA. Six of the ten largest MSAs are within 0.05 percent of the 20-percent limit: New York-Northern New Jersey-Long Island, NY-NJ-PA MSA; Los Angeles-Long Beach-Santa Ana, CA MSA; Dallas-Fort Worth-Arlington, TX MSA; Philadelphia-Camden-Wilmington, PA-NJ-DE-MD MSA; Houston-Sugar Land-Baytown, TX MSA; and Miami-Fort Lauderdale-Pompano Beach, FL MSA. Two of the ten smallest MSAs, Danville, IL MSA and Guayama, PR MSA, also contain at least 19.5 percent of the population of the MSA.

## PART VI ─ INCENTIVES FOR INVESTMENT IN INFRASTRUCTURE

### A. Provide America Fast Forward Bonds and Expand Eligible Uses

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal, which modified a proposal from the 2014 budget proposal. For a description of the 2015 modification, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 136-137. The President's fiscal year 2014 budget proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 61-68. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VI.A, reprinted in the back of this volume.

### B. Allow Current Refundings of State and Local Governmental Bonds

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 184-185. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VI.B, reprinted in the back of this volume.

### C. Repeal the $150 Million Non-Hospital Bond Limitation on Qualified Section 501(c)(3) Bonds

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 69-70. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VI.C, reprinted in the back of this volume.

### D. Increase National Limitation Amount for Qualified Highway or Surface Freight Transfer Facility Bonds

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 71-75. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VI.D, reprinted in the back of this volume.

## E. Provide a New Category of Qualified Private Activity Bonds for Infrastructure Projects Referred to as "Qualified Public Infrastructure Bonds"

### Present Law

#### Overview

Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes. Because of the income exclusion, investors generally are willing to accept a lower rate on tax-exempt bonds than they might otherwise accept on a taxable investment. This, in turn, lowers the borrowing cost for the beneficiaries of such financing.

Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") and other Code requirements are met.

Like other activities carried out and paid for by State and local governments, the construction, renovation, and operation of governmental transportation infrastructure projects such as public highways or governmental mass commuting systems (*e.g.*, rail and bus) are eligible for financing with the proceeds of governmental bonds. In addition, certain privately-used transportation infrastructure projects may be financed with qualified private activity bonds.

#### Tax-exempt governmental bonds

##### In general

Present law does not limit the types of facilities that can be financed with governmental bonds. Thus, State and local governments can issue tax-exempt, governmental bonds to finance a broad range of transportation infrastructure projects, including highways, railways, airports, etc. However, while the types of projects eligible for governmental bond financing are not circumscribed, present law imposes restrictions on the parties that may benefit from such financing. For example, present law limits the amount of governmental bond proceeds that can be used by nongovernmental persons. Use of bond proceeds by nongovernmental persons in excess of amounts permitted by present law may result in such bonds being treated as taxable private activity bonds, rather than governmental bonds. The Code defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test ("the private business test"); or (2) "the private loan financing test."[194] Generally, private activity bonds are taxable unless issued as qualified private activity bonds.

[194] Sec. 141.

Generally, governmental bonds are not subject to certain additional eligibility restrictions that apply to qualified bonds used to finance private activities. For example, governmental bonds are not subject to issuance cost, maturity, and annual volume limitations that generally apply to qualified private activity bonds.

Private business tests

Under the private business tests, a bond is a private activity bond if it is part of an issue in which both:

1. More than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit ("private business use test"); and

2. More than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, secured by (a) property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use ("private payment test").[195]

A bond is not a private activity bond unless both parts of the private business tests (*i.e.*, the private business use test and the private payment test) are met. Thus, a facility that is 100 percent privately used does not cause the bonds financing such facility to be private activity bonds if the bonds are not secured by or paid with private payments. For example, land improvements that benefit a privately-owned factory may be financed with governmental bonds if the debt service on such bonds is not payable or secured by payments or property used by the factory owner or other private businesses.

Private business test component 1: The private business use test

In general, for purposes of the private business use test, a broad standard applies under which private business use includes use of bond-financed property by a nongovernmental person as a result of ownership of property, a lease of property, or other actual or beneficial use of property under certain management or incentive payment contracts, output-type contracts, or certain other arrangements in which a nongovernmental person has legal contractual rights to use property.[196]

Management contracts and private business use

A contract between a private management or other service company and a governmental unit to operate bond-financed governmental facilities may result in private business use

[195] The 10-percent private business test is reduced to five percent in the case of private business uses (and payments with respect to such uses) that are either unrelated or disproportionate to any governmental use being financed by the issue.

[196] Treas. Reg. sec. 1.141-3(b).

depending on the terms of the contract.[197] Management contracts include management, service or incentive pay contracts between a governmental person and a service provider for all or a portion of a financed facility, or any function of a financed facility. A management contract that provides for compensation based in whole or in part on the net profits of the financed facility generally results in private business use. A management contract also results in private business use if the service provider is treated as the lessee or owner for Federal income tax purposes.

Treasury regulations identify four management contract arrangements that do not give rise to private business use:[198]

- Incidental services: Contracts for services incidental to the facility's primary functions (*e.g.*, janitorial, office equipment repair, hospital billing or similar services);
- Hospital admitting privileges: The granting of hospital admitting privileges to a doctor if such privileges are available to all qualified physicians in the area;
- Certain public utility property contracts: Contracts for the operation of public utility property if the only compensation reimbursement for actual, direct expenses of the service provider and reasonable administrative overhead expenses of the service provider; or
- Certain expense only reimbursement contracts: Contracts for services if compensation is limited to reimbursement of the service provider for actual direct expenses paid by the service provider to unrelated third parties.

In general, a management contract gives rise to private business use if the compensation under the contract is based on net profits. For example, a management contract with respect to a commuter rail facility that compensates the management company based on the profits of such facility would result in private use.

In Revenue Procedure 97-13, as modified by Rev. Proc. 2001-39, the IRS provided safe harbor guidelines under which certain management contract arrangements are treated as not giving rise to private business use, depending on the term of the contract and the nature of the management compensation arrangement.[199] Under these safe harbors, the permitted term of the contract generally depends on the extent to which the management compensation arrangement is based on periodic fixed fees. Thus, for example, these safe harbors permit a 15-year contract in which 95 percent of the management compensation consists of periodic fixed fees, and also a 5-year contract in which 50 percent of the management compensation consists of periodic fixed fees. The revenue procedure provides five "safe harbor" arrangements that if met, do not give rise to private business use:

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[197] Treas. Reg. sec. 1.141-3(b)(4).

[198] Treas. Reg. sec. 1.141-3(b)(4)(iii)(A)-(D).

[199] Rev. Proc. 97-13, 1997-1 C.B. 632.

- 95 percent periodic fixed fee arrangements: At least 95 percent of service compensation for each annual period during the term of the contract is based on a periodic fixed fee, and the term of the contract (including renewals) does not exceed the lesser of 15 years (20 years for public utility property) or 80 percent of the expected useful life of the related property.
- 80 percent periodic fixed fee arrangement: At least 80 percent of the compensation for services for each annual term during the term of the contract (including renewals) is based on a periodic fixed fee, and the term of the contract does not exceed the lesser of 10 years (20 years for public utility property) or 80 percent of the expected useful life of the related property.
- 50 percent periodic fixed fee arrangement: 50 percent of more of the compensation for services for each annual period is based on a periodic fixed fee or all of the compensation is based on a capitation fee[200] or a combination of a capitation fee and a periodic fixed fee. The contract term (including renewals) cannot exceed five years. The contract must be terminable at the option of the qualified user at the end of three years.
- Per unit fee[201] arrangement: 100 percent of the compensation must be based on a per-unit fee or a combination of a per-unit fee and periodic fixed fee, the term of the contract (including renewals) cannot exceed three years (and must be terminable by the qualified user after two years).
- Percentage of revenue or expense fee arrangements: 100 percent of the compensation must be based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee. During start up, compensation may be based on gross revenues or expenses of a facility. The term of the contract cannot exceed two years, and the contract must be terminable by the qualified user in one year. This exception applies only to service contracts under which the service provider primarily provides service to third parties or during an initial start-up period where there is no reasonable estimate of annual gross revenues and expenses.

In Notice 2014-67, the IRS further modified the safe harbor guidelines for private management contracts.[202] A modified safe harbor for five-year contracts allows the compensation is based on a stated amount, a periodic fixed fee, a capitation fee, a per unit fee, or a combination of the foregoing. These five-year contracts need not be terminable by the qualified user. In addition, the IRS provided a safe harbor against private business use for

[200] "Capitation fee" means a fixed periodic amount for each person who is covered by the contract as long as the quantity and type of services actually provided to covered persons is substantially different (*e.g.*, a monthly fee for each member of an HMO).

[201] "Per-unit fee" means a fee based on a unit of service provided which is specified in the contract by an independent third party (*e.g.* Medicare administrator) or the qualified user.

[202] Notice 2014-67, 2014-46 I.R.B. 822 (November 10, 2014).

arrangements for participation in Medical Shared Savings Programs by Affordable Care Organizations under the Affordable Care Act if the arrangements meet certain conditions.

Private business test component 2: The private payment test

For purposes of the second component of the private business test, the private payment test, both direct and indirect payments made by any private person treated as using the financed property are taken into account. Payments by a person for the use of proceeds generally do not include payments for ordinary and necessary expenses (within the meaning of section 162) attributable to the operation and maintenance of financed property.[203]

Private loan financing test

In addition to the two-part private business test, a bond may be classified as a private activity bond if it meets the "private loan financing test." A bond issue satisfies the private loan financing test if proceeds exceeding the lesser of $5 million or five percent of such proceeds are used directly or indirectly to finance loans to one or more nongovernmental persons. Private loans include both business and other (*e.g.*, personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments that are subject to the private business test.

**Qualified private activity bonds**

Qualified private activity bonds are tax-exempt private activity bonds issued to provide financing for specified privately used facilities. The definition of a qualified private activity bond includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[204]

To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance an eligible facility.[205] Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, high-speed intercity rail facilities, and qualified highway or surface freight transfer facilities); privately owned and/or operated public works facilities (sewage, solid waste disposal, water, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated residential rental housing; and certain private facilities for the local furnishing of electricity or gas. Bonds issued to finance "environmental enhancements of hydro-electric generating facilities," qualified public educational facilities, and qualified green building and sustainable design projects also may qualify as exempt facility bonds.

[203] Treas. Reg. sec. 1.141-4(c)(3).

[204] Sec. 141(e).

[205] Sec. 142(a).

Generally, qualified private activity bonds are subject to a number of additional eligibility restrictions that do not apply to governmental bonds. For example, the aggregate volume of most qualified private activity bonds is restricted by annual State volume limitations (the "State volume cap").[206] For calendar year 2015, the State volume cap, which is indexed for inflation, equals $100 per resident of the State, or $301,515,000, if greater.[207]

Qualified private activity bonds also are subject to additional limitations under section 147, including a substantial user limit, a bond maturity restriction, a limit on financing land acquisition, a limit on financing existing property absent substantial rehabilitation, certain prohibited facilities, a public approval requirement, and a limit on financing issuance costs. Further, qualified private activity bonds (other than qualified 501(c)(3) bonds) are ineligible for advance refundings.[208] In addition, the interest income from qualified private activity bonds (other than qualified 501(c)(3) bonds) generally is a preference item for purposes of calculating the alternative minimum tax ("AMT").[209]

**Rules governing private activity bonds for certain surface transportation infrastructure**

Airports

Exempt facility bonds may be issued to finance airports. Exempt facility bonds for airports are not subject to the State volume cap. However, all tax-exempt-bond-financed airport property must be governmentally owned. Property eligible for this financing includes land, terminals, runways, public parking facilities, and related equipment. Airplanes are not eligible for tax-exempt financing. Additionally, certain real property facilities (and related equipment) are excluded from this financing:

[206] The following private activity bonds are not subject to the State volume cap: qualified 501(c)(3) bonds, exempt facility bonds for airports, docks and wharves, environmental enhancements for hydroelectric generating facilities, and exempt facility bonds for solid waste disposal facilities that are to be owned by a governmental unit. The State volume cap does not apply to 75 percent of exempt facility bonds issued for high speed intercity rail facilities, 100 percent if the high speed intercity rail facility is to be owned by a governmental unit. Qualified veterans mortgage bonds, qualified public educational facility bonds, qualified green building and sustainable project design bonds, and qualified highway or surface freight transfer facility bonds also are not subject to the State volume cap, but the Code subjects such bonds to volume limitations specific to the category of bonds.

[207] Rev. Proc. 2014-61.

[208] See sec. 149(d)(2).

[209] Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and to certain bonds issued before September 1, 1986. Further, tax-exempt interest on private activity bonds issued in calendar years 2009 and 2010 is not an item of tax preference for purposes of the alternative minimum tax and interest on tax-exempt bonds issued in 2009 and 2010 is not included in corporate adjustment based on current earnings.

1. Hotels and other lodging facilities;

2. Retail facilities (including food and beverage facilities) located in a terminal, if the facilities are in excess of a size necessary to serve passengers and employees at the airport;

3. Retail facilities for passengers or the general public (including, but not limited to, rental car lots) located outside the terminal;

4. Office buildings for individuals who are not employees of a governmental unit or of the public airport operating authority; and

5. Industrial parks or manufacturing facilities.

Port facilities

Exempt facility bonds may be issued to finance port ("dock and wharf") facilities and related storage and training facilities. Facilities that are specifically ineligible for financing with airport bonds may not be financed with port bonds. Further, ships and other vessels are not eligible for private activity tax-exempt bond financing. All property financed with these bonds must be governmentally owned. Exempt facility bonds issued for ports are not subject to the State volume cap.

Mass commuting facilities

Exempt facility bond financing for mass commuting facilities is subject to restrictions similar to those which apply to such bonds for airports and ports. All property financed with these bonds must be governmentally owned. Further, "rolling stock" (*e.g.*, buses and rail cars) is not eligible for financing with exempt facility bonds.

High-speed intercity rail facilities

The definition of an exempt facility bond includes bonds issued to finance high-speed intercity rail facilities.[210] A facility qualifies as a high-speed intercity rail facility if it is a facility (other than rolling stock) for fixed guideway rail transportation of passengers and their baggage between metropolitan statistical areas.[211] The facilities must use vehicles that are reasonably expected to be capable of attaining a maximum speed in excess of 150 miles per hour between scheduled stops, and the facilities must be made available to members of the general public as passengers.

Unlike other bond-financed transportation facilities, high-speed intercity rail facilities may be privately owned. However, if the bonds are to be issued for a nongovernmental owner of

[210] Sec. 142(a)(11) and sec. 142(i).

[211] A metropolitan statistical area for this purpose is defined by reference to section 143(k)(2)(B). Under that provision, the term metropolitan statistical area includes the area defined as such by the Secretary of Commerce.

the facility, such owner must irrevocably elect not to claim depreciation or credits with respect to the property financed by the net proceeds of the issue.[212]

The Code imposes a special redemption requirement for these types of bonds. Any proceeds not used within three years of the date of issuance of the bonds must be used within the following six months to redeem such bonds.[213]

Seventy-five percent of the principal amount of the bonds issued for high-speed rail facilities is exempt from the volume limit.[214] If all the property to be financed by the net proceeds of the issue is to be owned by a governmental unit, then such bonds are completely exempt from the volume limit.

Qualified highway or surface freight transfer facility bonds

Present law authorizes the issuance of tax-exempt private activity bonds to finance qualified highway or surface freight transfer facilities. A qualified highway facility or surface freight transfer facility is any surface transportation or international bridge or tunnel project (for which an international entity authorized under Federal or State law is responsible) which receives Federal assistance under title 23 of the United States Code or any facility for the transfer of freight from truck to rail or rail to truck which receives Federal assistance under title 23 or title 49 of the United States Code.

Qualified highway or surface freight transfer facility bonds are not subject to the State volume limitations. Rather, the Secretary of Transportation is authorized to allocate a total of $15 billion of issuance authority to qualified highway or surface freight transfer facilities in such manner as the Secretary determines appropriate.[215]

Similar to the requirement for high-speed intercity rail facilities, the Code imposes a special redemption requirement for qualified highway or surface freight transfer facility bonds. Under present law, the proceeds of qualified highway or surface freight transfer facility bonds must be spent on qualified projects within five years from the date of issuance of such bonds. Proceeds that remain unspent after five years must be used to redeem outstanding bonds.

The qualified highway or surface freight transfer facility bond provision was enacted in 2005 as part of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy

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[212] Sec. 142(i)(2).

[213] Sec. 142(i)(3).

[214] Sec. 146(g)(4).

[215] See Department of Transportation, *Notice of Solicitation for Requests for Allocations of Tax-exempt Financing and Request for Comments*, 71 Fed. Reg. 642 (January 5, 2006) and Internal Revenue Service, Notice 2006-45, *Exempt Facility Bonds for Qualified Highway or Surface Freight Transfer Facilities*, 2006-20 I.R.B. 891 (May 15, 2006).

for Users ("SAFETEA-LU").[216] As reflected below, as of May 12, 2015, the Department of Transportation has made allocations of approximately $11 billion of the $15 billion it is authorized to allocate. Of the $11 billion that has been allocated, approximately $5.8 billion of bonds have been issued.[217]

## Description of Proposal

In general, the proposal would create a new category of tax-exempt qualified private activity bonds called "Qualified Public Infrastructure Bonds" (QPIBs) that would be eligible to finance the following specific categories of infrastructure projects that are permitted to be financed with exempt facility bonds under current law: (1) airports; (2) docks and wharves; (3) mass commuting facilities; (4) facilities for the furnishing of water; (5) sewage facilities; (6) solid waste disposal facilities; and (7) qualified highway or surface freight transfer facilities.

The proposal would impose two core eligibility requirements for QPIBs: a governmental ownership requirement and a public use requirement. The proposal would require that the projects financed by QPIBs must be owned by a State or local governmental unit. The proposal would provide a safe harbor for establishing governmental ownership of financed projects that would follow the same principles as the existing safe harbor under section 142(b)(1)(B) for governmental ownership of airports, docks and wharves, mass commuting facilities, and environmental enhancements of hydro-electric generative facilities that are financed with exempt facility bonds. In addition, the proposal would require that projects financed by QPIBs meet a public use requirement by serving a general public use or being available on a regular basis for general public use. Further, except as otherwise provided, the proposal would require that QPIBs meet the existing eligibility restrictions for qualified private activity bonds.

The proposal would make the bond volume cap requirement inapplicable to QPIBs. The proposal also would make the AMT preference for interest on specified private activity bonds inapplicable to QPIBs. The proposal would remove those existing categories of exempt facilities that overlap with QPIBs effective upon the effective date of the proposal, subject to a transitional exception for qualified highway or surface freight transfer facilities. Qualified highway or surface freight transfer facilities would be eligible for QPIBs at the same time as other eligible facilities when QPIBs became effective and that existing category of exempt facility bond also would continue to be available until such time as the Secretary of Transportation has allocated the total bond volume authorization for those bonds, including the existing $15 billion authorization and the additional $4 billion authorization proposed herein, and those bonds have been issued. Alternatively, Congress could consider continuing the existing categories of exempt facilities that overlap with QPIBs for privately-owned projects, subject to the unified annual State bond volume cap.

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[216] Pub. L. No. 109-59, sec. 11143.

[217] Federal Highway Administration, *Innovative Program Delivery* (website), *Tools & Programs: Federal Debt Financing Tools, Private Activity Bonds*, http://www.fhwa.dot.gov/ipd/finance/tools_programs/federal_debt_financing/private_activity_bonds/default.aspx#current.

Effective date.−The proposal would be effective for bonds issued starting January 1, 2016.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VI.E., reprinted in the back of this volume.

## Analysis

It is widely reported that the nation's infrastructure funding needs are great, with as much as $262 billion a year needing to be invested in U.S. highways, rail networks and transportation systems. The Administration's QPIB proposal does not in and of itself provide new Federal capital funding for infrastructure projects. Rather, the proposal provides a Federal supplement to capital funding from non-Federal sources through lower-cost financing for State and local governments. Some may argue that facilitating the use of private capital will help relieve some of the burden on the need for governmental investment in infrastructure. However, from the perspective of tax-exempt investors, such as pension funds without tax-liability, investment in tax-exempt instruments such as QPIBs may not draw very much interest. The Administration also has proposed to make QPIBs eligible for the direct payment subsidy option under its America Fast Forward Bond proposal,[218] which, if enacted, would have the potential to attract a broader class of investors, such as pension funds, without regard to tax benefits.

The proposal seeks to increase the rate of return to investments in public infrastructure by reducing the cost of financing. This could direct investment away from private investments with a higher pre-tax rate of return and towards lower rate of return public investments. Estimates suggest that the return to public capital is approximately 85 percent of the return to private capital.[219] Proponents may argue that the public capital generates positive externalities that can justify this difference.[220] However, opponents may note that the public investment may crowd out more productive private investment such that the overall effect on growth is slight.[221]

Proponents argue that the proposal is designed to increase private participation by providing a permanent lower cost of financing tool to build infrastructure. Under present law,

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[218] See Part VI.A, *supra*.

[219] See, for example, Daniel J. Henderson and Subal C. Kumbhakar, "Public and Private Capital Productivity Puzzle: A Nonparametric Approach," *Southern Economic Journal*, vol. 73, no. 1, July 2006, pp. 219-232, 226, and Antonio Afonso and Miguel St. Aubyn, "Macroeconomic Rates of Return of Public and Private Investment: Crowding-In and Crowding-Out Effects," *European Central Bank Working Paper Series* No. 864, February 2008, p. 32.

[220] Daniel J. Henderson and Subal C. Kumbhakar, "Public and Private Capital Productivity Puzzle: A Nonparametric Approach," *Southern Economic Journal*, vol. 73, no. 1, July 2006, p. 226.

[221] Antonio Afonso and Miguel St. Aubyn, "Macroeconomic Rates of Return of Public and Private Investment: Crowding-In and Crowding-Out Effects," *European Central Bank Working Paper Series* No. 864, February 2008, p. 21.

interest on qualified private activity bonds is a preference item for purposes of calculating the alternative minimum tax ("AMT). Interest on QPIBs would not be a preference item for AMT purposes under the proposal in hopes that the pool of potential buyers would expand and the market would look more favorably on the bonds and bring down the interest rate. The lower interest rates implies an implicit ranking of the tax-exempt debt on par with governmental debt.

Proponents argue that the proposal will allow State and local governments to take advantage of private sector management, operations expertise, as well as cost and time savings. On the other hand, such collaboration can take place within the current management contract rules and safe harbors when issuing governmental bonds. However, proponents argue that the current management contract rules do not give State and local governments flexibility in compensation arrangements. Under present law, this flexibility can be achieved if the State or local government issues taxable debt. However, some may argue that the issuance of taxable debt to avoid these rules and take advantage of private expertise is too costly. If the spread between taxable and tax-exempt interest rates narrows, the difference between taxable and tax-exempt debt should be less of a factor.

The proposal would make it easier for governmentally owned projects to enter into long-term leases and concessions with private parties. Analysts have noted that "many States and local governments do not have sufficient legal flexibility within their existing procurement statutes to accommodate the multi-phased, negotiated, project finance bidding required of" public-private partnerships.[222] Thus, even with the Federal authority to issue QPIBs in place, some State and local governments may not be able to take full advantage of the provision.

The Administration's proposal could be viewed as a relatively modest in its changes as compared to present law. Private activity bonds for airports, docks and wharves and solid waste disposal facilities are already not subject to the State volume caps if owned by a governmental unit. Thus, these projects are not competing with other projects for an allocation of volume cap. Under the proposal, bonds for facilities for the furnishing of water would benefit from not being subject to the volume cap as they are under present law. However, most States have excess volume cap that is carried over and thus current volume caps are not being fully utilized.

### F. Modify Qualified Private Activity Bonds for Public Educational Facilities

#### Present Law

**Qualified public educational facilities**

States or local governments may issue tax-exempt private activity bonds to finance certain types of exempt facilities, including qualified public educational facilities. Qualified educational facilities are public elementary and secondary school facilities that are owned by

[222] Recommendations of the Build America Investment Initiative Interagency Working Group, p. 5, available at http://www.treasury.gov/resource-center/economic-policy/Documents/Build%20America%20Recommendation%20Report%201-15-15%20FOR%20PUBLICATION.pdf.

private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency. The term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events) and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools. These bonds are subject to a separate annual volume cap equal to the greater of $10 multiplied by the State population, or $5 million.

## Description of Proposal

The proposal would eliminate the private corporation ownership requirement and instead would allow any private person, including private entities organized in ways other than as corporations, either to own the public school facilities or to operate those school facilities through lease, concession, or other operating arrangements.

The proposal would remove the requirement to transfer the school facilities to a public agency at the end of the term of the bonds for no additional consideration.

Finally, the proposal would remove the separate volume cap for qualified public educational facilities and instead would include these facilities under the unified annual State bond volume cap for private activity bonds under section 146.

Effective date.−The proposal would be effective for bonds issued after the date of enactment.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VI.F, reprinted in the back of this volume.

## Analysis

The proposal would eliminate the requirement that a private corporation own the school facilities. Eliminating that requirement could allow more flexibility in these public-private partnerships for school facilities by allowing different business configurations, such as pass-through entities like partnerships.

The Administration indicated that one reason for the proposal was to address legal uncertainty associated with the apparent conflict between the private ownership requirement and the requirement that the private owner also transfer the school facilities to a public agency at the end of the term of the bonds for no additional consideration. This uncertainty may have impeded usage of this provision. The elimination of this requirement may require the school system to obtain additional money to acquire the facility, notwithstanding that it has already borrowed on behalf of the private party to construct it. The private party has benefited from a reduced cost of capital and the ability to use the facility in its trade or business in running the school as part of the public school system.

Some may argue that receiving consideration for the school facility at the end of the term of the bonds represents a windfall for the private party, as it likely that the private party would be receiving management fees from the school system to cover the cost of running the school in a profitable manner. However, the removal of this requirement may alter the economics of the arrangement struck between the State and local government and the private party, such that the value of the payment flows may account for the private party's retention of some residual value in the school facility at the end of the bond's term.

Additionally, because the private party no longer needs to transfer the school facility to a public agency, opponents of the proposal may argue that the proposal may produce detrimental outcomes in the event that a school system is unable or unwilling to buy out the private party. In such a circumstance, a public school system's loss of a school facility may be disruptive to students, teachers, and residents of that school system. A related point is that, because of the understandable desire to avoid such disruptions, school systems may feel pressure to repurchase the school facility at a value in excess of the facility's market value.

The proposal would remove the separate volume cap for these school facilities and place them under the unified private activity bond volume cap. Some would argue that this would result in these projects having to compete with other State projects for an allocation of volume cap, meaning that such projects may not receive the priority Congress intended. Others would argue that because many States have excess volume cap, competition with other projects should not adversely affect these projects.

### G. Modify Treatment of Banks Investing in Tax-Exempt Bonds

#### Present Law

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax.[223] In general, an interest deduction is disallowed only if the taxpayer has a purpose of using borrowed funds to purchase or carry tax-exempt obligations; a determination of the taxpayer's purpose in borrowing funds is made based on all of the facts and circumstances.[224]

Two-percent rule for individuals and certain nonfinancial corporations

In the absence of direct evidence linking an individual taxpayer's indebtedness with the purchase or carrying of tax-exempt obligations, the Internal Revenue Service takes the position that it ordinarily will not infer that a taxpayer's purpose in borrowing money was to purchase or carry tax-exempt obligations if the taxpayer's investment in tax-exempt obligations is insubstantial.[225] An individual's holdings of tax-exempt obligations are presumed to be insubstantial if during the taxable year the average adjusted basis of the individual's tax-exempt

[223] Sec. 265(a).

[224] See Rev. Proc. 72-18, 1972-1 C.B. 740.

[225] *Ibid.*

obligations is two percent or less of the average adjusted basis of the individual's portfolio investments and assets held by the individual in the active conduct of a trade or business.

Similarly, in the case of a corporation that is not a financial institution or a dealer in tax-exempt obligations, where there is no direct evidence of a purpose to purchase or carry tax-exempt obligations, the corporation's holdings of tax-exempt obligations are presumed to be insubstantial if the average adjusted basis of the corporation's tax-exempt obligations is two percent or less of the average adjusted basis of all assets held by the corporation in the active conduct of its trade or business.

Financial institutions

In the case of a financial institution, the Code generally disallows that portion of the taxpayer's interest expense that is allocable to tax-exempt interest.[226] The amount of interest that is disallowed is an amount which bears the same ratio to such interest expense as the taxpayer's average adjusted bases of tax-exempt obligations acquired after August 7, 1986, bears to the average adjusted bases for all assets of the taxpayer.

Exception for certain obligations of qualified small issuers

The general rule in section 265(b), denying financial institutions' interest expense deductions allocable to tax-exempt obligations, does not apply to qualified tax-exempt obligations.[227] Instead, as discussed in the next section, only 20 percent of the interest expense allocable to qualified tax-exempt obligations is disallowed.[228] A qualified tax-exempt obligation is a tax-exempt obligation that (1) is issued after August 7, 1986, by a qualified small issuer, (2) is not a private activity bond, and (3) is designated by the issuer as qualifying for the exception from the general rule of section 265(b).

A qualified small issuer is an issuer that reasonably anticipates that the amount of tax-exempt obligations that it will issue during the calendar year will be $10 million or less.[229] The Code specifies the circumstances under which an issuer and all subordinate entities are aggregated.[230] For purposes of the $10 million limitation, an issuer and all entities that issue obligations on behalf of such issuer are treated as one issuer. All obligations issued by a subordinate entity are treated as being issued by the entity to which it is subordinate. An entity formed (or availed of) to avoid the $10 million limitation and all entities benefiting from the device are treated as one issuer.

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[226] Sec. 265(b)(1). A financial institution is any person that (1) accepts deposits from the public in the ordinary course of such person's trade or business and is subject to Federal or State supervision as a financial institution or (2) is a corporation described by section 585(a)(2). Sec. 265(b)(5).

[227] Sec. 265(b)(3).

[228] Secs. 265(b)(3)(A), 291(a)(3) and 291(e)(1).

[229] Sec. 265(b)(3)(C).

[230] Sec. 265(b)(3)(E).

Composite issues (*i.e.*, combined issues of bonds for different entities) qualify for the qualified tax-exempt obligation exception only if the requirements of the exception are met with respect to (1) the composite issue as a whole (determined by treating the composite issue as a single issue) and (2) each separate lot of obligations that is part of the issue (determined by treating each separate lot of obligations as a separate issue).[231] Thus a composite issue may qualify for the exception only if the composite issue itself does not exceed $10 million, and if each issuer benefitting from the composite issue reasonably anticipates that it will not issue more than $10 million of tax-exempt obligations during the calendar year, including through the composite arrangement.

Treatment of financial institution preference items

Section 291(a)(3) reduces by 20 percent the amount allowable as a deduction with respect to any financial institution preference item. Financial institution preference items include interest on debt to carry tax-exempt obligations acquired after December 31, 1982, and before August 8, 1986.[232] Section 265(b)(3) treats qualified tax-exempt obligations as if they were acquired on August 7, 1986. As a result, the amount allowable as a deduction by a financial institution with respect to interest incurred to carry a qualified tax-exempt obligation is reduced by 20 percent.

In the case of a bank that is an S corporation or a qualified S corporation subsidiary ("QSub"), section 291 applies if the S corporation (or any predecessor) was a C corporation for any of the three immediately preceding taxable years.[233] The United States Court of Appeals for the Seventh Circuit has ruled that after the three year period has elapsed, an S corporation or QSub bank may deduct all of the interest expense incurred to purchase qualified tax-exempt obligations.[234]

## Description of Proposal

The proposal permanently increases from $10 million to $30 million the annual limit for qualified small issuers.

The proposal treats tax-exempt obligations held by a financial institution, in an amount not to exceed two percent of the adjusted basis of the financial institution's assets, as not taken into account for the purpose of determining the portion of the financial institution's interest expense subject to the pro rata interest disallowance rule of section 265(b), regardless of whether the bond is a qualified tax-exempt obligation.

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[231] Sec. 265(b)(3)(F).

[232] Sec. 291(e)(1).

[233] Sec. 1363(b)(4).

[234] *Vainisi v. Commissioner*, 599 F.3d 567 (7th Cir. 2010).

The proposal also amends section 291(e) to provide that tax-exempt obligations held by a financial institution, and not taken into account for purposes of the calculation of a financial institution's interest expense subject to the pro rata interest disallowance rule, are treated as having been acquired on August 7, 1986. As a result, such obligations are financial institution preference items, and the amount allowable as a deduction by a financial institution with respect to interest incurred to carry such obligations is reduced by 20 percent.

Finally, the proposal applies the same rules that are applicable to C corporation financial institutions to financial institutions that are S corporations or qualified subchapter S subsidiaries.

Effective date.−The proposal is effective for bonds issued in calendar years beginning on or after January 1, 2016.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VI.G, reprinted in the back of this volume.

## Analysis

The proposal loosens the interest deduction disallowance rules applicable to financial institutions. These rules are designed to prevent tax arbitrage by denying the deduction of expenses incurred to earn income that is tax-exempt. The proposal could by criticized for violating this principle of tax policy.

On the other hand, it may be argued that Congress has determined to permit such tax arbitrage in the case of the debt of small issuers to offset any disadvantage these borrowers may have in marketing their debt obligations or who may need to do so at greater expense. Loosening the interest disallowance rules for financial institutions, while leaving the rules unchanged with respect to other institutional or retail investors, makes the debt of small issuers relatively more attractive to financial institutional investors. Proponents may observe that the annual limit for qualified small issuers was set in 1986 and that the expansion updates the dollar amount for inflation over the last 30 years. However, the $10 million amount indexed for inflation since 1986 would only be about $21 million in 2015.

Applying the same interest limitation rules that apply to C corporation financial institutions to financial institutions that are S corporations or qualified subchapter S subsidiaries treats similarly situated taxpayers similarly. Nearly one-third of all financial institutions insured by the Federal Deposit Insurance Corporation are S corporation or Qsub banks.[235] To the extent that these institutions are not subject to the interest disallowance rules that apply to C corporation financial institutions, they may have an advantage over their competitors and may be able to earn a higher after-tax rate of return. This may lead to distortions in the allocation of capital.

[235] Federal Deposit Insurance Corporation, *Institution Directory*, available at https://www2.fdic.gov/IDASP/main.asp. As of April 9, 2015, 2,113 of the 6,430 FDIC-insured institutions were found matching the specialized category of subchapter S corporation.

However, there are other differences between the tax treatment of financial institutions organized as C corporations and those organized as S corporations. Furthermore, other financial institutions are exempt from Federal income tax entirely.[236] To the extent that other differences remain, there may still be economic distortions despite the conformity of treatment among financial institutions with respect to interest expense incurred to carry tax-exempt obligations.

## H. Repeal Tax-Exempt Bond Financing of Professional Sports Facilities

### Present Law

Gross income generally does not include interest on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or are primarily repaid with governmental funds. Private activity bonds are bonds in which States or local governments provide financing to nongovernmental persons (*e.g.*, private businesses or individuals). The Code defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test ("the private business test"); or (2) "the private loan financing test."

### Description of Proposal

The proposal eliminates the private payments test for professional sports facilities. As a result, bonds to finance professional sports facilities would be taxable private activity bonds if more than 10 percent of the facility is used for private business use.

Effective date.−The proposal would be effective for bonds issued after December 31, 2015.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VI.H, reprinted in the back of this volume.

### Analysis

In 1986, Congress eliminated a provision expressly allowing tax-exempt financing for sports facilities. Nevertheless, professional sports facilities continue to be financed with tax exempt bonds despite the fact that privately owned sports teams are the primary (if not exclusive) users of such facilities. This is because present law permits the use of tax-exempt bond proceeds for private activities if either part of the two-part private business test is not met.

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[236] Federal credit unions generally are treated as United States instrumentalities, exempt from tax under section 501(c)(1). Since 1951, there has been an exemption for credit unions without capital stock organized and operated for mutual purposes and without profit (not including Federal credit unions that are exempt as U.S. instrumentalities). Sec. 501(c)(14)(A).

In the case of bond-financed professional sports facilities, issuers have intentionally structured the tax-exempt bond issuance and related transactions to fail the private payment test. In most of these transactions, the professional sports team is not required to pay for more than a small portion of its use of the sports facility. As a result, the private payment test is not met and the bonds financing the facility are not treated as private activity bonds, despite the existence of substantial private business use. Under the proposal, by removing the private payment test, it is thought that tax-exempt governmental bond financing of sports facilities with significant private business use by professional sports teams would be eliminated.

### I. Allow More Flexible Research Arrangements for Purposes of Private Business Use Limits

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 82-86. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VI.I, reprinted in the back of this volume.

### J. Modify Tax-Exempt Bonds for Indian Tribal Governments

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 89-97. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VI.J, reprinted in the back of this volume.

### K. Exempt Foreign Pension Funds from the Application of the Foreign Investment in Real Property Tax Act (FIRPTA)

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 89-97. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VI.K, reprinted in the back of this volume.

## PART VII – ELIMINATE FOSSIL FUEL PREFERENCES

### A. Eliminate Oil and Natural Gas Preferences

#### 1. Repeal enhanced oil recovery credit

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.A.1, reprinted in the back of this volume.

#### 2. Repeal credit for oil and natural gas produced from marginal wells

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.A.2, reprinted in the back of this volume.

#### 3. Repeal expensing of intangible drilling costs

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.A.3, reprinted in the back of this volume.

#### 4. Repeal deduction for tertiary injectants

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.A.4, reprinted in the back of this volume.

**5. Repeal exception to passive loss limitation for working interests in oil and natural gas properties**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.A.5, reprinted in the back of this volume.

**6. Repeal percentage depletion for oil and natural gas properties**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.A.6, reprinted in the back of this volume.

**7. Repeal domestic manufacturing deduction for oil and natural gas production**

This proposal is substantially similar to a proposal found in last year's budget proposal. Last year's proposal was a modification of the prior year's proposal. That modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 47, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 88-96. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.A.7, reprinted in the back of this volume.

**8. Increase geological and geophysical amortization period for independent producers to seven years**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.A.8, reprinted in the back of this volume.

## 9. Repeal Exemption from the Corporate Income Tax for Publicly Traded Partnerships with Qualifying Income and Gains from Activities Relating to Fossil Fuels

### Present Law

#### Partnerships in general

A partnership generally is not treated as a taxable entity (except for certain publicly traded partnerships), but rather, is treated as a passthrough entity. Income earned by a partnership, whether distributed or not, is taxed to the partners.[237] The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[238]

#### Publicly traded partnerships

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes.[239] A corporation is subject to tax at the corporate level on its taxable income.[240] For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).[241] As of the first day that a partnership is treated as a corporation, the partnership is treated for Federal tax purposes as transferring all its assets (subject to liabilities) to a newly formed corporation in exchange for the stock of the corporation, and distributing the stock to its partners in liquidation of their partnership interests.[242]

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.[243] Qualifying income includes interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not

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[237] Sec. 701.

[238] Sec. 702.

[239] Sec. 7704(a).

[240] Sec. 11(a).

[241] Sec. 7704(b).

[242] Sec. 7704(f).

[243] Sec. 7704(c)(2).

described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of partnership, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts.

## Description of Proposal

The proposal repeals the exception from corporate treatment for publicly traded partnerships with certain natural resources income and gains. However, the provision continues to permit partnership treatment for publicly traded partnerships, 90 percent of whose gross income consists of other qualifying income under present law.

Under the proposal, it is understood that the exception from corporate treatment is repealed for those publicly traded partnerships, 90 percent or more of whose gross income is (1) income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including geothermal energy and excluding fertilizer and timber) or industrial source carbon dioxide, and (2) any gain from the sale or disposition of a capital asset (or property described in section 1231(b)) held for the production of income of described in (1).

Effective date.−The proposal is effective after December 31, 2020.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.A.9, reprinted in the back of this volume.

## Analysis

The proposal is aimed at addressing economic distortions created by tax subsidies for fossil fuels. The rationale is that these subsidies encourage overinvestment in certain types of energy sources and relative underinvestment in other types of energy, or underinvestment in other sectors of the economy.

Opponents of the proposal might dispute its merits on energy policy grounds by arguing that U.S. energy policy should continue to subsidize the oil and gas sector. They might point to the recent drop in the price of crude oil and the greater U.S. reserves of oil following the growth of fracking in the United States as beneficial for domestic energy security, and therefore worthy of Federal government subsidies (whether through the tax law or otherwise). However, the implementation of nontax policy, such as energy policy, through the tax law has been criticized as inefficient, difficult to track, and leading to a perception of unfairness in the tax system.

Others might criticize the use of the particular tax subsidy involved, that is, passthrough tax treatment for a publicly traded business entity. When the rules treating publicly traded partnerships generally as corporations whose income is subject to entity level tax were enacted in

1987, Congress expressed "concern about long-term erosion of the corporate tax base" and stated that "in important respects, publicly traded partnerships resemble corporations."[244] When enacted, the publicly traded partnership rules provision included both grandfather rules excluding certain existing publicly traded partnerships from the new rules for 10 years, and an exclusion from the new rules based on certain types of income. These provisions limited the use of publicly traded partnerships to those areas where they already had come into existence, while preventing them from applying to other incorporated businesses.

Based on this historical perspective, one might argue that the current use of publicly traded partnerships in the oil and gas sector is a historical anomaly not based on any particular policy rationale, and there is no tax policy reason to retain such tax treatment. Access to public capital markets and free tradeability of interests in a business are a hallmark of corporate status. On the other hand, it could be argued that forward-looking tax policy should seek to integrate the two levels of taxation of corporate income (*i.e.*, the corporate income tax and the shareholder level tax on dividends), and that in light of that goal, it would be more appropriate to retain or expand rules that tax business income once rather than to reduce the applicability of single taxation of business income. The argument in favor of applying one level of income tax to business income is not limited to any particular industry, however, and is more supportable when applied without regard to any particular sector of the economy.

Existing publicly traded partnerships might point to the costs and business disruption associated with losing passthrough status and becoming subject to corporate income tax. They may also point to the fact that owners of publicly traded units of the partnership would lose passthrough treatment for losses, if any, attributable to the partnership's business activities. These tax detriments could negatively affect the market price of the units. However, the proposal's effective date is deferred until 2021. Because none of these changes resulting from the proposal would be immediate, partnerships would have several years to restructure the business entity and its operations. Similarly, the unit holders would have several years to rebalance their portfolios before the brunt of any price decline attributable to the entity's change in tax status takes effect.

## B. Eliminate Coal Preferences

### 1. Repeal expensing of exploration and development costs

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.B.1, reprinted in the back of this volume.

[244] Omnibus Budget Reconciliation Act of 1987, H.R. Rept. 100-391, 110th Congress, 1st Session, Part 2 of 2, October 26, 1987, Report to accompany recommendations of the Committee on Ways and Means, pages1065 and 1066.

**2. Repeal percentage depletion for hard mineral fossil fuels**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.B.2, reprinted in the back of this volume.

**3. Repeal capital gains treatment for royalties**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 481-505. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.B.3, reprinted in the back of this volume.

**4. Repeal domestic manufacturing deduction for the production of coal and other hard mineral fossil fuels**

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. That proposal was a modification of the President's fiscal year 2013 budget proposal. The modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 48, and the original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 88-96. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VII.B.4, reprinted in the back of this volume.

## PART VIII – REFORM THE TREATMENT OF FINANCIAL AND INSURANCE INDUSTRY PRODUCTS

### A. Require That Derivatives Contracts be Marked to Market with Resulting Gain or Loss Treated as Ordinary

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 81-97. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VIII.A, reprinted in the back of this volume.

### B. Modify Rules that Apply to Sales of Life Insurance Contracts

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal, which modified a proposal from prior years. For a description of the 2015 modification, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 97-98. The original budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCX-2-12), June 2012, pp. 459-463. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VIII.B, reprinted in the back of this volume.

### C. Modify Proration Rules for Life Insurance Company General and Separate Accounts

#### Present Law

**Reduction of reserve deduction and dividends received deduction to reflect untaxed income**

A life insurance company is subject to proration rules in calculating life insurance company taxable income.

The proration rules reduce the company's deductions, including reserve deductions and dividends received deductions, if the life insurance company has tax-exempt income, deductible dividends received, or other similar untaxed income items, because deductible reserve increases can be viewed as being funded proportionately out of taxable and tax-exempt income.

Under the proration rules, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest.[245]

Similarly, under the proration rules, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends,[246] but not for the policyholders' share. Fully deductible dividends from affiliates are excluded from the application of this proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer. In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts.

**Company's share and policyholder's share**

The life insurance company proration rules provide that the company's share, for this purpose, means the percentage obtained by dividing the company's share of the net investment income for the taxable year by the net investment income for the taxable year.[247] Net investment income means 95 percent of gross investment income, in the case of assets held in segregated asset accounts under variable contracts, and 90 percent of gross investment income in other cases.[248]

Gross investment income includes specified items.[249] The specified items include interest (including tax-exempt interest), dividends, rents, royalties and other related specified items, short term capital gains, and trade or business income. Gross investment income does not include gain (other than short term capital gain to the extent it exceeds net long-term capital loss) that is, or is considered as, from the sale or exchange of a capital asset. Gross investment income also does not include the appreciation in the value of assets that is taken into account in computing the company's tax reserve deduction under section 817.

The company's share of net investment income, for purposes of this calculation, is the net investment income for the taxable year, reduced by the sum of (a) the policy interest for the taxable year and (b) a portion of policyholder dividends.[250] Policy interest is defined to include required interest at the greater of the prevailing State assumed rate or the applicable Federal rate (plus some other interest items). Present law provides that in any case where neither the

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[245] Secs. 807(a)(2)(B) and (b)(1)(B).

[246] Secs. 805(a)(4), 812.

[247] Sec. 812(a).

[248] Sec. 812(c).

[249] Sec. 812(d).

[250] Sec. 812(b)(1). This portion is defined as gross investment income's share of policyholder dividends.

prevailing State assumed interest rate nor the applicable Federal rate is used, "another appropriate rate" is used for this calculation. No statutory definition of "another appropriate rate" is provided; the law is unclear as to what rate or rates are appropriate for this purpose.[251]

In 2007, the IRS issued Rev. Rul. 2007-54,[252] interpreting required interest under section 812(b) to be calculated by multiplying the mean of a contract's beginning-of-year and end-of-year reserves by the greater of the applicable Federal interest rate or the prevailing State assumed interest rate, for purposes of determining separate account reserves for variable contracts. However, Rev. Rul. 2007-54 was suspended by Rev. Rul. 2007-61, in which the IRS and the Treasury Department stated that the issues would more appropriately be addressed by regulation.[253] No regulations have been issued to date.

**General account and separate accounts**

A variable contract is generally a life insurance (or annuity) contract whose death benefit (or annuity payout) depends explicitly on the investment return and market value of underlying assets.[254] The investment risk is generally that of the policyholder, not the insurer. The assets underlying variable contracts are maintained in separate accounts held by life insurers. These separate accounts are distinct from the insurer's general account in which it maintains assets supporting products other than variable contracts.

**Reserves**

For Federal income tax purposes, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[255] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

For purposes of determining the amount of the tax reserves for variable contracts, however, a special rule eliminates gains and losses. Under this rule,[256] in determining reserves

[251] Legislative history of section 812 mentions that the general concept that items of investment yield should be allocated between policyholders and the company was retained from prior law. H. Rep. 98-861, Conference Report to accompany H.R. 4170, the Deficit Reduction Act of 1984, 98th Cong., 2d Sess., 1065 (June 23, 1984). This concept is referred to in Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84, December 31, 1984, p. 622, stating, "[u]nder the Act, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under prior law in computing gain or loss from operations (*i.e.*, by reference to 'required interest')." This may imply that a reference to pre-1984-law regulations may be appropriate. See Rev. Rul. 2003-120, 2003-2 C.B. 1154, and Technical Advice Memoranda 20038008 and 200339049.

[252] 2007-38 I.R.B. 604.

[253] 2007-42 I.R.B.799.

[254] Section 817(d) provides a more detailed definition of a variable contract.

[255] Sec. 807.

[256] Sec. 817.

for variable contracts, realized and unrealized gains are subtracted, and realized and unrealized losses are added, whether or not the assets have been disposed of. The basis of assets in the separate account is increased to reflect appreciation, and reduced to reflect depreciation in value, that are taken into account in computing reserves for such contracts.

**Dividends received deduction**

A corporate taxpayer may partially or fully deduct dividends received.[257] The percentage of the allowable dividends received deduction depends on the percentage of the stock of the distributing corporation that the recipient corporation owns.

Limitation on dividends received deduction under section 246(c)(4)

The dividends received deduction is not allowed with respect to stock either (1) held for 45 days or less during a 91-day period beginning 45 days before the ex-dividend date, or (2) to the extent the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property.[258] The taxpayer's holding period is reduced for periods during which its risk of loss is reduced.[259]

## Description of Proposal

The proposal modifies the life insurance company proration rule for reducing dividends received deductions and reserve deductions with respect to untaxed income.

Under the proposal, the company's share of untaxed income, for purposes of reducing deductions, is determined on an account by account basis. That is, a company determines its company's share separately for the general account and for each separate account.

The policyholder's share is the ratio of an account's mean reserves to its mean assets. The company's share is the excess of 100 percent over the policyholder's share.[260]

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[257] Sec. 243 *et seq*. Conceptually, dividends received by a corporation are retained in corporate solution; these amounts are taxed when distributed to noncorporate shareholders.

[258] Sec. 246(c).

[259] Sec. 246(c)(4). For this purpose, the holding period is reduced for periods in which (1) the taxpayer has an obligation to sell or has shorted substantially similar stock; (2) the taxpayer has granted an option to buy substantially similar stock; or (3) under Treasury regulations, the taxpayer has diminished its risk of loss by holding other positions with respect to substantially similar or related property.

[260] This is similar to the proposal in the Tax Reform Act of 2014 Discussion Draft, but stated in the inverse. That proposal provides that the company's share is the excess of the mean assets of such account over the mean reserves with respect to such account divided by the mean assets of such account for such taxable year. The policyholder's share is the excess of 100 percent over the company share. Further detail in that proposal provides that mean assets for any taxable year are 50 percent of the sum of the fair market value of the assets of an account as of the beginning of the taxable year and the fair market value of the assets as of the close of the taxable year. Mean reserves are 50 percent of the sum of the reserves with respect to such account determined under section 807 as of the beginning of the year and the reserves with respect to such account determined under section 807 as of the close

Effective date.−The proposal applies to taxable years beginning after December 31, 2015.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VIII.C, reprinted in the back of this volume.

## Analysis

The proposal is directed towards improving the accuracy of measurement of income of life insurance companies by modifying the proration rules that limit deductions associated with untaxed income. The proposal also serves to simplify these proration rules, which are rather complex. The proposal aims to improve the clarity of the law and resolve interpretive issues that have arisen in recent years, thus reducing controversies between the IRS and taxpayers.

In analyzing the proposal, it is useful to compare the life insurer proration rules to other present-law rules limiting deductions associated with untaxed income of taxpayers other than life insurers. A further question is why the life insurance company proration rules involve such complex calculations, and whether complexity is inevitable. In addition, analysis of the proposal may be aided by examining other possible options for modifying the life insurance company proration rules.

### Expenses and interest relating to tax-exempt income of taxpayers generally

For taxpayers other than insurance companies, present-law section 265 disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax (tax-exempt obligations).[261] The interest expense disallowance rules are intended to prevent taxpayers from engaging in tax arbitrage by deducting interest on indebtedness that is used to purchase tax-exempt obligations. Similarly, present law disallows a deduction for expenses allocable to tax-exempt interest income.

These present-law limitations are expressions of the concept that, under an income tax, expenses are deductible only if related to the production of income subject to tax. This policy concept is not expressed uniformly throughout the tax law, it may be observed. Examples of the failure of the tax law to match deductible expenses with taxable income can be cited, such as the allowance of home mortgage interest as a deduction though the imputed rental value of residence in the home is not includable in income for individuals. However, these instances may reflect nontax social policies that are implemented through the tax law, practical difficulties of valuation or administrability, or historical norms that are broadly accepted even though inconsistent with

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of the taxable year. For purposes of determining mean assets or mean reserves, dividends described in section 246(c) (relating to the holding period limitation on the dividends received deduction), fees, and expenses, are not taken into account.

[261] Sec. 265. A pro rata interest expense allocation rule applies in the case of financial institutions, and exceptions to the general rule apply in the case of certain types of tax-exempt obligations (sec. 265(b)).

fundamental tax policy. The proration rule applicable to property and casualty insurers could also be cited as perhaps a partial failure to match deductible expenses with taxable income. That rule disallows a deduction for expenses of earning untaxed income at a flat 15 percent rate. If untaxed income represents more than 15 percent of after-tax income, the rule may not operate effectively to prevent tax arbitrage.[262]

## Historical background

### In general

Proration rules limiting deductions associated with untaxed income of life insurance companies were adopted as part of the earliest Federal income tax rules applicable to life insurers in 1921.[263] Those rules required that the reserve deduction for investment income be reduced by tax-exempt interest. In 1928, however, the Supreme Court held that this deduction limitation rule was unconstitutional because it indirectly imposed Federal tax on State obligations.[264]

In subsequent legislation, the proration rule was restructured,[265] and ultimately in 1959 a further revised proration rule was adopted providing that taxable investment yield of a life insurance company was reduced by the company's share of tax-exempt interest and deductible dividends received.[266] The 1959 provision included the notions of required interest and an amount retained by the company in determining the company's share of investment income for separate accounts. More generally, the 1959 Act provided for a three-phase system of taxation of life insurers, under which, generally, gain from operations was taxed only if it exceeded the company's taxable investment income. The rules for taxing life insurance companies were substantially revised in 1984 to eliminate the three-phase system and generally to tax both operating income and investment income.[267] The 1984 revisions retained proration rules for life

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[262] For a discussion of a proposal to modify the property and casualty insurer proration rule, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000, pp. 425-428.

[263] Sec. 245(a)(2) of the Revenue Act of 1921, Pub. L. No. 67-98, 67th Cong. 2d Sess., ch. 136, 42 Stat. 227.

[264] *National Life Insurance Company v. U.S.*, 277 U.S. 508 (1928), in which the Court relied on "settled doctrine that directly to tax the income from securities amounts to taxation of the securities themselves," and held that "Congress had no power purposely and directly to tax state obligations by refusing to their owners deductions allowed to others."

[265] Sec. 163 of the Revenue Act of 1942, Pub. L. No. 77-753, 77th Cong. 2d Sess., enacting section 202(b) of the Internal Revenue Code (1942), 56 Stat. 798, 899. See also Letter of Walter C. Welsh, Executive Vice President, and William Elwell, Senior Counsel, American Counsel of Life Insurers, to the Honorable Eric Solomon, Assistant Secretary for Tax Policy, U.S. Treasury Department, and the Honorable Donald L. Korb, Chief Counsel, Internal Revenue Service, June 26, 2008, p. 5-6, and Harold Wurzel, "Tax-Exempt Interest of Life Insurance Companies: A Study in 'Discriminatory' Taxation, *Yale Law Journal*, vol. 70, 1960, p. 15.

[266] Sec. 801, as enacted in the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 86th Cong., 1st Sess.

[267] See Title II, Life Insurance Provisions, Deficit Reduction Act of 1984, Pub. L. No. 98-369, July 18, 1984.

insurers, and generally retained the 1959 notion that the proration rules are based on a determination of the company's share of income and deductions.

In 1988, the Supreme Court held that imposing Federal tax on interest earned on State bonds does not violate the intergovernmental tax immunity doctrine, and so is not unconstitutional.[268] The life insurance company proration rules have not been substantially modified since the 1988 Supreme Court decision.

The current proration formula for life insurers may provide a benefit independent of the amount of any reserve deduction or tax-exempt interest and deductible dividend income because of the way the calculation treats investment expenses. The company's share increases when the actual net investment income is less than the statutorily defined net investment income. That is, a company receives a benefit from the proration rules for a separate account if the amount retained by the company is greater than five percent of defined gross investment income. This may be particularly true of separate accounts that attribute more of their appreciation to items excluded from the definition of gross investment income, such as capital gains.

Sources of complexity derived from 1959 law

It could be argued that the complexity of the rules and the calculations under the life insurance company proration provisions is largely attributable to the origin of the rules over 90 years ago and Congress' multiple attempts during the period to express tax policy in a manner that did not violate Constitutional doctrine. The complexity of the current proration rules may be exacerbated by the application of a few details of the 1959 Act three-phase system under modern rules shorn of that context.

The company's share served multiple purposes under the 1959 Act. It served to prorate the deduction for tax-exempt interest and dividends received as under present law. It also determined the amount of taxable investment yield included in taxable investment income. While an increase in the company's share under present law necessarily lowers taxable income, an increase in the company's share under prior law had a differing effect on taxable income depending on whether a company's gain from operations exceeded taxable investment income and the importance of tax-exempt interest and deductible dividends in investment yield.

Similarly, under the 1959 Act, gross investment income served multiple purposes. Not only did it determine the company's share for proration, but also it provided the basis for calculation of investment yield and taxable investment income. Gross investment income includes only positive ordinary income items, perhaps to avoid having to interpret and allocate negative amounts. It may be argued that the selection of items included in the current definition of gross investment income stem primarily from this function under prior law, rather than the present law proration function, and that the definition of gross investment income should now be tailored to mesh with the proration rule where it is used today.

[268] *South Carolina v. Baker*, 485 U.S. 505, reh'g denied, 486 U.S. 1062 (1988).

Furthermore, retention of the 1959 Act concepts arguably is no longer necessitated by concern for potential unconstitutionality. The Federal income tax policy not to allow a deduction for expenses of earning amounts that are not included in income could be expressed more simply in the life insurance tax rules. An explicit statutory statement of the operation of the proration of the dividends received deduction would be simplifying. Administrability of the law would be enhanced, and disputes would be reduced, if reliance on arcane, layered pre-1984 regulations were no longer an interpretive option.

If the problem is incorrect or aggressive taxpayer positions under the proration rule (as under any present-law rule), the IRS can address this through enforcement action. If this is the situation, perhaps legislative change is not needed. To the extent that the problem arises from aggressive interpretation of the current rules, it could be countered that a case by case approach, potentially leading to the expense of litigating each taxpayer's case, may be an inefficient use of government and taxpayer resources, without effectively clarifying the law in all circuits or giving a near-term answer to all taxpayers.

Nevertheless, enforcement of the law may not be the sole or even the principal issue: rather, clarification of, or change to, the law arguably is needed to eliminate uncertainty about how to determine interest when present law refers to "another appropriate rate" (in the flush language of section 812(b)(2)). In short, a change is needed to the legislative language to state a clear rule. Alternatively, Treasury Department guidance is needed to clarify application of the current rules.[269] However, further administrative guidance may be viewed as insufficient or inadequate without a legislative pronouncement of the rules.

**Operation of the proposal**

Simplification

By eliminating the investment income-based rules of section 812, the proposal achieves significant simplification compared to present law. Application of the same ratio test to the insurer's general account and separately to each separate account is not only simplifying but also limits potential inaccuracy in reflecting the actual investment returns of pools of assets. Most of the disputes and uncertainties arising under the rules of present law are eliminated with the elimination of the complexity and definitional uncertainty of the present law rules.

The proposal could be characterized as providing a greater degree of simplification than the earlier President's fiscal year 2013 budget proposal on proration, which provided two

[269] Arguably, the rules were relatively clear − if complex − prior to the 2003 IRS issuance of Technical Advice Memoranda that addressed some issues but left others open and the subsequent issuance and suspension of Rev. Rul. 2007-54 which set forth a different approach. It is possible that these developments served to fuel disputes between the IRS and taxpayers based on differing interpretations of the law. See Susan J. Hotine, "Proration for Segregated Asset Accounts − How is the Company's Share Computed?," *Taxing Times*, vol. 3, September 2007, p. 1; Richard N. Bush and Greg L. Stephenson, "Separate Account DRD Under Attack: Five Decades of Practice Regarding Company Share Computation Ignored," *The Insurance Tax Review*, vol. 4, February 2008, p. 21; and Susan J. Hotine, "Proration for Segregated Asset Accounts − Part Two," *Taxing Times*, vol. 39, January 2008.

different rules: one for the general account, and one for the separate accounts of a life insurance company. For the general account, a 15-percent reduction rule applies to the company's deductions, calculated with respect to the dividends received deduction, tax-exempt interest, and policy cash values of the company, similar to the property and casualty insurance company proration rule. For each separate account, that proposal applied a version of the ratio of an account's mean reserves to its mean assets.

Proper scope of proration rule

It might be argued that no proration rule should apply to general account assets, because the obligation of the life insurer to policyholders of general account products is more attenuated than its obligation to credit separate account dividends received directly to variable contracts. Thus, perhaps like other corporate taxpayers that are not required to prorate their deduction for dividends received, the general account of life insurers arguably should not be subject to proration. Because life insurers tend to have a relatively low proportion of dividend-paying assets in the general account, imposing a complex proration rule on general account assets may not be worthwhile if the asset mix of general accounts remains low on dividend-producing assets.

On the other hand, money is fungible, and proration of untaxed income is appropriate in any case in which the insurer has a reserve deduction with respect to amounts ultimately payable to a policyholder. Moreover, under present law, no dividends received deduction is allowed to corporate taxpayers for any dividend to the extent the taxpayer is under an obligation to make related payments with respect to similar property.[270] Thus, the concept exists outside the insurance context.

A question raised by the proposal is whether it would be appropriate to apply a comparable proration rule to property and casualty insurance companies as well. Currently, a 15-percent proration rule applies to them. Conceivably, the ratio of reserves to mean assets could be applied on a line of business basis to such insurers, or a rule more similar to section 265 could be applied to all insurers.

Diminished risk of loss

An aspect of the proposal that is not clarified is the operation of the section 246(c) rule relating to stock in which the taxpayer's risk of loss is diminished in the context of tax-exempt assets that are not stock. That is, the proration rule applies not only with respect to dividends for which the dividends received deduction is otherwise allowed, but also with respect to other assets generating untaxed income. These assets include tax-exempt debt and insurance policy cash values. For the proposal to be fully administrable, rules would have to be developed to determine when a taxpayer's risk of loss is diminished with respect to these assets.

[270] Sec. 246(c)(1)(B) provides that no dividends received deduction is allowed in respect of any dividend to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Effect on product price

A possible criticism of the proposal, or of any proposal that reduces deductions pursuant to a change in the proration rule with respect to insurance products, is that the price of the products could increase. The insurer could pass some or all of the increased tax cost through to shareholders, employees, or customers. In fact, if the proration rule does not accurately measure the insurer's income by allowing either too great, or too little, a deduction, the company can share with product purchasers the unintended benefit or detriment of income mismeasurement. If it is not intended to provide either a Federal tax subsidy, or an excessive tax burden, that would affect the price of products of insurance companies, then improving the accuracy and administrability of the life insurance proration rule is a desirable improvement in the tax law.

**Merits of proration rules generally**

Taxpayers may argue, on horizontal equity grounds, that the proration rules for life insurance companies should not give rise to any reduction in the dividends received deduction, by analogy to nonlife corporations that are not subject to any rule reducing their dividends received deduction. On the other hand, dividend income of life insurance companies is arguably most analogous to operating income of nonfinancial-intermediation businesses. The normal rationale for the dividends received deduction − that it eliminates multiple applications of tax on the same income items while they remain in corporate solution − does not apply if the business the firm engages in includes the earning of dividends on the customers' behalf. Under this view, no portion of the dividends received deduction should be allowed for what is effectively business income or operating income.

A nontax policy line of reasoning might suggest that Federal tax proration rules discouraging insurance companies from investing in tax-exempt bonds could be considered undesirable, because such Federal tax rules have the indirect effect of increasing the borrowing and related costs of the municipalities and other government jurisdictions that issue the bonds. On the other hand, concepts of transparency in government may suggest that Federal subsidies of State and local jurisdictions' borrowing costs should be direct rather than implemented indirectly through the tax code, and should not depend on whether the jurisdiction issues bonds or not. Further, other business taxpayers already are subject to proration rules in the Federal tax law; this line of reasoning should apply to all Federal income tax proration rules, or none, but not to just those relating to life insurance companies.

## D. Expand Pro Rata Interest Expense Disallowance for Corporate-Owned Life Insurance

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 475-480. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VIII.D, reprinted in the back of this volume.

## E. Conform Net Operating Loss Rules of Life Insurance Companies to Those of Other Corporations

### Present Law

A net operating loss ("NOL") generally means the amount by which a taxpayer's business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years. NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.[271]

For purposes of computing the alternative minimum tax ("AMT"), a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI.[272]

In the case of a life insurance company, present law allows a deduction for the operations loss carryovers and carrybacks to the taxable year, in lieu of the deduction for net operation losses allowed to other corporations.[273]

A life insurance company is permitted to treat a loss from operations (as defined under section 810(c)) for any taxable year as an operations loss carryback to each of the three taxable years preceding the loss year and an operations loss carryover to each of the 15 taxable years following the loss year.[274]

### Description of Proposal

The proposal modifies the carryover rules applicable to a life insurance company's loss from operations (equivalent to an NOL) to provide that, like NOLs, such losses from operations may be carried back two years and carried over 20 years.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2015.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item VIII.E, reprinted in the back of this volume.

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[271] Sec. 172(b)(2).

[272] Sec. 56(d).

[273] Secs. 810, 805(a)(5).

[274] Sec. 810(b)(1).

## Analysis

The proposal is aimed at increasing neutrality in the tax law. By conforming the carryover periods for operations losses life insurance companies to the carryover periods for NOLs of all other corporations, the proposal not only increases the neutrality of the tax law across taxpayers but also provides a small simplifying effect.

The proposal may ameliorate life insurance companies' possible concern about the potential future expiration of loss carryforwards by extending their loss carryforward period five additional years. Though taxpayers may consider the concomitant shortening of the carryback period a disadvantage, it is no greater a disadvantage to life insurance companies than to other corporate taxpayers.

The proposal provides parity in carryover treatment for losses of life insurance companies and losses of property and casualty insurance companies. It is noteworthy that property and casualty insurance companies are subject to the same NOL rules as other corporations under Code section 172. It is not clear whether the proposal puts life insurance companies on this same footing. Details of the proposal might accomplish this result by providing that the NOL deduction of a life insurance company is determined by treating the NOL for any taxable year generally as the excess of the life insurance deductions for such taxable year, over the life insurance gross income for such taxable year.

## PART IX – OTHER REVENUE CHANGES AND LOOPHOLE CLOSERS

### A. Repeal Last-In, First-Out (LIFO) Method of Accounting for Inventories

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 516-520. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.A, reprinted in the back of this volume.

### B. Repeal Lower-Of-Cost-Or-Market (LCM) Inventory Accounting Method

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 521-522. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.B, reprinted in the back of this volume.

### C. Modify Like-Kind Exchange Rules for Real Property and Collectibles

#### Description of Modification

The fiscal year 2015 budget proposal is modified by the addition of collectibles to the prior provision's coverage only of real property, as a type of property that would no longer be eligible for like kind exchange treatment under section 1031.

This proposal modifies a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 106-111. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.C, reprinted in the back of this volume.

### D. Modify Depreciation Rules for Purchases of General Aviation Passenger Aircraft

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 523-524. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue*

*Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.D, reprinted in the back of this volume.

### E. Expand the Definition of Substantial Built-In Loss for Purposes of Partnership Loss Transfers

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 553-555. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.E, reprinted in the back of this volume.

### F. Extend the Partnership Basis Limitation Rules to Nondeductible Expenditures

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 556-558. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.F, reprinted in the back of this volume.

### G. Limit the Importation of Losses Under Related Party Loss Limitation Rules

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 559-561. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.G, reprinted in the back of this volume.

### H. Deny Deduction for Punitive Damages

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 562-564. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.H, reprinted in the back of this volume.

## I. Conform Corporate Ownership Standards

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 112-116. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.I, reprinted in the back of this volume.

## J. Tax Corporate Distributions as Dividends

### Description of Modification

This proposal combines three separate prior-year proposals into a single proposal, with a modification of one of these, and adds a fourth proposal that is described further below. The estimated budget effect of these four combined provisions can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.J, reprinted in the back of this volume.

The proposal to prevent elimination of earnings and profits through distributions of certain stock with basis attributable to dividend equivalent exemptions is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 117-124.

The proposal to prevent the use of leveraged distributions from related foreign corporations to avoid dividend treatment modifies a substantially similar proposal found in the President's fiscal year 2015 budget proposal, which modified prior years' proposals. The FY 2016 modification provides that a leveraged distribution is treated as the receipt of a dividend directly from the funding corporation, rather than simply disregarding the basis for purposes of basis recovery under section 301(c)(2) as in the prior proposal. For a description of the prior proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 24. The original proposal is described in *Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 417.

The proposal to repeal gain limitation for dividends received in reorganization exchanges is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal, which modified prior years' proposals. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 103-104. The prior proposal is described in *Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 527.

The new proposal modifies the treatment of a subsidiary's purchase of stock of a direct or indirect parent corporation ("hook stock") for property, and is described further below.

**Treat purchases of hook stock by a subsidiary as giving rise to a dividend distribution**

**Present Law**

A distribution of cash or other property by a corporation to a shareholder is generally treated as a dividend to the shareholder, to the extent of the distributing corporation's current or accumulated earnings and profits. Under the Code, certain transactions that would otherwise be treated as sales of a shareholder's stock are also treated as dividends, including redemptions of shareholder stock that do not significantly reduce a shareholder's interest in the distributing corporation[275] and certain transactions involving the acquisition of stock of one member of a controlled group by another for cash or other property.[276]

The Code also permits a number of corporate transactions to be accomplished generally without tax except to the extent certain non-qualified property is received. These tax- free transactions include the liquidation of a corporation into a parent corporation owing 80 percent of the vote and value of the liquidating entity (excluding certain nonvoting preferred stock), the contribution of property to a corporation by persons owning 80 percent of the voting power and 80 percent of each class of nonvoting shares of corporate stock immediately after the contribution, and certain other corporate acquisitions and divisions generally referred to as "corporate reorganizations".[277] A separate Code provision provides that a corporation does not recognize gain or loss on the receipt of cash or other property in exchange for its stock.[278]

In the international context, the Code further grants the Treasury Department broad regulatory authority to override specified tax-free liquidation, organization or reorganization provisions where necessary to prevent the transfer of appreciated corporate stock or property beyond the U.S. taxing jurisdiction,[279] and to require dividend treatment in cases that otherwise would be treated as sales or exchanges of corporate stock.[280] The Treasury Department has issued regulations under this authority. The Code provision that a corporation does not recognize gain or loss on the receipt of cash or other property in exchange for its stock is not among the provisions that the Treasury is authorized to override under this regulatory authority.

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[275] Sec. 302.

[276] Sec. 304.

[277] Secs. 332, 351, 354, 356, and 361.

[278] Sec. 1032.

[279] Sec. 367(a).

[280] Sec. 367(b).

In cases that are not covered by current statutory rules or by the special cross-border transaction regulations that recharacterize a sale of stock as a dividend, a subsidiary corporation may acquire stock of a direct or indirect corporate shareholder (often referred to as "hook stock"), issued to the subsidiary in exchange for cash or other property, without tax consequences, and may obtain basis in that stock equal to the fair market value of the cash or property. The issuing corporation does not recognize gain or loss (or any income) upon the receipt of the subsidiary's cash or other property, under the general statutory provision that receipt of property for stock is not a taxable event for a corporation.[281]

The IRS has announced that it will not issue rulings on the treatment or effects of hook equity, including as a result of its issuance, ownership, or redemption.[282]

## Description of Proposal

The proposal disregards a subsidiary's purchase of hook stock for property so that the property used to purchase the hook stock gives rise to a deemed distribution from the purchasing subsidiary (through any intervening entities) to the issuing corporation. Under the proposal, the hook stock is treated as being contributed by the issuer (through any intervening entities) to the subsidiary. The proposal grants the Secretary authority to prescribe regulations to treat purchases of interests in shareholder entities other than corporations in a similar manner and provide rules related to hook stock within a consolidated group.

Effective date.−The proposal applies to transactions occurring after December 31, 2015.

## Analysis

Treasury has previously addressed some issues related to the purchase of hook stock in various contexts. The Administration's proposal attempts a more comprehensive approach to issues involving the purchase of hook stock.

Generally, the proposal targets a transaction that involves the purchase by a corporation ("subsidiary") of stock in a parent company ("parent") in exchange for cash or other property. The stock of the parent company may be acquired in anticipation of the further transfer of the

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[281] "Hook stock" is not a generally defined term. However, Treas. Reg. sec. 1.7874-1 defines hook stock as "stock of a corporation that is held by an entity in which at least 50 percent of the stock (by vote or value) or at least 50 percent of the capital or profits interest, as applicable, in such entity, is held directly or indirectly by the corporation." This definition is applicable only in the application of the "anti-inversion" provisions of section 7874, for the purpose of excluding hook stock owned within a corporate group from the numerator and denominator of a fraction in determining whether, after a transaction, at least 60 percent of the outstanding stock of a corporation is owned by former shareholders of that corporation and certain related purposes.

[282] This administrative practice applies to domestic as well as international transactions. For this purpose, "hook equity" means an ownership interest in a business entity (such as stock in a corporation) that is held by another business entity in which at least 50 percent of the interests (by vote or value) in such latter entity are held directly or indirectly by the former entity. However, if an entity directly or indirectly owns all of the equity interests in another entity, the equity interests in the latter entity are not hook equity. Rev. Proc. 2014-3, 2014-1 C.B. 1, sec. 4.02(11); Rev. Proc. 2014-7, 2014-1 C.B. 238, sec. 4.02(7).

parent stock by subsidiary to acquire the stock or assets of a target corporation ("target"). Target may or may not be affiliated with parent and subsidiary before the transaction. Following the completed acquisition transaction, subsidiary owns the target stock or assets and parent holds cash or other property without the parent company having had any material inclusion of dividend income with respect to its receipt of the cash or property used to acquire its stock.

In recent years, Treasury and the IRS have issued guidance in the cross-border context to change the tax treatment that results from a variation of this transaction, which is colloquially known as a "Killer-B" transaction, including final regulations in 2011 (the "final regulations"). Prior to the guidance, taxpayers took the position that no gain or loss was recognized on the exchange of parent stock for cash or other property under section 1032 and the regulations thereunder, even if the subsidiary acquired the parent stock for cash or other property (*e.g.*, a note) and had untaxed earnings and profits. The final regulations generally provide that, where either parent or subsidiary is domestic and the other is foreign, the transfer of cash or other property in exchange for parent stock that will be further transferred in a reorganization transaction is treated as a deemed distribution from subsidiary to parent to which section 301 applies.[283] Under section 301, the parent would include dividend income to the extent of the earnings and profits of subsidiary.

However, the Administration remains concerned regarding cases not covered by the final regulations, which explicitly apply only to transactions that otherwise qualify as tax-free reorganizations. For example, a taxpayer may engage in a transaction that is largely similar to the transaction addressed in the final regulations, but which is designed not to qualify as a tax-free reorganization. In those cases, taxpayers may take the position that the final regulations do not apply since the transaction does not qualify for tax-free reorganization treatment and that the deemed distribution under the regulations does not occur. Instead, taxpayers may take the position that the transaction is designed to fall under section 1032, which provides for nonrecognition treatment with respect to the exchange of a corporation's own stock for cash or other property. Moreover, in cases of application of section 1032 where other nonrecognition provisions of the Code do not apply, the subsidiary receives a tax basis in the parent shares equal to the cash or other property transferred in exchange for the shares.[284] Following the purchase of the parent shares, subsidiary may then transfer the parent shares in exchange for shares of a target company in a "taxable" exchange, one which does not result in the recognition of any material amount of gain by subsidiary since the subsidiary has a fair market value basis in the parent shares (*i.e.*, the hook stock) it transferred in the exchange. Since a taxpayer is generally free to choose the form of its transactions, deemed dividend treatment may not result despite the

[283] Treas. Reg. section 1.367(b)-10(b)(1). The relevant historical guidance in relation to these types of transactions includes IRS Notices 2006-45 and 2007-48, Temp. Treas. Reg. section 1.367(b)-14T which was issued in 2008, and the subsequent finalization of these regulations in 2011 as Treas. Reg. section 1.367(b)-10. Certain aspects of these final regulations were further modified in 2014 in Notice 2014-32. For a more in-depth description of the killer-B transactions, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 525-537.

[284] Treas. Reg. section 1.1032-1(d) and sec. 1012.

existence of untaxed earnings and profits in the subsidiary and the transfer of cash or other property to the parent.

The proposal goes beyond the scope of the final regulations, which only apply to reorganizations, to require deemed distribution treatment in all cases involving the purchase of hook stock by a subsidiary.

Moreover, the Administration believes that deemed distribution treatment should apply not only in the cross border context, as described, but also in purely domestic transactions where there is a transfer of cash or other property to the parent. For example, this may occur where a domestic corporation with earnings and profits wishes to pay a shareholder dividend without causing a dividend inclusion and may decide instead to purchase parent stock in exchange for cash or other property. This transaction may be of special interest with respect to ownership structures that do not qualify for the 100-percent dividends-received-deduction.

Under the proposal, in situations that do not afford a 100-percent dividends-received-deduction, the dividend treatment may result not only in a distribution by the subsidiary and receipt by the parent, but also in taxation of the dividend at each ownership level as it is deemed distributed through any tiers of entities. However, since the parent group has control of the structure of the transaction, the group need not experience this result if it does not enter such a transaction.

Authority may be given to the Secretary of the Treasury to write regulations describing transactions that do not have a tax motivation and which would be exempt from deemed distribution treatment.

It should also be noted that additional clarification of the proposal may be desirable. For example, the proposal does not specifically define the extent of control over a direct or indirect subsidiary that a parent corporation must have in order for its stock to be considered hook stock. Possibilities include, but are not limited to, the tax consolidation rules of affiliation under section 1504(a)(2), which generally require at least 80 percent vote and value, or the affiliation rules of section 304(c), which generally require at least 50 percent vote or value.

The proposal does not address acquisitions of hook stock in transactions that do not constitute purchases. Consideration might also be given to granting explicit Treasury authority to except from the provision any cases treated as purchases under present law that may not be within the intended scope of the provision.

### K. Repeal Federal Insurance Contributions Act (FICA) Tip Credit

#### Present Law

The Federal Insurance Contributions Act ("FICA") imposes taxes on employers and employees based on the amount of wages (as defined for FICA purposes) paid to an employee during the year.[285] The tax imposed on the employer and on the employee is each composed of

[285] Secs. 3101-3128.

two parts: (1) the Social Security or old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($118,500 for 2015); and (2) the Medicare or hospital insurance ("HI") tax equal to 1.45 percent of all covered wages.[286] Employers are generally required to withhold the employee share of FICA taxes from wages paid to the employee.

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

Wages for FICA purposes includes cash and charge tips of $20 or more received by an employee in a calendar month. Employees are generally required to report to their employers the amount of tips received.[287] In addition, certain large food and beverage establishments must impute (or allocate) additional tips to employees as needed for aggregate tips to total eight percent of an establishment's gross receipts.[288]

A business tax credit is provided to certain employers in the amount of the employer share of FICA taxes paid on tips in excess of those treated as wages for purposes of meeting the minimum wage requirements of the Fair Labor Standards Act (the "FLSA") as in effect on January 1, 2007 ("FICA tip credit").[289] The credit applies with respect to employer FICA tax paid on tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption if the tipping of employees delivering or serving food or beverages by customers is customary. The credit is available whether or not the employee reports the tips on which the employer FICA tax is paid. No deduction is allowed for any

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

[287] Sec. 6053(a). This reporting requirement applies to cash tips received by employees directly from customers or from other employees under a tip-sharing arrangement and tips charged by customers that are paid to employees by the employer. Under section 6053(b), if the employee FICA tax attributable to tips reported by an employee exceeds the amount that can be withheld from wages paid to employees, the employer is required to provide the employee with a statement showing the amount of the excess, which the employee must pay separately. Alternatively, the employee may give the employer separate funds to cover the excess.

[288] Sec. 6053(c).

[289] Sec. 45B. As of January 1, 2007, the FICA tip credit took into account the amount of tips in excess of the minimum wage under the FLSA, without reference to a specific date. At that time, the Federal minimum wage under the FLSA was $5.15 per hour. In the case of tipped employees, the FLSA provided that the minimum wage could be reduced to $2.13 per hour (that is, the employer was required to pay only compensation equal to $2.13 per hour) if the combination of tips and employer-paid compensation equaled the Federal minimum wage. In 2007, the minimum wage under the FLSA was increased by Pub. L. No. 110-28. The increase in the minimum wage would have automatically reduced the amount of tips taken into account for purposes of the FICA tip credit, thus also reducing the credit. In order to prevent a reduction in the credit, section 45B was amended so that the amount of tips taken into account is based on the minimum wage as in effect on January 1, 2007.

amount taken into account in determining the tip credit. A taxpayer may elect not to have the credit apply for a taxable year.

## Description of Proposal

The proposal repeals the FICA tip credit.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2015.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.K., reprinted in the back of this volume.

## Analysis

Although tips received by employees are wages subject to FICA taxes, as a practical matter, whether FICA taxes on tip income are paid often depends on whether employees report the tip income to their employer. Reporting of tip income by employees also affects the amount of Social Security and Medicare wages shown on the Forms W-2 (Wage and Tax Statement) issued by an employer to employees, which serve as the basis for the amount of wages credited to an employee by the Social Security Administration for benefit eligibility purposes. Moreover, tip income is includible in gross income, and tip income reported by employees to their employer is included in taxable wages shown on Forms W-2.

Supporters of the FICA tip credit note that, in response to the FICA tip credit, employers have developed administrative systems that improve tip reporting by employees. They argue that repeal of the credit will result in reduced FICA (and income tax) compliance, with a related revenue loss, as well as less accurate crediting of wages for Social Security and Medicare purposes. However, the staff of the Joint Committee on Taxation estimates that any positive revenue effect of the increased compliance is small compared to the tax expenditure associated with the credit. Thus, repeal of the credit would have a significant net positive revenue effect. In addition, advocates for repeal suggest that other, more effective measures could be taken to improve tax compliance with respect to tip income.

Some argue that the FICA tip credit provides an inappropriate financial incentive to provide more compensation in the form of tips rather than a stated rate of cash compensation. Moreover, although the credit originally applied only to tips in excess of the amount needed to bring an employee's compensation up to the minimum wage, it currently applies to some amounts required to satisfy minimum wage standards. To the extent that employers receive the credit with respect to tip income that would be reported even if the credit did not apply, the credit fails to provide an incentive for more complete reporting of that tip income. Some also argue that the credit creates inequities across taxpayers because only some businesses are eligible for the credit, while other businesses in which the tipping of employees is customary (such as hair salons and hotels) are not eligible for the credit.

## L. Repeal the Excise Tax Credit for Distilled Spirits with Flavor and Wine Additives

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 49-52. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item IX.L, reprinted in the back of this volume.

## PART X – TAX REFORM FOR FAMILIES AND INDIVIDUALS

### A. Reform Childcare Tax Incentives

#### Present Law

**Child and dependent care credit**

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

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

**Dependent care assistance plans**

Exclusion for employer-provided dependent care

Amounts paid or incurred by an employer for dependent care assistance provided to an employee generally are excluded from the employee's gross income and wages if the assistance is furnished under a program meeting certain requirements.[290] These requirements include that the program be described in writing, satisfy certain nondiscrimination rules, and provide for notification to all eligible employees. Dependent care assistance expenses eligible for the exclusion are defined the same as employment-related expenses with respect to a qualifying individual under the dependent care tax credit.

The dependent care exclusion is limited to $5,000 per year, except that a married taxpayer filing a separate return may exclude only $2,500. Dependent care expenses excluded from income are not eligible for the dependent care tax credit.[291]

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[290] Sec. 129.

[291] Sec. 21(c).

Cafeteria plans and flexible spending arrangements

A cafeteria plan is an arrangement established by an employer under which employees may choose whether to receive cash or instead to receive certain nontaxable benefits.[292] No amount is included in the gross income of an employee who participates in a cafeteria plan solely because, under the plan, the employee may choose among cash and the other benefits offered under the plan.

Permissible cafeteria plan benefits include reimbursements of dependent care expenses. Reimbursements under a cafeteria plan may be provided through a flexible spending arrangement ("FSA"). A dependent care FSA is an arrangement under which employees are given the option to reduce their current cash compensation and instead have the amount of the salary reduction made available for reimbursing the employee for his or her dependent care expenses

## Description of Proposal

The proposal would modify the child and dependent care credit, while repealing dependent care FSAs.

The proposal modifies the child and dependent care credit in three principal ways. First, the phaseout thresholds of the credit would be substantially increased. The proposal would increase the beginning of the phaseout threshold from AGI of $15,000 under present law to AGI of $120,000. The phase-out rate would remain the same as under present law, that is, the credit rate would decrease by one percentage point for every $2,000 (or fraction thereof) by which AGI exceeds $120,000, until the credit reaches 20-percent. Thus, except as described below, the credit reaches a 20-percent rate for taxpayers with AGI in excess of $148,000.

Second, the proposal provides an enhanced credit for taxpayers with children under age five. Under the proposal, taxpayers with young children could claim a credit of up to 50 percent of expenses up to $6,000 for one child, or $12,000 for two or more young children. Thus, the maximum credit for a taxpayer with one young child would be $3,000, and would be $6,000 for taxpayers with two or more young children. This enhanced credit rate would decrease by one percentage point for every $2,000 (or fraction thereof) by which AGI exceeds $120,000, until the credit reaches 20 percent. Thus, the proposed young child dependent care credit would reach its minimum value of 20 percent of creditable expenses for AGI in excess of $178,000.

Third, the proposal indexes for inflation both the expense limitations (those for young children and other dependents) as well as the phaseout thresholds. [293]

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[292] Sec. 125.

[293] This proposal represents a modification of the Administration's 2015 Budget Proposal, which provided for an enhanced credit for children under age 5 which provided for a 65-percent credit rate. The enhanced credit phased out by one percentage point for AGI in excess of $61,000, until the rate reached zero at $119,000. The 2015 proposal did not contain an increase of the phase-out threshold for taxpayers without young children, did not index the expense limitations and phaseout thresholds for inflation, and did not repeal dependent care FSAs. For a

Effective date.−The proposal is effective for tax years beginning after December 31, 2015.

The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.A, reprinted in the back of this volume.

## Analysis

The effect of the proposal is to increase the value of the child and dependent care credit for taxpayers with children under age five, and for taxpayers with AGI above $15,000 but below $148,000. Additionally, by indexing both the maximum eligible expenses and the phaseout range for inflation, the proposal ensures that the credit retains its value in real dollars over time.

### Considerations in expanding the child and dependent care credit

#### Rationale for the credit

As described above, this proposal largely represents an expansion of the child and dependent care tax credit. The child and dependent care credit has as its base child and dependent care expenses, and its effect is to lower the cost of care for such individuals. Any expansion of the credit may warrant consideration of the underlying theory of such a credit, and an evaluation of whether that expansion is consistent with the credit's underlying purpose. One can discern three rationales upon which providing a tax benefit for expenses associated with child and dependent care might be based.

Measurement of income.−Under this rationale, a taxpayer's child and dependent care expenses are viewed as income that is generally unavailable for consumption, and thus inappropriate to include in the tax base. A related rationale would be the view that such expenses are equivalent to an expense necessary for the production of income (*i.e.*, an expense that is incurred in order to enable the taxpayer to work). Under either view, under an income tax the appropriate treatment of such expenses would be to provide a deduction from the taxpayer's gross income. Whether that deduction should be above-the-line (*i.e.*, without regard to whether the taxpayer takes the standard deduction or itemizes his or her deductions) or a below-the-line deduction depends on the value of the standard deduction and whether, in the judgment of policymakers, the standard deduction is sufficient to encompass the expenses of child care for those taxpayers whose itemized deductions do not exceed the standard deduction.[294]

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description of this proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 143-147.

[294] Because the value of the standard deduction distinguishes those with dependents only in some circumstances (which is to say, individual filers with dependents have a larger standard deduction than individual filers with no dependents, but joint filers have the same standard deduction without regard to the presence of dependents), it seems difficult to argue that the standard deduction is meant to encompass the full extent of child and

Encouraging workforce participation.−Under this rationale, a taxpayer's child and dependent care expenses should be subsidized by the Federal government because such a subsidy encourages second earners to enter the workforce.[295] If, for example, in the case of married taxpayers who filed their return jointly, the primary-earning spouse had income sufficient to place the taxpayers into the 25-percent tax bracket, the secondary-earning spouse would be taxed at 25 percent on the first dollar of income that spouse earned, in addition to payroll taxes on that income.[296] That tax burden (*i.e.*, the burden of having the first dollar of earnings taxed at the couple's highest marginal rate), plus the additional cost of child care paid so as to allow the secondary-earning spouse to work, may be so great as to render working uneconomical. Implicit in this rationale is the notion that the secondary-earner's remaining out of the workforce to care for his or her dependents represents an inefficient allocation of resources.

The effectiveness of such a subsidy will depend on the level of the subsidy, the taxpayer's marginal tax rate, the earnings potential of the secondary-earning taxpayer, and the cost of child care. If one would abide purely by this rationale, the subsidy should increase as the primary-earning spouse's marginal tax rate increases (*i.e.*, the subsidy should increase for higher-income taxpayers), as a greater subsidy would be needed to overcome the additional tax expense incurred by the secondary-earning spouse. This would be achieved most directly with a deduction that was neither capped at a fixed dollar amount nor phased out. Additionally, under this rationale, it is not clear that unmarried filers should be eligible for such a subsidy (if the purpose is to encourage secondary-earners to join the workforce, presumably it is not necessary to provide a subsidy to a household's primary earner).[297]

Income assistance to low and moderate income taxpayers.−A third rationale for such a tax benefit would be to provide financial assistance to low and moderate income taxpayers. Under this rationale, a tax benefit for child care expenses serves a function similar to that of the earned income tax credit or the child tax credit. However, it is unclear why child care expenses should, in and of themselves, trigger additional assistance to low income families, absent the presence of one of the two aforementioned rationales. Furthermore, to the extent that any tax benefit (other than in the case of refundable credits) is limited by a taxpayer's ability to reduce tax liability, financial assistance provided through the tax system necessarily excludes the lowest income taxpayers from the reaping the benefits of such a provision. Additionally, under such a rationale, we would expect any benefit for child care expenses to phase out completely as a taxpayer's income exceeded a certain level.

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dependent care expenses. If the standard deduction is intended to encompass dependent care expenses, joint filers without dependents garner a windfall benefit from the value of the standard deduction.

[295] In some cases the credit may encourage a head-of-household to return to work, such as in the case of a single parent who receives alimony and child support.

[296] The combined employee and employer share of Federal Insurance Contributions Act (FICA) tax is 15.3 percent.

[297] However, as previously noted, the child and dependent care credit may in some circumstances provide an incentive for unmarried parents to work in the case of those unmarried parents who are not working and supporting their family through the use of alimony and child support payments, or other means.

Congress has not articulated a clear rationale for the child and dependent care credit. Prior to the enactment of the Tax Reform Act of 1976, rather than a credit for child and dependent care expenses, taxpayers were eligible for an itemized deduction for such expenses.[298] The stated reasoning for the change from an itemized deduction to a tax credit does not provide evidence of a clear choice among these rationales. The legislative history states:

> Treating child care expenses as itemized deductions denied any beneficial tax recognition of such expenses to taxpayers who elected the standard deduction. The Congress believed that such expenses should be viewed more as a cost of earning income than as personal expenses. One method for extending the allowance of child care expenses to taxpayers generally and not just to itemizers was to replace the itemized deduction with a credit against income tax liability for a percentage of qualified expenses. While deductions favor taxpayers in the higher marginal tax brackets, a tax credit provides relatively more benefit to taxpayers in the lower brackets.[299]

Although the intent of Congress, as described by the staff of the Joint Committee on Taxation, appears to be to treat such expenses as a "cost of earning income," the fact that Congress chose to provide taxpayers with a credit (rather than expanding the deduction, which would be more consistent with accommodating a "cost of earning income") suggests that Congress had mixed objectives.

Indeed, the current form of the child and dependent care credit has elements of all three of the above-listed rationales. Because the credit applies only to child and dependent care expenses that are incurred so as to pursue gainful employment, the credit represents more than income assistance to low-income taxpayers. However, the credit is not obviously intended to properly measure income, as child and dependent care expenses upon which the credit is based are capped, and the subsidy is provided as a credit whose percentage is determined without regard to the taxpayer's marginal tax rate. Furthermore, the credit is not obviously intended to encourage a second-earning spouse to work, given that the credit does not increase as taxpayers' marginal tax rate increases, and is available for non-joint filers.

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[298] The itemized deduction was enacted in the Internal Revenue Code of 1954, Pub. L. No. 83-591, providing limited relief to taxpayers who were unable to deduct such expenses as a business expense (see *Smith v. Commissioner*, 40 BTA 1038 (1939)). In its original form, only certain taxpayers were eligible for the deduction: 1) working wives where the taxpayers filed a joint return and the taxpayers' combined AGI did not exceed $6,000; 2) working wives whose husbands were incapable of work because they were physically or mentally incapacitated; 3) widows and working women (other than wives) with children or incapacitated dependents; 4) widowers; and 5) husbands whose wives were incapacitated or institutionalized. The deduction was substantially liberalized to apply to all taxpayers who qualified (without regard to gender) in the Revenue Act of 1971, Pub. L. No. 92-178. Subsequently, a Federal Circuit Court declared the limited scope of the credit, as it existed prior to 1971 to be unconstitutional. See *Moritz v. Commissioner*, 469 F.2d 466 (10th Cir. 1972) (R.B. Ginsburg and M. Ginsburg arguing on behalf of petitioner-appellant).

[299] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, (JCS-33-76), December 29, 1976, p. 124.

Consistency of the proposal with rationales

For a tax credit to have the same economic effect as an above-the-line deduction from gross income, that tax credit should be provided at the taxpayer's marginal tax rate. If one believes that the intent of the child and dependent care credit is to reduce gross income by child care expenses, either because those expenses are deemed unavailable for the taxpayer's consumption or because such expenses are necessary for gainful employment, the President's proposal appears to provide a greater financial subsidy than would be appropriate under such a policy, at least with respect to the proposal for an increased credit for taxpayers with young children. As described above, taxpayers with young children would receive a 50-percent credit on their child care expenses under the proposal. This is significantly higher than the marginal federal income tax rate faced by taxpayers below the phaseout threshold, which likely does not exceed 25 percent.

By providing an increased benefit for taxpayers with children under five years of age, the proposal benefits a segment of taxpayers that may have particularly high employment-related child care expenses, because these children are generally too young to attend public elementary school. By increasing the after-tax return to employment for non-working individuals with child care responsibilities, the proposal could further encourage these individuals to seek work outside of the home. However, to the extent that, for certain taxpayers, the elimination of dependent care FSAs offsets benefits under the proposal, the proposal does not increase the after-tax return to employment for non-working individuals and thus does not further encourage work outside the home.

By increasing the value of the credit for taxpayers with young children, and for taxpayers whose AGI is in excess of $15,000 but below $148,000, the proposal may reduce the net cost of child care for those taxpayers, and thereby provide income assistance to those taxpayers. As described below, however, the repeal of dependent care FSAs may result in a significant offsetting of this benefit, and may in some cases be detrimental to taxpayers. It should also be noted that if income assistance is a primary policy goal, a limitation of both present law and the President's proposal is that the credit can provide a benefit only to those taxpayers having an income tax liability; low-income taxpayers with no income tax liability cannot benefit from the credit.

**Benefits and burdens of the proposal**

The benefit of the expansion of the child credit may in some respects be offset by the repeal of dependent care FSAs. Because under present law a taxpayer who pays for child and dependent care expenses using funds from an FSA must decrease eligible expenses for purposes of calculating the child and dependent care credit, taxpayers must determine which means of funding child care expenses provides them with the greater benefit. From an income tax perspective, the benefit of using funds from a dependent care FSA is the same as the benefit of deducting those expenses. However, because contributions to an FSA are also excluded from Federal Insurance Contribution Act ("FICA") taxes, there is an additional 7.65-percent benefit for those taxpayers whose individual earnings are below the Social Security wage base ($118,500 for 2015) and a benefit of 1.45-percent to those whose earnings are above that amount (representing the employee's share of the Medicare tax). Thus, a taxpayer in the 25-percent

marginal rate bracket who earns less than $118,500 would receive an income tax benefit of 25 percent of the amount expended (up to $5,000), for a maximum benefit of $1,250, plus an additional 7.65-percent benefit of $382.50, for a total maximum benefit of $1,632.50.

For those who are currently able to contribute to dependent care FSAs, whether the proposal on net represents a benefit for any particular taxpayer will depend upon the taxpayer's credit rate under the proposal, the amount of eligible expenses allowed under the proposal, the taxpayer's marginal income tax rate and the taxpayer's marginal FICA tax rate.

For example, in the case of taxpayers with children under age five with child and dependent care expenses of less than $5,000, as a general matter the proposal will be to their benefit only when their AGI is less than $168,000. This is the point at which such a taxpayer (either a joint filer or a head-of-household filer) would have a marginal tax rate (plus the 1.45-percent Medicare tax rate[300]) that exceeds the credit rate.[301] However, a taxpayer with AGI in excess of $168,000 could benefit to the extent that the proposal increases the maximum eligible expenses allowable for purposes of the credit. For instance, a high-income taxpayer who had two or more children under age five could claim a 20-percent credit for up to $12,000 in child and dependent care expenses under the proposal, for a tax benefit of $2,400. Under present law, such a taxpayer could exclude $5,000 from income at the highest marginal tax rate, which is approximately 40-percent. Additionally, under present law this taxpayer could still claim a child and dependent care credit on $1,000 of eligible expenses (the $6,000 maximum reduced by the $5,000 FSA distribution), at a credit rate of 20-percent. Thus, the taxpayer's total benefit under present law would be $2,200, or $200 less than the Administration's proposal. As a general matter, a taxpayer in the highest marginal tax bracket who spends less than $11,000 on child and dependent care expenses will fare worse under the proposal, while a taxpayer who spends beyond that amount (up to the $12,000 cap) will fare better.[302]

However, it should be noted that while all taxpayers are potentially eligible to receive child and dependent care credit, the benefit of a dependent care FSA is dependent upon whether a taxpayer works for an employer that provides one. IRS data reveals that only 1.4 million taxpayers receive dependent care benefits from their employer, with an average benefit of

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[300] Whether, in the case of joint filers, the benefit of the FICA exclusion is 1.45 percent or 7.65 percent depends upon the earnings of the particular spouse whose employer offers the dependent care FSA.

[301] The credit rate falls below 26-percent for taxpayers with AGI in excess of $168,000. At this level of AGI, it is likely that married taxpayers who file their returns jointly or taxpayers who file as head-of-household will face a marginal tax rate of 25-percent or greater. A taxpayer's marginal tax rate is determined by a taxpayer's taxable income, which will vary by taxpayer depending on the extent to which AGI is reduced by a taxpayer's deductions. Adding on the 1.45-percent Medicare tax rate brings that taxpayer's marginal tax rate to 26.45 percent.

[302] This analysis does not take into account any State income tax benefits that may accrue to a taxpayer. Because many States use Federal AGI as their income tax base, funding child care through the use of a dependent care FSA often has State income tax benefits, as those amounts are excluded from AGI.

$2,840.[303] Because taxpayers need their employer to offer a child and dependent care FSA in order to benefit from the provision, in many cases taxpayers cannot benefit. Present law thus creates inconsistent treatment across taxpayers with the same wages, marginal tax rate and expenses, as taxpayers who are only able to claim the credit may be worse off than those who can also participate in a child and dependent care FSA.

Nonetheless, the benefit of a dependent care FSA may be limited because it requires that the taxpayer correctly predict the amount of child and dependent care expenses that will be incurred in a given year. Although child and dependent care expenses tend to be more certain than health care expenses, there is nonetheless risk in funding a dependent care FSA that a taxpayer would lose some of the funds that go unused. The Administration's proposal eliminates that planning risk, by providing benefits solely based on expenses incurred in the past year.

Finally, proponents of the proposal may suggest that it should not be viewed in isolation, but rather in conjunction with the President's separate proposal to provide for a second-earner credit of five-percent of earnings of the lower-earning spouse, up to $10,000.[304] In the case of married couples filing a joint return who qualify for that credit, the credit could potentially offset any loss that a taxpayer may have experienced as a result of the repeal of dependent care FSAs. However, a taxpayer filing as head-of-household could not claim this credit.

## B. Simplify and Better Target Tax Benefits for Education

### Description of Modifications

**Consolidation of prior-year proposals**

The fiscal year 2016 budget proposal combines four separate prior-year proposals into a single proposal and adds new proposals which are described below. The prior-year proposals that are combined for fiscal year 2016 are: (1) a proposal to modify the tax treatment of Pell Grants; (2) a proposal to modify the reporting of tuition expenses and scholarships on Form 1098-T; (3) a proposal to provide for an exclusion from income upon the forgiveness of certain Federal student loans; and (4) a proposal to provide for an exclusion from income for both student loan forgiveness and for certain scholarship amounts for participants in the Indian Health Service Health Professions Programs.

The proposal to modify the tax treatment of Pell Grants is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 148-152. The estimated budget effect of the current proposal can be found at Joint Committee

[303] This figure includes both taxpayers that are receiving tax benefits through the use of child and dependent care FSAs and taxpayers that are receiving tax benefits through the use of employer-provided dependent care facilities.

[304] For a description and analysis of this credit, see Part X.K.

on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.B.2, reprinted in the back of this volume.

The proposal to modify the reporting of tuition expenses and scholarships on Form 1098-T is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 155-156. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.B.3, reprinted in the back of this volume.

The proposal to provide for an exclusion from income upon the forgiveness of certain Federal student loans is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 67-69. The estimated budget effect of the current proposal, in combination with the proposal to repeal the student loan interest deduction and the proposal regarding participants in the Indian Health Service Health Professions Programs (described below), can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.B.4, reprinted in the back of this volume.

The proposal to provide for an exclusion from income for both student loan forgiveness and for certain scholarship amounts for participants in the Indian Health Service Health Professions Programs is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 70-72. The estimated budget effect of the current proposal, in combination with the proposal to repeal the student loan interest deduction and the proposal to provide an exclusion from income upon the forgiveness of certain Federal student loans, can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.B, reprinted in the back of this volume.

## New proposals

### Present Law

### Hope credit and American Opportunity tax credit

#### Hope credit

For taxable years beginning before 2009 and after 2017, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to $1,950 (estimated 2015 level) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate

program.[305] The Hope credit rate is 100 percent on the first $1,300 of qualified tuition and related expenses, and 50 percent on the next $1,300 of qualified tuition and related expenses (estimated for 2015). These dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of $100. Thus, for example, a taxpayer who incurs $1,300 of qualified tuition and related expenses for an eligible student is eligible (subject to the AGI phaseout described below) for a $1,300 Hope credit. If a taxpayer incurs $2,600 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a $1,950 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $55,000 and $65,000 ($110,000 and $130,000 for married taxpayers filing a joint return), as estimated by the JCT staff for 2015. The beginning points of the AGI phaseout ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of $1,000. The size of the phaseout ranges for single and married taxpayers are always $10,000 and $20,000 respectively.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The Hope credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.

The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (*e.g.*, in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may claim only one of the Hope credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student.

The Hope credit is available for qualified tuition and related expenses, which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution.

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[305] Sec. 25A. For taxable years 2009-2017, the American Opportunity tax credit applies (discussed *infra*). Both the Hope credit and the American Opportunity tax credit (in the case of taxable years from 2009-2017) may be claimed against a taxpayer's alternative minimum tax liability.

Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one-half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a Federal or State felony for the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. To qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

American Opportunity tax credit ("AOTC")

The AOTC refers to modifications to the Hope credit that apply for taxable years beginning in 2009 through 2017. The maximum allowable modified credit is $2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses, and 25 percent on the next $2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

The modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the Hope credit to two more years of post-secondary education.

The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom section 1(g) applies for such taxable year (generally, any child who has at least one living parent, does not file a joint return, and is either under age 18 or under age 24 and a student providing less than one-half of his or her own support).

**Lifetime Learning credit**

Individual taxpayers may be eligible to claim a nonrefundable credit, the Lifetime Learning credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents.[306] Up to $10,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (*i.e.*, the maximum credit per taxpayer return is $2,000). In contrast with the Hope credit, the maximum credit amount is not indexed for inflation.

In contrast to the Hope and American Opportunity tax credits, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the Hope and American Opportunity tax credits, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return does not vary based on the number of students in the taxpayer's family—that is, the Hope credit is computed on a per student basis while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit is available to students who attend school on a part-time basis, unlike the rule for the Hope and AOTC that requires students attend on a half-time or greater basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $55,000 and $65,000 ($110,000 and $130,000 for married taxpayers filing a joint return) in 2015. These phaseout ranges are the same as those for the Hope credit as it applies for tax years beginning before 2009 and after 2017, and are similarly indexed for inflation.

The Lifetime Learning credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. As with the Hope credit and AOTC, qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Lifetime Learning credit. Repayment of a loan is not a qualified tuition expense.

As with the Hope credit and AOTC, a taxpayer may claim the Lifetime Learning credit with respect to a student who is not the taxpayer or the taxpayer's spouse (*e.g.*, in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the

[306] Sec. 25A. The Lifetime Learning credit may be claimed against a taxpayer's AMT liability.

taxable year for which the credit is claimed. If a student is claimed as a dependent by a parent or other taxpayer, the student may not claim the Lifetime Learning credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a Hope or American Opportunity tax credit for that same taxable year with respect to other students. If, for a taxable year, a taxpayer claims a Hope credit or AOTC with respect to a student, then the Lifetime Learning credit is not available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same student for other taxable years). As with the Hope credit and AOTC, a taxpayer may not claim the Lifetime Learning credit and also claim the section 222 deduction for qualified tuition and related expenses.

As with the Hope credit, the Lifetime Learning credit is available for qualified tuition and related expenses, which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution. However, unlike the AOTC, the Lifetime Learning credit is not available for the expenses of course materials. Eligible higher education institutions are defined in the same manner for purposes of both the Hope and Lifetime Learning credits. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the Lifetime Learning credit. Expenses involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program, or the education is undertaken to acquire or improve the job skills of the student.

Qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level courses.[307] Additionally, in contrast to the Hope credit and AOTC, the eligibility of a student for the Lifetime Learning credit does not depend on whether the student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

As with the Hope credit and AOTC, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student during the taxable year (such as employer-provided educational assistance excludable under section 127). The Lifetime Learning credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

[307] As explained above, the Hope credit is available only with respect to the first two years of a student's undergraduate education. The AOTC is available only with respect to the first four years of a student's post-secondary education.

**Deduction for student loan interest**

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit.[308] Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending on at least a half-time basis (1) eligible educational institutions,[309] or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. The cost of attendance is reduced by any amount excluded from gross income under the exclusions for qualified scholarships and tuition reductions, employer-provided educational assistance, interest earned on education savings bonds, qualified tuition programs, and Coverdell education savings accounts, as well as the amount of certain other scholarships and similar payments.

The maximum allowable deduction per year is $2,500. For 2015, the deduction is phased out ratably for taxpayers with AGI between $65,000 and $80,000 ($130,000 and $160,000 for married taxpayers filing a joint return). The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of $5,000

## Description of Proposal

The fiscal year 2016 budget proposal modifies prior proposals pertaining to education tax incentives in four principal ways. First, the 2016 proposal would make changes to the American Opportunity Tax Credit ("AOTC"), in addition to making it permanent.[310] The 2016 proposal expands the AOTC to cover the first five years of post-secondary education, rather than the first four years under present law. The 2016 proposal also allows students who are enrolled on a less than half-time basis to claim 50-percent of the AOTC. In addition, the 2016 proposal would increase the portion of the AOTC that is refundable, providing that the first $1,500 of the allowable credit is refundable. This is a departure from present law in two ways: 1) it increases the maximum refundability of the credit from $1,000 to $1,500; and 2) it stacks the refundable portion of the credit first, rather than allocating it pro rata, as under present law. Finally, the 2016 proposal provides that, in the case of certain students who do not provide more than one-half of their own support, such students would no longer be able to claim the AOTC on their own

[308] Sec. 221.

[309] This definition of an eligible educational institution is the same as that used for the Hope, American Opportunity, and Lifetime Learning credits, and the expired deduction for qualified tuition expenses.

[310] See Part I.C., *supra*.

return (whereas under present law they are currently able to claim the non-refundable portion of the credit).

Second, the fiscal year 2016 budget proposal repeals the Lifetime Learning Credit. Thus, under the Administration's proposal, taxpayers may only receive tax credits for tuition paid for the first five years of post-secondary education.

Third, the fiscal year 2016 budget proposal repeals the student loan interest deduction for student loan interest on new student loans.

Finally, the 2016 proposal would provide a new exception under Code section 6103 to allow the Secretary of Treasury to disclose identifying information to the Department of Education ("DOE") in the case of late-stage delinquency of loans so that the DOE could inform borrowers about options to avoid default. The proposal would also allow the DOE to re-disclose this information, as under current law for defaulted borrowers, to certain lenders, guarantee agencies, and educational institutions for this purpose.[311]

Effective date.−The proposal is effective for taxable years beginning after December 31, 2015.

## Analysis

AOTC proposal

The AOTC is intended to provide some financial relief to taxpayers with higher education expenses. By providing taxpayers with a refundable credit, the AOTC serves as a grant that reduces the cost of college attendance. The modification both increases the amount of the credit that is refundable and provides that the refundable portion of the credit is allocated to the first tuition dollars spent, such that the first $1,500 spent on tuition would be returned in the form of a refundable credit. To the extent that taxpayers are able to benefit only from the portion of the AOTC that is refundable (because they have no net tax liability otherwise), the proposal provides further financial relief for that segment of taxpayers.

Credit ordering.−With respect to allocating the entirety of the refundable portion of the credit to the first $1,500 spent on tuition, on the one hand this puts those without net tax liability

[311] In general, under section 6103 tax returns and return information are confidential and may be disclosed only in certain strictly regulated circumstances. Return information includes a taxpayer's identification and the nature and source of his or her income. However, present law provides an exception under section 6103(m)(4) to permit the Secretary of the Treasury, upon written request from the Secretary of Education, to disclose the mailing address of any taxpayer who is in default on any Federally insured student loan made with respect to higher education or made with respect to certain student assistance programs. These disclosures may be made for use by officers, employees, or agents of the Department of Education to assist in locating the defaulting taxpayer and collecting the unpaid amounts. These disclosures may also be made to any lender, or any State or nonprofit guaranteeing agency participating in loans under the Higher Education Act of 1965 or any education institution with which the Secretary of Education has an agreement under the Higher Education Act, for use by such persons in collecting such loans.

on par with those who do have net tax liability. Under the present-law AOTC, taxpayers with net tax liability receive a dollar-for-dollar tax benefit on 100-percent of the first $2,000 spent on qualified tuition. This is because such a taxpayer benefits from a tax credit without regard to whether it is refundable or non-refundable. A taxpayer without net tax liability only benefits to the extent the credit is refundable, which is 40-percent of the otherwise allowable credit. By making the entirety of the first $1,500 spent on tuition refundable, the proposal ensures that all taxpayers are able to benefit equally from the AOTC to that extent without regard to their net tax liability.

However, opponents might argue that, to the extent that the AOTC provides an incentive for educational institutions to capture some of the benefit by raising their tuition and fees, providing a refundable credit for 100-percent of the first $1,500 of tuition may exacerbate this behavior. To the extent they have not already captured the benefit of the credit, colleges will be able to raise their tuition up to the $1,500 refundable portion, without the student paying more out of-pocket on an after-tax basis, regardless of that student's net tax position. To the extent that institutions had previously felt constrained from fully capturing the benefit of the credit due to the population of students who would not fully benefit from the nonrefundable credit amounts, this constraint would now be removed.

Expansion to five years.−Proponents of the expansion of the AOTC to cover the first five-years of tuition expenses might argue that the goal of the AOTC is to provide tuition support for students attending college. Many students take longer than four years to complete their college education -- a recent report that found that at public colleges and universities, fewer than 36-percent of students graduated on time.[312] Supporters of the proposal may argue that these studies demonstrate the need for financial assistance in tuition payments extends beyond the first four years of post-secondary education.

Opponents might counter, as a threshold matter, that such a proposal may serve to exacerbate the trend of students extending their time in college, by providing financial assistance for an additional year. To the extent that policy-makers consider it desirable for students to complete their post-secondary education in a timely fashion, adding an extra year to the AOTC provides an incentive that may work against that policy goal.

An additional but related criticism is that extending one's education over the course of five years does not necessarily imply that overall spending on that education has increased. The proposal nonetheless provides a greater subsidy to students who spread their education over the course of five years rather than four. It is unclear why spending an additional year obtaining one's post-secondary education should warrant an additional subsidy, per se. Proponents may counter that a student who spends an additional year obtaining their education will have to incur additional cost-of-living expenses during that fifth year, which the additional tuition subsidy can help offset.

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[312] Complete College America, Four-Year Myth: Make College More Affordable, December 2014, available at: http://completecollege.org/wp-content/uploads/2014/11/4-Year-Myth.pdf. The report finds that the on-time completion rate for flagship institutions was 36-percent while the on-time completion rate for non-flagship institutions was 19-percent.

Modification of one-half support rule.−Finally the proposal establishes a new rule which provides that certain students who do not provide one-half of their own support[313] will no longer be able to claim the non-refundable portion of the AOTC. Because under current law such students may not claim the refundable portion of the credit, these students will no longer be able to claim the AOTC. Proponents of the proposal will point out that this rule will prevent high-income taxpayers from being able to benefit from the AOTC, collectively within the family unit, by not claiming their child as a dependent and instead having them file their taxes independently. Under present law, to the extent the child had income tax liability, the child could receive a subsidy. This problem may be especially prominent in the case of families whose modified AGI was in excess of the personal exemption phaseout ("PEP") threshold for 2015 ($258,250 for single filers and $309,900 for joint filers). In this case, the parents may not benefit from the additional dependency exemption they might receive in claiming the child as a dependent, and thus there is little cost for the parents in having the child file his or her return independently.

Proponents of the proposal might also point out that under present law, a student who files independently from his or her parents who does not provide over half of his or her support receives a subsidy only to the extent that there is tax liability to offset. It is not clear what the rationale would be to provide a subsidy only to those individuals who have a tax liability in this circumstance. This may be especially true among this population of students, who do not provide their own support through earned income. Having positive tax liability could well be an indicia of having large sources of unearned income. Proponents may thus argue that students who have assets which produce unearned income to this extent do not need an additional subsidy for their education.

Additional consideration may be needed in the design of this rule in combination with the Administration's proposal to allow the AOTC to students who attend school on a less than half-time basis. Under present law, the rule denying the refundable portion of the AOTC does not apply to these students, but because the AOTC is available only to students who attend on an at-least-half-time basis, this is of no moment. Once the AOTC is available to students who attend on a less-than-half-time basis, consideration needs to be given to whether these students should be subject to the same rules as full-time students, bearing in mind that their parents cannot claim them as dependents on their own tax returns,[314] and that while many of these students may be working to support themselves, others may be unemployed and looking for work, while others may simply be living off of the support of their family.

[313] For purposes of this rule, a student will be ineligible to claim the AOTC on their own return if either parent of the child is still alive at the close of the taxable year and if the student does not file a joint return, provided that the student is either: (i) under the age of 18 or; (ii) age 18 or above and does not have earned income which exceeds one-half of the student's support for the taxable year.

[314] A student age 19-23 may only be considered a dependent for purposes of section 152 if the student is pursuing school on a full-time basis during each of five calendar months during the year. Sec. 152(f)(2).

Lifetime Learning credit

The proposal would repeal the Lifetime Learning credit, which allows individuals to claim a credit for 20-percent of tuition for all taxable years, including years beyond their first four years of post-secondary education. The Lifetime Learning credit is generally used by students whose undergraduate education extends beyond four years, students who attend college on a less than half-time basis, and individuals who wish to pursue higher education beyond an undergraduate degree. With respect to the first two categories, by extending the AOTC such that it covers five years of post-secondary education, and by allowing students who attend school on a less than half-time basis to claim the AOTC on a pro-rata basis, the proposal on the whole may in some cases benefit those students who claimed the Lifetime Learning credit under present law. However, students who are pursuing education beyond the first five years of post-secondary education will no longer be provided with a tuition subsidy through the tax code.

The net effect of the proposal then is to increase the subsidy for the first five years of post-secondary education at the expense of post-secondary education obtained thereafter, which in many cases will constitute post-graduate education. Opponents of the proposal might point out that the Federal government already provides need-based subsidies for undergraduate education through the Pell Grant program. These grants are generally not available for post-graduate education. Opponents might argue that, if the Federal government believes that all higher education is worthy of Federal subsidies, policymakers should be least willing to remove the subsidy for that aspect of post-secondary education that is not covered by Pell Grants.

Repeal of the student loan interest deduction

The proposal would repeal the student loan interest deduction on a prospective basis. Current students who have borrowed for post-secondary education would still be able to claim the student loan interest deduction, but new borrowers would not be able to deduct future interest payments. The effect of this proposal is to raise the cost of borrowing for those students who would otherwise have been able to deduct some or all of the interest on their student loans. In a private market one might expect interest rates to fall in response to the removal of a subsidy, to account for the decrease in demand associated with the increased cost of borrowing.[315] However, because the student loan interest rates are set by Federal law, we should not expect interest rates on student loans to behave in the same manner as if they were offered in the private market.

Proponents of the proposal would argue that the student loan interest deduction is no longer necessary, and in fact may serve as an excessive subsidy, given the recent changes to Federal law such as the Income-Based Repayment program ("IBR") and the Pay As You Earn program ("PAYE"), which cap the monthly payment on student loans based on the borrower's income. Although under some circumstances, borrowers' loans may be forgiven,[316] for many

[315] The degree to which the interest rates would fall to reflect the loss of the subsidy will depend on the elasticity of demand for student loans.

[316] Those who work in public-service jobs may be eligible for loan forgiveness after making 120 months of payments. Borrowers may otherwise be eligible for loan forgiveness after 20 years in the case of those in the PAYE

borrowers PAYE and similar programs simply spread out the payment schedule of student loans. This amounts to a consumption smoothing mechanism, which, even without loan forgiveness, does offer borrowers the benefit of deferring principal and interest payments without compounding. Whether that benefit would amount to a greater benefit to a borrower than the benefit of a student loan interest deduction would depend on the specific facts and circumstances of the individual borrower, such as the nature of work the borrower undertakes, the borrower's adjusted gross income, and the level of borrowing.

Because income-based repayment plans are based in large part on monthly repayment amounts, taxpayers with low levels of student loan debt often cannot benefit from these plans. Consideration might be given to modifying the proposal such that borrowers who are not repaying their student loans on an income-based repayment plan are still able to deduct student loan interest in the same manner as present-law. This would allow taxpayers who have lower-levels of student loans, and who cannot otherwise take advantage of IBR or PAYE, to retain some additional form of Federal subsidy on their student loans. By using this one-or-the-other approach, it may be that the availability of the interest deduction encourages students to rein in their borrowing, while at the same time prevents taxpayers who receive large subsidies from student loan forgiveness provisions from receiving a windfall through the further benefit of the student loan interest deduction.

### C. Provide for Automatic Enrollment in IRAs, Including a Small Employer Tax Credit, Increase the Tax Credit for Small Employer Plan Start-Up Costs, and Provide an Additional Tax Credit for Small Employer Plans Newly Offering Auto-Enrollment

#### Description of Modification

The fiscal year 2015 proposal is modified by increasing the two credits included in that proposal and adding a new credit.

Small employers (those with fewer than 100 employees) that offer an automatic payroll deduction IRA program can claim a temporary nonrefundable tax credit for expenses associated with the arrangement for the first years of the arrangement. Under the fiscal year 2015 proposal, the credit was $500 for the first year and $250 for the second year. Under the modification, the credit is increased to $1,000 for each year and can be claimed for each of the first three years. The additional credit of $25 per employee up to $250 for six years is unchanged.

The fiscal year 2015 proposal increased the present-law nonrefundable tax credit for a small employer that adopts a new qualified retirement plan, SEP or SIMPLE retirement plan so that the $500 present law credit was doubled to $1,000 for three years. Under the modification, the amount of the credit is increased to $1,500 per year (tripled instead of doubled). The remainder of the proposal is unchanged. Thus, the credit applies for three years but is extended to four years for any employer that adopts the new plan during the three years when it first offers (or is required to offer) an automatic IRA arrangement.

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program those beginning the IBR program on or after July 1, 2014, or 25 years in the case of those beginning the IBR program prior to July 1, 2014 or borrowers making repayments on the Income Based Contingent plan.

The modification includes an additional credit for small employers that adopt new qualified retirement plans, SEPs or SIMPLE retirement plans that include automatic enrollment. The new credit also applies to a small employer that adds automatic enrollment to an existing plan. The credit is $500 per year for up to three years. This credit is in addition to the $1,500 per year credit (for an employer that qualifies for that credit).

This proposal modifies a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 40-58. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.C, reprinted in the back of this volume.

### D. Expand Penalty-Free Withdrawals for Long-Term Unemployed

#### Present Law

Tax-favored retirement savings arrangements include individual retirement arrangements ("IRAs") and several types of employer-sponsored retirement plans, specifically, qualified retirement plans, tax-deferred annuity plans (referred to as section 403(b) plans), and eligible deferred compensation plans of State and local government employers (referred to as governmental section 457(b) plans).[317] Qualified retirement plans consist of qualified defined benefit plans and qualified defined contribution plans.

**Early distributions, in general**

The Code imposes an early distribution tax on distributions made from qualified retirement plans, 403(b) plans and IRAs before an employee or an IRA owner attains age 59½.[318] The tax is equal to 10 percent of the amount of the distribution that is includible in gross income unless an exception applies. The 10-percent tax is in addition to the taxes that would otherwise be due on distribution. This additional tax is designed to help insure that distributions from qualified retirement plans are preserved for retirement.

There are a number of exceptions to the early distribution tax. Some exceptions apply to all plans and others apply only to IRAs or only to qualified retirement plans and section 403(b) plans. The exceptions that apply to all plans include distributions due to death or disability; distributions made in the form of certain periodic payments; distributions made on account of a tax levy on the plan; distributions to the extent that they do not exceed the amount allowable as a deduction for amounts paid during the taxable year due to medical care (determined without

[317] Secs. 408, 401(a), 403(a), 403(b), 457(b) and (e)(1)(A).

[318] Sec. 72(t). The early distribution tax does not apply to distributions from governmental section 457(b) plans.

regard to whether the employee itemizes deductions for such year);[319] or distributions made to a member of a reserve unit called to active duty for 180 days or longer.

The exceptions that only apply to distributions from IRAs include distributions used to purchase health insurance for certain unemployed individuals; used for higher education expenses; and used for first-time homebuyer expenses of up to $10,000. The exceptions that only apply to distributions from qualified retirement plans and 403(b) plans include distributions made subsequent to the employee's separation from service after attaining age 55;[320] distributions made to an alternate payee pursuant to a qualified domestic relations order; and distribution of dividends paid with respect to stock held by an ESOP.

**Exceptions for the long-term unemployed**

Distributions from an IRA to an individual after separation from employment are excepted from the 10-percent early distribution tax if 1) the individual received unemployment compensation for 12 consecutive weeks by reason of the separation from employment, 2) the distributions are made during any taxable year during which such unemployment compensation is paid or during the succeeding taxable year, and 3) the total amount of all such distributions is not greater than the premiums paid during the taxable year for health insurance. This exception does not apply to any distributions made after the individual has been employed for at least 60 days after the separation from employment.

There is no corresponding exception from the 10-percent additional tax for early distributions from a qualified retirement plan by reason of separation from employment.

**Forms 1099-R and 5498**

A distribution from an IRA, qualified retirement plan or section 403(b) plan is required to be reported by the IRA trustee or plan administrator on Form 1099-R issued to the recipient of the distribution, with a copy provided to the IRS.[321] In the case of a distribution made before the individual attains age 59½, the Form 1099-R includes a code indicating that one of certain exceptions to the 10-percent additional tax applies or that it is unknown whether any exception applies.[322] The code indicating that it is unknown whether any exception applies is used also when one of certain other exceptions applies, such as in the case of a distribution made for medical expenses.

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[319] Sec. 213.

[320] Age 50 is substituted for age 55 in the case of distributions to a qualified public safety officer from a governmental defined benefit plan.

[321] Secs. 408(i) and 6047(d).

[322] Instructions for Form 1099-R, available at http://www.irs.gov/pub/irs-pdf/i1099r.pdf.

The trustee of an IRA is required to report the fair market value of the IRA as of the end of the calendar year on Form 5498 issued to the IRA owner, with a copy provided to the IRS.[323]

## Description of Proposal

The proposal expands the exception from the 10-percent additional tax to cover more distributions to long-term unemployed individuals from an IRA in excess of the premiums paid for health insurance. It also expands the exception to include distributions to long-term unemployed individuals from qualified defined contribution plans. Although the 10-percent additional tax and exceptions apply to distributions from section 403(b) plans, the proposal does not provide that it applies to distributions from section 403(b) plans.

Under the proposal, the exception applies if 1) the individual has been unemployed for more than 26 weeks by reason of a separation from employment and has received unemployment compensation for that period (or, if less, for the maximum period allowable under State law), 2) the distribution is paid in the year the unemployment compensation is paid or in the succeeding taxable year, and 3) the sum of all applicable distributions does not exceed limits as described below.

To be eligible for the exception from the 10-percent additional tax, the sum of all such distributions received by an eligible individual from IRAs with respect to separation from employment may not exceed half of the aggregate fair market value of the individual's IRAs as of the end of the year preceding the first distribution (as reported on Form 5498 for each such IRA). Likewise, the sum of all such distributions received by an eligible individual from qualified defined contribution plans with respect to separation from employment may not exceed half of the aggregate fair market value of the individual's nonforfeitable accrued benefits under those plans as of the date of the first distribution. However, regardless of fair market value of an individual's IRAs and defined contribution plan benefits, the individual is eligible for this exception for a minimum of $10,000 in total distributions and is subject to a maximum of $50,000 per year during each of the two years when distributions are permitted under the exception.

The proposal also provides for a new code to be added to Form 1099-R for the administrator of a qualified defined contribution plan to report a distribution that is eligible for this exception. No additional reporting applies to an IRA trustee.

The proposal retains the present-law exception to the 10-percent additional tax for distributions up to the amount of health insurance premiums paid during the year after receiving unemployment compensation for 12 consecutive weeks.

Effective date.−The proposal applies to eligible distributions occurring after December 31, 2015.

[323] Sec. 408(i); Treas. Reg. sec. 1.408-5.

The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.D, reprinted in the back of this volume.

## Analysis

Standard economic models show that rational individuals maximize their well-being by choosing to smooth their consumption over their life cycles.[324] That is, individuals save during their working years and dissave when they retire from work. According to these standard life-cycle models, tax subsidies to workers and to employers that effectively increase the net rate of return may encourage individuals to delay consumption and encourage employers to provide retirement plans, thereby increasing saving by individuals during their working years.[325]

However, there may be a number of reasons why individuals may not save through qualified retirement plans. For example, individuals may be sufficiently liquidity-constrained that they are unable to pay for basic necessities when faced with an unemployment spell. Since government subsidies for retirement saving are often accompanied by additional taxes for early withdrawal, individuals must accurately anticipate their current and future need for liquidity to avoid additional taxes and may choose alternative methods of saving rather than risk these additional taxes.

Also, uncertainty over liquidity needs over the life cycle creates a need for precautionary saving. Because precautionary saving tends to be relatively insensitive to the after-tax rate of return,[326] the existence of uncertainty over a life cycle may reduce the extent to which individuals alter their saving behavior in response to tax subsidies that attempt to encourage saving.[327]

In either case, removing the 10-percent additional tax on early distributions may ease the pressure of these disincentives to save through qualified retirement plans. Individuals may be more willing to save through qualified retirement plans if they know they can access these funds when unemployed without incurring the additional tax. On the other hand, if individuals do not replace funds when they return to employment, removing the 10-percent additional tax on early distributions serves to reduce average overall savings through these arrangements.

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[324] This idea is captured in models built on the Life-Cycle Hypothesis. See F. Modigliani and R. Brumberg, "Utility Analysis and the Consumption Function: an Interpretation of Cross-Section Data," in K.K. Kurihara, ed., *Post-Keynesian Economics*, Rutgers University Press, New Brunswick, NJ, 1954, pp. 388-436.

[325] A.J. Auerbach, L.J. Kotlikoff, and J. Skinner, "The Efficiency Gains From Dynamic Tax Reform," *International Economic Review,* Vol. 24, 1983, pp. 80-100.

[326] Doug Bernheim, "Taxation and Saving," in A.J. Auerbach and M. Feldstein, eds., *Handbook of Public Economics*, Vol. 3, Elsevier, 2002, pp. 1173-1249.

[327] E.M. Engen and W.G. Gale, "Taxation and Saving: the Role of Uncertainty," *Mimeo* (Federal Reserve Board, Washington DC), 1997.

## E. Require Retirement Plans to Allow Long-Term Part-Time Workers to Participate

### Present Law

#### Qualified retirement plans

Qualified retirement plans are of two general types: defined benefit plans, under which benefits are determined under a plan formula and paid from general plan assets, rather than individual accounts; and defined contribution plans, which include section 401(k) plans, under which benefits are based on a separate account for each participant, to which are allocated contributions, earnings and losses.

A section 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan[328] that contains a qualified cash or deferred arrangement under which employees may make elective deferrals.[329] The maximum annual amount of elective deferrals that can be made by an employee to a section 401(k) plan for 2015 is $18,000 plus $6,000 for employees age 50 or older (catch-up contribution amount) or, if less, the employee's compensation.[330] Section 401(k) plans may provide for matching contributions, which are contributions made on account of elective deferrals,[331] and may provide for employer nonelective contributions.

#### Participation requirement

A qualified retirement plan generally can delay participation in the plan based on attainment of age or completion of years of service but not beyond the later of completion of one year of service (that is, a 12-month period with at least 1,000 hours of service) or attainment of age 21.[332] In addition, once an employee has completed 1,000 hours of service during a plan year, the employee cannot be precluded from making elective deferrals based on a service

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[328] Defined contribution plans include money purchase pension plans, profit-sharing plans, and stock bonus plans. Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement. Except for certain grandfathered plans, a State or local governmental employer may not maintain a section 401(k) plan.

[329] Elective deferrals are generally made on a pretax basis, excludable from the participant's gross income when contributed but includable with attributable earnings when distributed. However, under section 402A, a section 401(k) plan is permitted to include a "qualified Roth contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are not excludable from the participant's gross income when contributed, but qualified distributions of designated Roth contributions and attributable earnings are excluded from gross income.

[330] Secs. 402(g) and 414(v).

[331] Sec. 401(m). Matching contributions can also be made on account of after-tax employee contributions.

[332] Secs. 401(a)(3) and 410(a)(1). Parallel requirements generally apply to plans of private employers under section 202 of the Employee Retirement Income Security Act of 1974 ("ERISA). Governmental plans under section 414(d) and church plans under section 414(e) are generally exempt from these Code requirements and from ERISA.

requirement.[333] Employees can be excluded from plan participation on other bases, such as job classification, as long as the other basis is not an indirect age or service requirement.

**Vesting**

In the case of a defined contribution plan, a participant's accrued benefit is the balance of his or her account under the plan.[334] The portion of an employee's account balance attributable to employee after-tax contributions and elective deferrals must be nonforfeitable at all times.[335] Generally, the portion of an employee's account balance attributable to nonelective or matching contributions must become nonforfeitable (meaning vested) after the completion of a specified number of years of service in accordance with a minimum vesting schedule.[336] Generally, a year of vesting service is only required to be credited if an employee completes 1,000 house of service during the year.[337] The minimum vesting schedules specify the maximum periods of service that a plan can require for the account balance to become 100 percent vested.

For matching and nonelective contributions under a defined contribution plan, there are two alternative minimum vesting schedules. Under the first vesting schedule, the participant's accrued benefit derived from employer contributions must become 100 percent vested upon completion of no more than three years of service (often referred to as "three-year cliff vesting"). Under the second vesting schedule (referred to as "graduated vesting"), the participant's accrued benefit derived from employer contributions must become vested ratably at least over the period from two to six years of service.

**Minimum coverage and nondiscrimination requirements**

In general

A qualified retirement plan is prohibited from discriminating in favor of highly compensated employees, referred to as the nondiscrimination requirements. These requirements are intended to ensure that a qualified retirement plan provides meaningful benefits to an employer's rank-and-file employees as well as highly compensated employees, so that qualified retirement plans achieve the goal of providing retirement security for both lower-paid and higher-paid employees. The nondiscrimination requirements consist of a minimum coverage requirement and general nondiscrimination requirements.[338] For purposes of these requirements,

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[333] Sec. 401(k)(2)(D).

[334] Sec. 411(a)(7)(A)(ii).

[335] Secs. 411(a)(1) and 401(k)(2)(C). Certain nonelective contributions under a section 401(k) plan and employer matching contributions with respect to elective deferrals must also be nonforfeitable at all times.

[336] Sec. 411(a)(2)(B).

[337] Sec. 411(a)(5).

[338] Sections 401(a)(3) and 410(b) deal with the minimum coverage requirement; section 401(a)(4) deals with the general nondiscrimination requirements, with related rules in section 401(a)(5). In applying these requirements, employees of all members of a controlled group or affiliated service group are treated as employed by

an employee generally is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of $120,000 (for 2015).[339]

The minimum coverage and general nondiscrimination requirements apply annually on the basis of the plan year. Employees who have not satisfied minimum age and service conditions under the plan, certain nonresident aliens, and employees covered by a collective bargaining agreement are generally disregarded.[340] However, a plan that covers employees with less than a year of service or who are under age 21 must generally include those employees in any nondiscrimination test for the year but can test the plan for nondiscrimination in two parts: (1) by separately testing the portion of the plan covering employees who have not completed a year of service or are under age 21 and treating all of the employer's employees with less than a year of service or under age 21 as the only employees of the employer; and (2) then testing the rest of the plan taking into account the rest of the employees of the employer and excluding those employees. If a plan does not satisfy the nondiscrimination requirements on its own, it may in some circumstances be aggregated with another plan, and the two plans tested together as a single plan.

Minimum coverage requirement

Under the minimum coverage requirement, the plan's coverage of employees must be nondiscriminatory. This is determined by calculating the plan's ratio percentage, that is, the ratio of the percentage of nonhighly compensated employees (of all nonhighly compensated employees in the workforce) covered under the plan over the percentage of highly compensated employees covered. In the case of a section 401(k) plan, the right to make elective deferrals, the right to receive matching contributions, and the allocation of nonelective contributions are each tested separately for nondiscriminatory coverage as though provided under separate plans.

If the plan's ratio percentage is 70 percent or greater, the plan satisfies the minimum coverage requirement. If the plan's ratio percentage is less than 70 percent, a multi-part test applies. First, the plan must cover a group (or "classification") of employees that is reasonable and established under objective business criteria, such as hourly or salaried employees (referred to as a reasonable classification), and the plan's ratio percentage must be at or above a specific level specified in the regulations. In addition, the average benefit percentage test must be satisfied. Under the average benefit percentage test, the average rate of contributions or benefit accruals for all nonhighly compensated employees in the workforce (taking into account all plans

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a single employer. Detailed regulations implement the statutory requirements. Governmental plans are generally exempt from these requirements.

[339] Sec. 414(q). At the election of the employer, employees who are highly compensated based on compensation may be limited to the top 20 percent highest paid employees. A nonhighly compensated employee is an employee other than a highly compensated employee.

[340] A plan or portion of a plan covering collectively bargained employees is generally deemed to satisfy the nondiscrimination requirements.

of the employer) must be at least 70 percent of the average contribution or accrual rate of all highly compensated employees.

General nondiscrimination requirements

Nondiscrimination in the amount of contributions or benefits

There are two general approaches to testing the amount of contributions or benefits under a qualified retirement plan:[341] (1) design-based safe harbors under which the benefit formula under a defined benefit plan, or the formula for allocating employer nonelective contributions under a defined contribution plan to participants' accounts, satisfies certain uniformity standards; and (2) a mechanical general test under which the distribution of the rates of benefit among highly compensated and nonhighly compensated employees within a plan is tested for nondiscrimination by applying a modified version of the minimum coverage requirement.[342] The safe harbors and general test may include cross-testing of equivalent accruals or allocations.[343] A plan is not discriminatory merely because benefit accruals or allocations for highly compensated and nonhighly compensated employees are provided as a percentage of compensation (up to $265,000 for 2015).[344] Thus, the various testing approaches are generally applied to the amount of contributions or benefits provided as a percentage of compensation (expressed as allocation or accrual rates).

Special nondiscrimination tests for section 401(k) plans

A special annual nondiscrimination test, called the actual deferral percentage test (the "ADP" test) applies to test the amount of elective deferrals under a section 401(k) plan.[345] The ADP test generally compares the average rate of deferral for highly compensated employees to the average rate of deferral for nonhighly compensated employees. The ADP test allows the average deferral rate for highly compensated employees to exceed that for nonhighly compensated employees within limits: (1) the average deferral rate for highly compensated employees can be up to 125 percent of the average deferral rate for nonhighly compensated employees; or (2) the average deferral rate for highly compensated employees can be two percentage points greater than the average deferral rate for nonhighly compensated employees or, if less, twice the average deferral rate for nonhighly compensated employees. Employer matching contributions and after-tax employee contributions are subject to a similar special

[341] Treas. Reg. sec. 1.401(a)(4)-1.

[342] These approaches are explained in Treas. Reg. secs. 1.401(a)(4)-2, -3 and -8. Sections 401(a)(5)(C)-(D) and 401(l) and Treas. Reg. secs. 1.401(a)(4)-7 and 1.401(l)-1 through -6 provide rules under which nondiscrimination testing may take into account the employer-paid portion of social security taxes or benefits, referred to as permitted disparity.

[343] Treas. Reg. sec. 1.401(a)(4)-8.

[344] Sec. 401(a)(5)(B).

[345] Sec. 401(k)(3).

nondiscrimination test (the actual contribution percentage test or "ACP test") which compares the average rate of matching and after-tax contributions to the plan of the two groups.[346]

If the ADP test is not satisfied, a mechanism is provided for the employer to make immediately vested additional contributions for nonhighly compensated employees (and certain other corrections) or to distribute deferrals of highly compensated employees to such employees, so that the ADP test is satisfied. Similar correction mechanisms apply for purposes of satisfying the ACP test.

There are also designed-based safe harbor methods of satisfying the ADP and ACP tests. These safe harbors are based on the premise that, for a 401(k) plan with certain design features with respect to contributions (elective, matching, and nonelective) and enrollment (one of the safe harbors is combined with automatic enrollment), satisfaction of the minimum coverage requirement is a sufficient test of whether the amount of elective deferrals and matching contributions is nondiscriminatory.[347]

**Top heavy rules**

Top-heavy rules apply to limit the extent to which accumulated benefits or account balances under a qualified retirement plan can be concentrated with key employees.[348] Whereas the general nondiscrimination requirements are designed to test annual contributions or benefits for highly compensated employees, compared to those of nonhighly compensated employees, the top-heavy rules test the portion of the total plan contributions or benefits that have accumulated for the benefit of key employees as a group. If a plan is top-heavy, minimum contributions or benefits are required for participants who are non-key employees, and, in some cases, faster vesting is required. Non-key employees who have become participants in a defined contribution plan, but who subsequently fail to complete 1,000 hours of service (or the equivalent) for an accrual computation period must receive the top-heavy defined contribution minimum.

For this purpose, a key employee is an officer with annual compensation greater than $170,000 (for 2015), a five-percent owner, or a one-percent owner with compensation in excess of $150,000. A defined benefit plan generally is top-heavy if the present value of cumulative accrued benefits for key employees exceeds 60 percent of the cumulative accrued benefits for all employees. A defined contribution plan is top-heavy if the aggregate of accounts for key employees exceeds 60 percent of the aggregate accounts for all employees.

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[346] Sec. 401(m)(2).

[347] The safe harbors that only require certain matching contributions potentially allow satisfaction of the nondiscrimination requirement with respect to elective and matching contributions under a 401(k) plan for a year even though no contributions are ultimately provided to nonhighly compensated employees under the plan for the year due to a lack of voluntary participation.

[348] Secs. 401(a)(10)(B) and 416. The nature of the top-heavy test is such that a plan of a large business with many employees is unlikely to be top-heavy. The top-heavy requirements are therefore viewed as primarily affecting plans of smaller employers in which the owners participate.

**Section 403(b) plans**

Tax-deferred annuity plans (referred to as section 403(b) plans) are generally similar to qualified defined contribution plans, but may be maintained only by (1) tax-exempt charitable organizations,[349] and (2) educational institutions of State or local governments (that is, public schools, including colleges and universities).[350] Section 403(b) plans may provide for employees to make elective deferrals, including catch-up contributions, or other after-tax employee contributions, and employers may make nonelective or matching contributions on behalf of employees. Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the limits on elective deferrals.

Contributions to a section 403(b) plan must be fully vested. The minimum coverage and general nondiscrimination requirements applicable to a qualified retirement plan generally apply to a section 403(b) plan and to employer matching and nonelective contributions and after-tax employee contributions to the plan.[351] However, the special section 401(k) plan nondiscrimination testing, including the ADP test, does not apply to elective deferrals under a section 403(b) plan. Instead, if a section 403(b) plan provides for elective deferrals, the plan is subject to a "universal availability" requirement under which all employees must be given the opportunity to make deferrals of more than $200. In applying this requirement, nonresident aliens, students, and employees who normally work less than 20 hours per week may be excluded.[352] For this purpose, an employee works less than 20 hours per week, if and only if, for the first year of the employee's employment, the employer reasonably expects the employee to work fewer than 1,000 hours of service, and, for each subsequent year, the employee worked less than 1,000 hours in the preceding year. Also an employee can be excluded on this basis only if the same exclusion applies to all employees who work less than 20 hours a week.[353]

## Description of Proposal

Under the proposal, a section 401(k) plans is not permitted to preclude an employee from being eligible to make elective deferrals by reason of not having completed a year of service if the employee has worked at least 500 hours per year with the employer for at least three consecutive years (for this proposal, an employee is referred to as a "long-term part-time

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[349] These are organizations exempt from tax under section 501(c)(3). Section 403(b) plans of private, tax-exempt employers may be subject to ERISA as well as the requirements of section 403(b).

[350] Sec. 403(b).

[351] These requirements do not apply to a governmental section 403(b) plan or a section 403(b) plan maintained by a church or a qualified church-controlled organization as defined in section 3121(w).

[352] For this purpose, nonresident alien has the meaning in section 410(b)(3)(C), and student has the meaning in section 3121(b)(10). The universal availability requirement does not apply to a section 403(b) plan maintained by a church or a qualified church-controlled organization.

[353] Treas. Reg. sec. 1.403(b)-5(b)(4).

employee" after having completed this period of service). The proposal does not require a long-term part-time employee to be otherwise eligible to participate in the plan. Thus, the employee can continue to be ineligible under the plan for employer nonelective and matching contributions by reason of not having completed a year of service. However, for a plan that does provide employer contributions for long-term part-time employees, the proposal requires a plan to credit, for each year in which such an employee worked at least 500 hours after the employee becomes a long term part-time employee, a year of service for purposes of vesting in any employer contributions.

With respect to long-term part-time employees, employers would receive nondiscrimination testing relief (similar to the present-law rules for plans covering otherwise excludable employees), including permission to exclude these employees from top-heavy vesting and top-heavy benefit requirements.

Effective date.−The proposal applies to plan years beginning after December 31, 2015.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.E, reprinted in the back of this volume.

## Analysis

Advocates for this proposal assert that it can be expected to allow some part-time employees to make elective deferrals under a section 401(k) plan who would not otherwise be eligible. Some suggest that the proposal be extended to section 403(b) plans by providing that long-term part-time employees cannot be excluded from the application of the universal availability requirement.

Opponents of the proposal argue that long-term part-time employees are unlikely to make deferrals at levels sufficient to justify the additional cost involved in complying with the proposal. They argue that any additional requirements imposed on qualified retirement plans may discourage employers from continuing or establishing plans. Others respond that the proposal attempts to minimize any additional cost by not requiring employer nonelective or matching contributions for long-term part-time employees and providing relief from the nondiscrimination and top-heavy requirements.

Advocates of the proposal also note that the vesting requirement under the proposal prevents a plan that allocates employer contributions to accounts for long-term part-time employees from never allowing the employee to become vested unless their hours of service increase. Some suggest that long-term part-time employees be treated as having completed a year of service for purposes of plan eligibility, including eligibility for employer nonelective and matching contributions, at the end of the three-year period of working at least 500 hours per year. They argue that, even if an employer is allowed to require 1,000 hours of service for a year as a service condition on employees who are employed for only short periods, the employer should not be allowed to impose this service condition on long-term part-time employees.

The proposal includes relief from nondiscrimination testing for long-term part-time employees in addition to the present law special nondiscrimination testing rules allowing separate testing of employees eligible to participate in the plan who have not attained age 21 or completed a year of service. Some argue that providing additional separate nondiscrimination testing for long-term part-time employees provides an additional layer of complexity without a significant enough reduction in the burden on employers to justify it. These employees could simply be included in the separate testing permitted under present law for participants who have not completed a year of service (or are under age 21).

The assumption underlying the provision of an additional layer of separate testing is that long-term part-time employees are not highly compensated. That may be the case generally, but there could be long-term part-time employees who earn more than $120,000 a year and are, thus, highly compensated. In fact, it is possible for an employer's only long-term part-time employee to be a highly compensated employee. Thus, under particular circumstances, separate testing for long-term part-time employees could exclude a highly compensated employee from nondiscrimination testing. This result could be changed by providing that any long-term part-time employee who is not highly compensated is not required to be taken into account for nondiscrimination testing but any long-term part-time employee who is highly compensated must be taken into account.[354]

In the case of the top-heavy rules, under the proposal, contributions of long-term part-time employees are disregarded even though, under present law, contributions for employees who have not completed a year of service or attained age 21, but who nevertheless are allowed to participate in the plan, must be taken into account and these participants must be provided top-heavy minimum contributions if the plan is top-heavy. Some argue that a simpler rule would be to change the top-heavy rules to allow all employees who have not completed a year of service or attained age 21 to be disregarded, including long-term part-time employees.

Some argue that, once long-term part-time employees are allowed to make elective deferrals, an employer may be more likely to expand their participation with respect to matching and nonelective contributions as well, allowing participation of these employees at the same level as full-time employees. Others posit that, in order to satisfy the nondiscrimination requirements, an employer might, in some cases, design its plan to provide employer contributions at a higher rate for long-term part time employees than for full time employees.[355]

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[354] This suggested approach is similar to the rule provided in section 401(k)(3)(F) as an alternative to separate ADP testing of employees who have not completed a year of service or are under age 21. This rule allows, in applying the ADP test, for the plan to disregard employees in this category who are not highly compensated as long as all highly compensated employees in that category of employees are included in the ADP test for the rest of the plan's employees.

[355] Some employers have designed their plan to provide benefits to low-paid employees who work only a limited number of hours during a year ("short-service" employees) in order to provide benefits to low-paid employees sufficient to enable the plan to maximize benefits to highly compensated without providing comparable benefits to low-paid full-time employees. See a discussion of this practice in IRS Memorandums to the field which can be found at http://www.irs.gov/pub/irs-tege/directive.pdf and http://www.irs.gov/pub/irs-tege/shortservice_letter.pdf.

For example, an employer with a plan in danger of not satisfying the nondiscrimination requirement (using the general test) with respect to the contributions or benefits provided to a group of executives (or another limited group of highly compensated employees) may view providing employer nonelective contributions to long-term part-time employees as less expensive than expanding coverage (or increasing contributions) under the plan for full-time employees.[356]

## F. Facilitate Annuity Portability

### Present Law

#### Distribution restrictions for accounts under employer-sponsored plans

Types of plans and contributions

Tax-favored employer-sponsored retirement plans under which individual accounts are maintained for employees include qualified defined contribution plans, tax-deferred annuity plans (referred to as "section 403(b)" plans), and eligible deferred compensation plans of State and local government employers (referred to as "governmental section 457(b)" plans).[357]

Contributions to a qualified defined contribution plan or section 403(b) plan may include some or all of the following types of contributions:

- pretax elective deferrals (that is, pretax contributions made at the election of an employee in lieu of receiving cash compensation),
- after-tax designated Roth contributions (that is, elective deferrals made on an after-tax basis to a Roth account under the plan),[358]
- after-tax employee contributions (other than designated Roth contributions),
- pretax employer matching contributions (that is, employer contributions made as a result of an employee's elective deferrals, designated Roth contributions, or after-tax contributions), and
- pretax employer nonelective contributions (that is, employer contributions made without regard to whether an employee makes elective deferrals, designated Roth contributions, or after-tax contributions).

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[356] As discussed in Footnote 40 of Joint Committee on Taxation, *Present Law and Background Relating to Tax-Favored Retirement Savings* (JCX-98-14), September 15, 2014, which can be found at www.jct.gov, some plans provide a benefit formula that produces a higher benefit rate for a few selected executives. This benefit rate can satisfy the nondiscrimination requirements if a relatively small portion of lower-paid employees have a benefit rate under the plan for the year that is the same or higher. These can be the lowest paid employees of the employer.

[357] Secs. 401(a), 403(a), 403(b), 457(b) and (e)(1)(A).

[358] For a discussion of rules relating to Roth IRAs and designated Roth contributions, see Part XII.G.

Contributions to a governmental section 457(b) plan generally consist of pretax elective deferrals and, if provided for under the plan, designated Roth contributions.

Restrictions on in-service distributions

The terms of an employer-sponsored retirement plan generally determine when distributions are permitted. However, in some cases, statutory restrictions on distributions may apply.

Elective deferrals under a qualified defined contribution plan are subject to statutory restrictions on distribution before severance from employment, referred to as "in-service" distributions.[359] In-service distributions of elective deferrals (and related earnings) generally are permitted only after attainment of age 59½ or termination of the plan. In-service distributions of elective deferrals (but not related earnings) are also permitted in the case of hardship.

Other distribution restrictions may apply to contributions under certain types of qualified defined contribution plans. A profit-sharing plan generally may allow an in-service distribution of an amount contributed to the plan only after a fixed number of years (not less than two).[360] A money purchase pension plan generally may not allow an in-service distribution before attainment of age 62 (or attainment of normal retirement age under the plan if earlier) or termination of the plan.[361]

Elective deferrals under a section 403(b) plan are subject to in-service distribution restrictions similar to those applicable to elective deferrals under a qualified defined contribution plan, and, in some cases, other contributions to a section 403(b) plan are subject to similar restrictions.[362] Deferrals under a governmental section 457(b) plan are subject to in-service distribution restrictions similar to those applicable to elective deferrals under a qualified defined contribution plan, except that in-service distributions under a governmental section 457(b) plan apply until age 70½ (rather than age 59½).[363]

Distributions and rollovers

A distribution from an employer-sponsored retirement plan is generally includible in income except for any portion attributable to after-tax contributions, which result in basis.[364]

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[359] Sec. 401(k)(2)(B). Similar restrictions apply to certain other contributions, such as employer matching or nonelective contributions required under the nondiscrimination safe harbors under section 401(k).

[360] Rev. Rul. 71-295, 1971-2 C.B. 184, and Treas. Reg. sec. 1.401-1(b)(1)(ii). Similar rules apply to a stock bonus plan. Treas. Reg. sec. 1.401-1(b)(1)(iii).

[361] Sec. 401(a)(36) and Treas. Reg. secs. 1.401-1(b)(1)(i) and 1.401(a)-1(b).

[362] Sec. Secs. 403(b)(7)(A)(ii) and 403(b)(11).

[363] Sec. 457(d)(1)(A).

[364] Secs. 402(a), 403(b)(1) and 457(a)(1). Under section 402A(d), a qualified distribution from a designated Roth account under an employer-sponsored plan is not includible in income.

Unless an exception applies, in the case of a distribution before age 59½ from a qualified retirement plan or a section 403(b) plan, any amount included in income is subject to an additional 10-percent tax, referred to as the "early withdrawal" tax.[365]

A distribution from an employer-sponsored retirement plan generally may be rolled over on a nontaxable basis to another such plan or to an individual retirement arrangement ("IRA"), either by a direct transfer to the recipient plan or IRA or by contributing the distribution to the recipient plan or IRA within 60 days of receiving the distribution.[366] If the distribution from an employer-sponsored retirement plan consists of property, the rollover is accomplished by a transfer or contribution of the property to the recipient plan or IRA.

**Investment of accounts under employer-sponsored plans**

Qualified defined contribution plans, section 403(b) plans, and governmental section 457(b) plans commonly allow employees to direct the manner in which their accounts are invested. Employees may be given a choice among specified investment options, such as a choice of specified mutual funds, and, in some cases, may be able to direct the investment of their accounts in any product, instrument or investment offered in the market.

The investment options under a particular employer-sponsored retirement plan may change at times.[367] Similarly, a plan that allows employees to direct the investment of their accounts in any product, instrument or investment offered in the market may be amended to limit the investments that can be held in the plan. In these cases, employees may be required to change the investments held within their accounts.

The terms of some investments impose a charge or fee when the investment is liquidated, particularly if the investment is liquidated within a particular period after acquisition. For example, a lifetime income product, such as an annuity contract, may impose a surrender charge if the investment is discontinued.

If an employee has to liquidate an investment held in an employer-sponsored retirement plan because of a change in investment options or a limit on investments held in the plan, the employee may be subject to a charge or fee as described above. In addition, restrictions on in-service distributions may prevent the employee from preserving the investment through a rollover.

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[365] Sec. 72(t).

[366] Secs. 402(c), 402A(c)(3), 403(b)(8) and 457(e)(16).

[367] In the case of a plan subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), a participant's exercise of control over the investment of the assets in his or her account by choosing among the investment options offered under the plan does not relieve a plan fiduciary from the duty to prudently select and monitor the investment options offered to participants. 29 C.F.R. sec. 2550.404c-1(d)(2)(iv) (2010); ***Tibble v. Edison International***, No. 13-550, 135 S. Ct. 1823 (2015). The duty to monitor investment options may result in a change in the options offered.

## Description of Proposal

Under the proposal, when a lifetime income investment held within an employee's account under an employer-sponsored retirement plan is no longer an authorized investment under the plan, the plan could permit the distribution of the investment by means of a direct transfer to another employer-sponsored retirement plan in which the employee participates, or to an IRA of the employee, without regard to whether a distribution would otherwise be permitted. The distribution would not be subject to the early withdrawal tax.

Effective date.−The proposal is effective for plan years beginning after December 31, 2015.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.F, reprinted in the back of this volume.

## Analysis

In recent years, discussions of retirement savings adequacy have focused on the need for lifetime income to supplement Social Security benefits. Although many active employees are covered by defined benefit plans, which are required to offer annuity benefits, the percentage of active employees covered by defined benefit plans has declined over the past several decades. In addition, many employees elect to receive their benefits in the form of a lump sum, rather than in annuity form. Over the same period, employee access to defined contribution plans has increased significantly, as well as contributions and rollovers to IRAs, including rollovers of lump sums from defined benefit plans. This has led to increased interest in the purchase of, or investment in, lifetime income products, such as annuity contracts.

The appropriateness of a lifetime income product for individuals may vary with circumstances. For example, as a result of the formula used to calculate Social Security benefits, including the annual limit on wages taken into account for benefit purposes, the portion of an employee's earnings replaced by Social Security benefits is higher for lower-paid employees than for higher-paid employees.[368] Thus, for some employees, Social Security benefits may provide sufficient lifetime retirement income. Moreover, for individuals with modest retirement accounts, the need for access to those funds to cover occasional, large expenses may be greater

[368] See, for example, Congressional Budget Office, "CBO's 2014 Long-Term Projections for Social Security: Additional Information," December 2014, Exhibit 9, available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/49795-Social_Security_Update.pdf. The portion of retirement income provided by Social Security benefits also varies among individuals. See, for example, Social Security Administration, "Income of the Aged Chartbook, 2012," April 2014, pp. 8, 16-18, available at http://www.ssa.gov/policy/docs/chartbooks/income_aged/2012/iac12.pdf. See also, AARP Public Policy Institute, "Sources of Income for Older Americans, 2012," December 2013, Figure 1, available at http://www.aarp.org/content/dam/aarp/research/public_policy_institute/econ_sec/2013/sources-of-income-for-older-americans-2012-fs-AARP-ppi-econ-sec.pdf.

than the need for additional lifetime income. However, for many, lifetime income products are a possible source of annuity income to supplement Social Security benefits.

In recent years, discussions of retirement savings adequacy have focused also on the effect of investment fees on retirement savings. High fees can significantly reduce a saver's net returns and, over time, impede efforts to accumulate sufficient savings to last through retirement.[369] In some cases fees may be embedded in the terms of an investment arrangement, making it difficult for the investor to understand the fees involved.[370] The need for investor awareness has been identified with various types of investment products, including some lifetime income products, such as certain types of annuity products.[371]

These types of annuity products combine the ability to benefit from investment returns with a guaranteed minimum annual payment for life and thus may be attractive as an investment under a defined contribution plan. The terms of such a product may include a surrender charge or other penalty if the investment is discontinued within a certain period after the initial purchase.

The restrictions on in-service distributions further the purpose of assuring that tax-favored retirement savings are used for retirement income, rather than being withdrawn and used for other purposes (often referred to as "leakage"). However, the inability to withdraw an investment that is no longer permitted under a plan can force an employee to liquidate the investment on unfavorable terms with an adverse impact on retirement savings.

The proposal provides relief to an employee who can no longer continue to hold a lifetime income product as an investment under an employer-sponsored plan by allowing the product to be transferred to an IRA (or possibly another employer-sponsored plan), subject to plan terms permitting such a transfer. Specifically, if provided for under the plan's terms, the proposal allows the employee to have the lifetime income product transferred to an IRA (or another employer-sponsored plan), thus continuing the investment and avoiding a possible charge to liquidate the investment.

The proposal applies to lifetime income investments generally without being limited to products for which there is a charge to liquidate the investment. However, another rationale for this proposal is that continued investment in a lifetime income product may increase the possibility that the individual will ultimately choose to take advantage of the lifetime income

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[369] See, for example, Securities and Exchange Commission (SEC) Office of Investor Education and Advocacy, "How Fees and Expenses Affect Your Investment Portfolio," February 2014, available at http://www.sec.gov/investor/alerts/ib_fees_expenses.pdf.

[370] See, for example, research by the North American Securities Administrators Association, April 8, 2015, available at http://www.nasaa.org/35128/nasaa-research-shows-investor-confusion-over-brokerage-fees/.

[371] See, for example, SEC Office of Investor Education and Advocacy, "Variable Annuities: What You Should Know," April 18, 2011, available at http://www.sec.gov/investor/pubs/varannty.htm, and Financial Industry Regulatory Authority (FINRA), "Equity-Indexed Annuities—A Complex Choice," June 2012, available at https://www.finra.org/sites/default/files/InvestorDocument/p125847.pdf.

feature at retirement. Once the investment has been changed, the individual may be less likely to choose a new lifetime income product as an investment.

The proposal does not describe the feature or features needed for an investment product to be a lifetime income investment. This lack of specificity could make it difficult to determine the investments to which the proposal applies and could cause the proposal to be applied more broadly than appropriate.

The requirement that the lifetime income product be transferred directly to another tax-favored retirement arrangement is intended to preserve the investment in retirement savings form, avoiding leakage. However, withdrawals may be permitted under the arrangement to which the investment is transferred. For example, the Code places no restrictions on an individual's ability to withdraw funds from an IRA at any time (though the 10-percent early withdrawal tax may apply). Thus, if the investment is transferred to an IRA, the individual would not be precluded from liquidating the investment and withdrawing the proceeds from the IRA. In that case, the reduction in retirement savings could be greater than a reduction caused by liquidating the investment and reinvesting the proceeds within the original plan.

### G. Simplify the Minimum Required Distribution ("MRD") Rules

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 232-239. That proposal modified a proposal from prior years, which is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 661-672. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.G, reprinted in the back of this volume.

### H. Allow All Inherited Plan and Individual Retirement Account or Annuity (IRA) Balances to be Rolled Over Within 60 Days

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 673-677. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.H, reprinted in the back of this volume.

### I. Expand the Earned Income Tax Credit for Workers Without Qualifying Children

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 140-143. The estimated budget effect of the

current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.I, reprinted in the back of this volume.

### J. Simplify the Rules for Claiming the Earned Income Tax Credit for Workers Without Qualifying Children

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 657-660. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.J, reprinted in the back of this volume.

### K. Provide a Second-Earner Tax Credit

#### Present Law

There are five different filing statuses available for individual income tax returns: (1) married individuals filing a joint return; (2) heads of households; (3) unmarried individuals (other than surviving spouses and heads of households); (4) married individuals filing separate returns; and (5) surviving spouses.

Filing status is primarily relevant because of the rate structure and the standard deduction. Separate rate schedules apply to each filing status, except that surviving spouses apply the same rate schedules as married individuals filing a joint return. Similarly, separate standard deduction amounts apply to each filing status, and surviving spouses are eligible for the same standard deduction as married individuals filing a joint return.

Filing status also may be relevant for purposes of determining eligibility for certain credits or deductions (*e.g.*, some credits are not available to married taxpayers filing separate returns). In addition, the income levels at which certain tax benefits phase-in or phase-out often vary by filing status.

Married individuals who file a joint return are generally treated as one tax unit which must pay tax on the unit's total taxable income. Although couples may elect to file separate returns, the law is structured so that filing separate returns is often disadvantageous.

Present law does not provide a tax credit that is directly based on the lower-earner's earned income, in the case of two-earner married couples.

#### Description of Proposal

The proposal would provide two-earner married couples who file their taxes jointly with a nonrefundable tax credit equal to a percentage of the lower-earner's earned income up to $10,000. For purposes of the credit, earned income includes wages and net earnings from self-employment. The credit rate would be 5-percent, and would phase down at a rate of one-half of

a percentage point for every $10,000 that the couple's AGI exceeds $120,000. Therefore, the maximum credit would be $500 and the credit would be fully phased out for couples with AGI in excess of $210,000. The maximum creditable earned income ($10,000) and the phaseout threshold would be indexed for inflation for taxable years after 2016.

Effective date.−The proposal is effective for tax years beginning after December 31, 2015.

The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.K, reprinted in the back of this volume.

## Analysis

The proposal, by providing a credit for two-earner married couples, is intended to offset the fact that a second-earner may face a higher marginal tax rate than that person would otherwise face had he or she filed as an unmarried individual. The proposal thus seeks to offset a potential disincentive to work for two-earner married couples.

### Taxing married couples

Any system of taxing married couples requires making a choice among three different concepts of tax equity. One concept is that the tax system should be "marriage neutral;" that is, the tax burden of a married couple should be exactly equal to the combined tax burden of two single persons where one has the same income as the husband and the other has the same income as the wife. A second concept of equity is that, because married couples frequently consume as a unit, couples with the same income should pay the same amount of tax regardless of how the income is divided between them.[372] A third concept of equity is that the income tax should be progressive; that is, as income rises, the tax burden should rise as a percentage of income.

These three concepts of equity are mutually inconsistent. A tax system can generally satisfy any two of them, but not all three. The current tax system is progressive: as a taxpayer's income rises, the tax burden increases as a percentage of income. It also taxes married couples with equal income equally: It specifies the married couple as the tax unit so that married couples with the same income pay the same tax. But it is not marriage neutral. A system of mandatory separate filing for married couples would sacrifice the principle of equal taxation of married couples with equal incomes for the principle of marriage neutrality unless it were to forgo progressivity.

Because our tax system has a progressive rate structure and taxes married couples as a single unit, by necessity it contains marriage penalties and marriage bonuses. A marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own

[372] This second concept of equity could apply equally well to other tax units that may consume jointly, such as the extended family or the household, defined as all people living together under one roof.

tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A marriage bonus exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return. The sources of marriage penalties (and bonuses) in the current Code are generally the marginal tax bracket breakpoints, income-based phase-ins and phase-outs, and the design of certain benefits for low-income individuals.[373]

In addition to those features described above, and most relevant to the proposal, because our tax system treats joint filers as one tax unit, the first dollar earned by the second-earning spouse will be taxed at the couples' highest marginal rate. In other words, the marriage penalty not only means the total tax liability of the two formerly single taxpayers is higher after marriage than before marriage, but it also may result in one or both of the formerly single taxpayers being in a higher marginal tax rate bracket. That is, the additional tax on an additional dollar of income of each taxpayer may be greater after marriage than it was when they were both single.

Economists argue that changes in marginal tax rates may affect taxpayers' decisions to work. Higher marginal tax rates may discourage household saving and labor supply by the newly married household. For example, suppose a woman currently in the 25-percent tax bracket marries a man who currently is unemployed. If they had remained single and the man became employed, the first $10,300 of his earnings would be tax-free.[374] However, because the man married a woman in the 25-percent income tax bracket, if the man becomes employed he would have a tax liability of 25 cents on his first dollar of earnings, leaving a net of 75 cents for his labor.[375] Filing a joint return may distort the man's decision regarding whether to enter the work force. If he chooses not to work, society loses the benefit of his labor. Some have suggested that the labor supply decision of the lower earner or "secondary earner" in married households may be quite sensitive to the household's marginal tax rate.[376]

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[373] For a further discussion of these issues, see Joint Committee on Taxation, *Overview of Present Law and Economic Analysis Relating to the Marriage Tax Penalty, the Child Tax Credit, and the Alternative Minimum Tax* (JCX-8-01), March 7, 2001.

[374] As a single taxpayer, the man could claim the standard deduction of $6,300 and one personal exemption of $4,000 for 2015, effectively exempting the first $10,300 of his earnings. This example ignores payroll taxes.

[375] This example assumes that as a result of the marriage the combined income is still high enough to place the couple in the 25 percent bracket with respect to the rate schedule for married taxpayers filing jointly. It is possible that if the woman were just into the 25-percent bracket as a single filer the combined income of the couple would place them in the 15-percent bracket for married couples. In this case the marginal tax rate with respect to the income tax for the man would have increased from 0 to 15 percent, while that of the woman would have fallen from 25 percent to 15 percent.

[376] See Charles L. Ballard, John B. Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review*, 75, March 1985, for a review of econometric studies on labor supply of so-called primary and secondary earners. See also Congressional Budget Office, *For Better or Worse: Marriage and the Federal Income Tax* (1997), pp. 10-12.

**The Administration's proposal**

By providing a nonrefundable credit to two-earner married couples, the proposal attempts to alleviate the effect of the high marginal tax rate faced by a second earner. The proposal is similar to a feature of the Code that existed from 1981 until 1986, which provided for a second earner deduction.[377] Under that provision, the deduction was 5-percent of a second earner's income, up to $30,000 (10-percent from for taxable years after 1982).

Similar to the deduction provided in the 1980's, by providing a credit against the first $10,000 of income earned by the lower-earning spouse, the proposal reduces the marginal tax rate on that spouse's first $10,000 of income. For instance, if one spouse earned $80,000, placing the married couple into the 25-percent marginal tax rate bracket, absent a tax credit, the other spouse's first dollar of earnings would be taxed at a 25-percent rate. A five-percent tax credit on the first $10,000 of earnings reduces the second-earner spouse's effective marginal tax rate on the first $10,000 of earnings from 25-percent to 20-percent.

Proponents of the proposal would argue, for the reasons described above, that the second-earner credit alleviates the disincentive for a second-earning spouse to return to work, by reducing that spouse's effective marginal tax rate. However, one might question why the mechanism to provide for relief here is a credit, as opposed to a deduction. The core of the problem that the proposal seeks to address is the high marginal tax rate on the lower-earning spouse's first dollar of earnings. Economically, the prescription for such problem is to provide a deduction from that spouse's income. A deduction would effectively exempt (or partially exempt, in the case of a partial deduction) the first dollars of income from tax, by reducing the total amount of taxable income. A credit, on the other hand, provides a subsidy that is unrelated to the taxpayer's taxable income.

Additionally, by making the credit non-refundable, many taxpayers who claim the earned income credit and who do not have regular tax liability would not see their marginal tax rate, per the phaseout of the earned income credit, reduced. If the credit were made refundable so as to solve this problem, others would receive a benefit even though their marginal tax rate on second earners may be zero. A deduction (including a deduction from earnings for purposes of computing the earned income credit) solves this problem without creating windfalls for taxpayers with a zero marginal rate.

Furthermore, although not the primary rationale offered for the proposal, proponents might argue that the second-earner credit is desirable so as to offset marriage penalties faced by many couples who face higher total tax liabilities as a married unit than they would otherwise face had they filed returns separately.[378]

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[377] The Economic Recovery Tax Act of 1981, P.L. 97-34, sec. 103.

[378] Whether a married couple is in a "marriage penalty" or "marriage bonus" situation under present law depends upon the individuals' incomes, number of dependents, and itemized deductions.

A criticism of this rationale may be that the second earner credit could potentially create a windfall benefit for those married couples who are in a "marriage bonus" situation. For instance, the hypothetical couple described above in which one spouse had taxable income of $80,000 and the other spouse earned no income, would receive a "marriage bonus." When filing jointly, the couple's total tax for 2015 would be $11,587.50. If the two taxpayers filed as single individuals, their total tax for 2015 would be $15,793.75 (all attributable to the one working spouse). Thus, by marrying, these taxpayers are better off by $4,206.25. Opponents might thus argue that providing this couple with an additional $500 tax credit serves to further distort the principle of "marriage neutrality," by exacerbating the "marriage bonus" associated with married taxpayers with relatively unequal incomes.

### L. Extend the Exclusion from Income for Cancellation of Certain Home Mortgage Debt

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 64-66. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item X.L, reprinted in the back of this volume.

## PART XI – REFORMS TO CAPITAL GAINS TAXATION, UPPER-INCOME TAX BENEFITS, AND THE TAXATION OF FINANCIAL INSTITUTIONS

### A. Reduce the Value of Certain Tax Expenditures

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal, which modified prior years' proposals. The modification is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 98. The original proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 219-228. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XI.A, reprinted in the back of this volume.

### B. Reform the Taxation of Capital Income by Modifying the Tax Rate for Long-Term Capital Gains and Qualified Dividends and Treating a Transfer of Appreciated Property by Gift or Bequest as a Sale of the Property

#### Present Law

**Taxation of capital gains and dividends**

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

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year.[379] Any remaining unused capital losses may be carried forward indefinitely to another taxable year.[380]

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions,

[379] Sec. 1211(b).

[380] Sec. 1212(b).

and (8) business supplies.[381] In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

A maximum rate applies to capital gains and dividends.[382] For 2015, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent on any amount of gain that otherwise would be taxed at a 39.6 percent rate. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. Adjusted net capital gain otherwise taxed at rates greater than 15 percent but less than 39.6 percent is taxed at a 15-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax. Dividends are generally taxed at the same rate as capital gains.

**Tax on net investment income**

An additional tax is imposed on net investment income in the case of an individual, estate, or trust.[383] In the case of an estate or trust, the tax is 3.8 percent of the lesser of the undistributed net investment income or the excess of the adjusted gross income over the dollar amount at which the highest tax bracket in section 1(e) begins. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. Thus, for taxpayers with sufficient income to trigger a net investment income tax, the rate on certain capital gains and dividends is 23.8%.

Net investment income is the excess of (1) the sum of (a) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities, and (b) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in the active conduct of a trade or business that is not in the trade or business of trading in financial instruments or commodities, over (2) deductions properly allocable to such gross income or net gain.

[381] Sec. 1221.

[382] Sec. 1(h).

[383] Sec. 1411.

**Income tax basis in property acquired from a decedent or received by gift**

In general

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

A gift or bequest of appreciated (or loss) property is not an income tax realization event for the transferor. In addition, the value of property received by gift and bequest is excluded from the recipient's gross income.[384]

Basis in property received by lifetime gift

Under present law, property received from a donor of a lifetime gift generally takes a carryover basis.[385] "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If a donor's basis in property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss on a subsequent sale of the property, the donee's basis is the property's fair market value on the date of the gift.

Basis in property acquired from a decedent

Property acquired from a decedent generally takes a stepped-up basis.[386] "Stepped-up basis" means that the basis of property acquired from a decedent generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). Providing a fair market value basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death and eliminates the tax benefit from any unrealized loss.

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any State, U.S. possession, or foreign country) generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Thus, both the decedent's one-half share and the surviving

[384] Sec. 102.

[385] See sec. 1015.

[386] See sec. 1014.

spouse's one-half share are stepped up to fair market value as of the decedent's death. This rule applies if at least one-half of the community interest is includible in the decedent's gross estate.

Stepped-up basis treatment generally is denied to certain interests in foreign entities. Stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that stock of a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped-up basis.[387] Stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped-up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (*i.e.*, generally the date of the decedent's death unless an alternate valuation date is elected).

## Description of Proposal

### Modification of tax rates

The proposal increases the highest long-term capital gains and qualified dividends rate from 20 percent to 24.2 percent. As a result, the maximum total tax rate on capital gains and dividends under the proposal (including the 3.8 percent tax on net investment income) is 28 percent.

### Treat a transfer of appreciated property as a sale of the property

The proposal generally treats a transfer of appreciated property by gift or bequest as a sale of the property. As a result, the donor of a lifetime gift realizes a capital gain at the time of a gift, and the deceased owner of an asset realizes a capital gain at the time an asset is bequeathed to an heir or to another beneficiary. The amount realized is the excess of the fair market value of the asset on the date of the gift or bequest over the donor or decedent's basis in the asset. The gain is taxable to a donor of a lifetime gift in the year the gift is made and to a decedent either on the decedent's final individual income tax return or on a separate capital gains return. The unlimited use of capital losses and carryforwards is allowed against ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any). Gifts or bequests to a spouse or charity would carry the basis of the donor or decedent. In the case of a gift or bequest to a spouse, gain is not realized until the spouse disposes of the asset or dies. In the case of a gift or bequest of appreciated property to charity, any gain is exempt from capital gains tax.

The proposal exempts from taxation the gain on tangible personal property such as household furnishings and personal effects (excluding collectibles). In addition, the proposal provides for a $100,000 (indexed for inflation after 2016) per-person exclusion of other capital gains recognized by reason of death. Any portion of a decedent's $100,000 exclusion that remains unused at death may be "ported" to and used by the decedent's surviving spouse to

[387] See secs. 1291(e) and 1296(i).

offset gain on bequests made by the surviving spouse at death,[388] making the exclusion effectively $200,000 for a married couple. The $250,000 per-person exclusion under present law for capital gain on a principal residence would apply to all residences and also would be portable to a decedent's surviving spouse (making the exclusion effectively $500,000 for a married couple).

The present-law exclusion for capital gain on certain small business stock also would apply. In addition, in the event of a gift or bequest of an interest in certain small family-owned and family-operated businesses, payment of tax on the gain is deferred and is not payable until the business is sold or ceases to be family-owned and operated. The proposal also provides for a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made.

The proposal describes other legislative changes that would be necessary to facilitate and implement the proposal, including:

1. the allowance of a deduction for the full cost of appraisals of appreciated assets;

2. the imposition of liens;

3. the waiver of penalties for underpayment of estimated tax if the underpayment is attributable to unrealized gains at death;

4. the grant of a right of recovery of the tax on unrealized gains;

5. rules to determine who has the right to select the return filed; and

6. rules requiring consistency in valuation for transfer and income tax purposes.

The proposal grants to the Secretary broad regulatory authority to issue any regulations necessary or appropriate to implement the proposal, including rules and safe harbors for determining the basis of assets in cases where complete records are not available.

Effective date.−The proposal is effective for capital gains realized and qualified dividends received in taxable years beginning after December 31, 2015, and for gains on gifts made and of decedents dying after December 31, 2015.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XI.B, reprinted in the back of this volume.

[388] Rules similar to the present-law estate tax portability rules would apply. See secs. 2010(c)(2)(B), (4), and (5).

## Analysis

### Modification of tax rates

For a detailed discussion of issues relating to modifying tax rates on capital gains and qualified dividends, see the Joint Committee staff's analysis of the Administration's fiscal year 2013 budget proposal.[389]

### Treat a transfer of appreciated property as a sale of the property

#### Overview

The proposal (referred to below as the Administration's "deemed-realization" proposal) treats a transfer of appreciated property by gift or at death as a sale, resulting in immediate realization of gain and the imposition of a capital gains tax on the transferor. At the same time, the Administration proposes to retain the present-law estate, gift, and generation-skipping transfer taxes, but in a more robust form, with a higher top marginal tax rate and lower exemption levels.[390]

By way of example, assume that a single taxpayer who has used all of his lifetime exclusion from the estate tax dies in 2016 owning only publicly traded stock with a fair market value of $2.1 million and a basis of $1 million, which he bequeaths to his children. Under the proposal, the decedent would pay a capital gains tax of $280,000 (28 percent[391] x ($1.1 million gain - $100,000 exclusion from gain)) on his final income tax return or on a separate capital gains tax return. The decedent's estate also is required to pay estate tax at a rate of 45 percent (*i.e.*, the increased estate tax rate provided in a separate fiscal year 2016 budget proposal), but in determining its estate tax liability may deduct the capital gains tax triggered by the deemed realization. Therefore, the estate's estate tax liability (disregarding any other available deductions or credits) is $819,000 (45 percent x ($2.1 million fair market value - $280,000 deduction for gains taxes paid)).

Because the capital gains tax on the deemed realization is deductible for estate tax purposes and therefore reduces a decedent's estate tax liability, one might say that the effective Federal tax rate on the capital gain is lower than 28 percent -- in the above example, 15.4 percent (($280,000 tax on gain - 126,000 estate tax savings) / $1 million gain).

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[389] Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 205-219.

[390] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals* (February 2015), pp. 193-194. The separate budget proposal generally retains the estate, gift, and generation-skipping transfer taxes, but increases the top tax rate to 45 percent and reduces the exclusions to $3.5 million for estate and generation-skipping transfer tax purposes and $1 million for gift tax purposes.

[391] The example assumes that the taxpayer's income exceeds the threshold for the 3.8 tax on net investment income, such that his total capital gains rate, as increased under the Administration's proposal, is 28 percent.

As described in greater detail below, the articulated goals of the Administration's deemed-realization proposal are to increase fairness and economic efficiency in the tax code.

Past efforts to treat a transfer by gift or at death as a realization event

*Prior Treasury Proposals*.−The Treasury Department has, on at least two prior occasions (in 1969 and 1977), issued proposals to tax unrealized appreciation when an asset is transferred by gift or at death. Neither proposal was enacted.

In 1969, the staff of the Treasury Department, as part of a study on tax reform, presented a number of proposals to Congress, including a proposal that was similar in many respects to the current deemed-realization proposal.[392] The 1969 proposal, like the present proposal, generally would tax as capital gain any unrealized appreciation in assets that are transferred by gift or at death. Other significant similarities include an exemption for smaller amounts of gain (stated as a minimum basis of $60,000 under the 1969 proposal) and complete exemptions for transfers to a spouse or to charity.

Unlike the current proposal, the 1969 proposal did not specify that tax related to interests in family-owned and -controlled businesses would be deferred. In addition, the 1969 proposal included a transition rule under which only appreciation occurring after the date of enactment would be subject to tax, whereas the new proposal includes no such transition rule.[393] Both the 1969 proposal and the new proposal contemplate the continued existence of an estate tax as a separate, additional tax, but the 1969 proposal contemplated using any revenue gains achieved under the proposal to reduce the estate tax burden, whereas the fiscal year 2016 budget proposes to expand the estate tax by increasing the top estate and gift tax rate and reducing the lifetime estate and gift tax exclusions.

In 1977, the Treasury Department issued a document entitled "Blueprints for Basic Tax Reform," a result of a year-long study of ways to develop an ideal income tax base that takes into account all possible forms of income.[394] Similar to the 1969 proposal, the 1977 Blueprint suggests treating a transfer by gift or at death as a realization event and imposing tax on the transferor at the rates applicable to other types of capital gains.[395] The proposal includes little detail, aside from a transition rule similar to the transition rule included in the 1969 proposal,

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[392] See Committee Print, Joint Publication of the House Committee on Ways and Means and the Senate Committee on Finance, *Tax Reform Studies and Proposals, U.S. Treasury Department* (February 5, 1969), Part 1, pp. 28-29.

[393] One could argue that the absence of a transition rule raises a question of fairness for taxpayers who have made decisions based on present law to retain appreciated assets in anticipation of death. On the other hand, taxing only appreciation that occurs after the effective date could be administratively complex, requiring a valuation of all property not only at the time of sale, but also as of the effective date of the proposal.

[394] Department of the Treasury, *Blueprints for Basic Tax Reform* (January 17, 1977).

[395] *Ibid*., p. 204.

under which the portion of gain deemed to have accrued prior to the effective date would be exempt from capital gains tax.

*Examples from other countries*.−Certain other countries, including Canada and Australia, tax capital gains on transfers at death and/or by gift. These countries employ a deemed-realization approach as a primary method of taxing transfers of wealth; they do not impose separate, additional taxes on transfers of wealth, such as estate or inheritance taxes.

Australia, for example, has no inheritance, estate, or gift tax. However, the transfer of capital assets generally is subject to Australia's capital gains tax ("CGT"). Under the CGT, lifetime gifts are taxed similarly to capital assets sold for profit. Testamentary transfers of capital assets, however, generally are not subject to the CGT and consequently there is no realization of gain on assets transferred at the time of death. Recipients generally take the transferor's basis in property (*i.e.*, the transferor's basis is carried over to the recipient).[396]

Canada also has no formal gift, estate, or inheritance tax. The deemed distribution provisions of Canada's Income Tax Act ("ITA"), however, impose a tax on capital gains of the decedent unrealized at the time of his death. In Canada, a decedent is deemed to have disposed of all property owned immediately before death. Depending on the property involved, this deemed disposition may cause the decedent to recognize income, recaptured depreciation, or capital gains. Transfers to a surviving spouse generally take a carryover basis, with any gain that accrued before the death of the decedent being deferred until it is realized by the surviving spouse.[397]

Policy arguments for or against treating a transfer by gift or at death as a realization event

*Fairness/equity*.−In describing its deemed-realization proposal, the Treasury Department first asserts that, because of inequities that exist in the current system for taxing gains, the proposal is necessary to help restore fairness:

> Because the person who inherits an appreciated asset receives a basis in that asset equal to the asset's fair market value on the decedent's death, the appreciation that accrued during the decedent's life is never subjected to income tax. In contrast, less-wealthy individuals who must spend down their assets during

[396] For a description of the application of the Australian CGT to gifts and transfers at death, see https://www.ato.gov.au/General/Capital-gains-tax/In-detail/Gifts,-inheritances-and-deceased-estates/Deceased-estate-and-CGT/. See also Joint Committee on Taxation, *Description and Analysis of Alternative Wealth Transfer Tax Systems* (JCX-22-08), March 10, 2008, pp. 11-13.

[397] For a description of Canada's income taxation of deemed realizations at death, see http://www.cra-arc.gc.ca/tx/ndvdls/lf-vnts/dth/dmd/menu-eng.html. See also Joint Committee on Taxation, *Description and Analysis of Alternative Wealth Transfer Tax Systems* (JCX-22-08), March 10, 2008, pp. 11-13.

> retirement must pay income tax on their realized capital gains. This increases the inequity in the tax treatment of capital gains.[398]

The Treasury Department made a similar equity-based argument in support of its 1969 deemed-realization proposal:

> [T]here is obvious and gross inequality in the income tax treatment of people who accumulate their estates by means of untaxed appreciation or value as compared to those who accumulate out of currently taxable income. Vast portions of capital gains . . . fall completely outside the income tax system.[399]

A tax on deemed realizations would attempt to address this perceived inequity by ensuring that taxpayers who transfer assets by gift or at death cannot permanently avoid tax on any accrued gains. A taxpayer who gratuitously transfers an asset thus will be treated the same as a taxpayer who sells or exchanges the asset.[400]

Some might argue that imposing a capital gains tax on a transfer by gift or at death is overly burdensome, particularly when combined with a separate, additional estate tax. If, for example, an estate has limited liquidity to pay the estate tax -- such as where much of the value of the estate is in a family business or farm -- one might argue that imposition of an additional tax on the decedent's deemed realization could exacerbate the estate's cash flow burden, causing a diversion of scarce resources that are needed to run the business. The proposal, however, seeks to address this liquidity concern by providing special rules under which: (1) capital gains tax relating to an interest in a small family-owned and -operated business may be deferred until the business is sold or ceases to be family-operated; and (2) capital gains tax relating to certain illiquid assets may be paid over a period of 15 years.

Others might argue that, under present law, unrealized gain does not escape taxation, because the estate tax applies to the entire value of an asset included in the decedent's state. Adding a new tax on gains to the existing wealth transfer taxes, they would argue, is unnecessary and will result in double taxation of wealth transfers. The proposal, however, allows for the tax on a capital gains realization resulting from death to be deducted for estate tax purposes, ensuring that assets used to pay the capital gains tax are not also included in the estate tax base.

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[398] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals* (February 2015), p. 156. See also Michael J. Graetz, "Taxation of Unrealized Gains at Death--An Evaluation of the Current Proposals," *Virginia Law Review*, vol. 59, 1973, pp. 830, 833-35 (noting that several commentators have criticized the present-law system as inequitable to the extent that it treats gains on death differently from gains when assets are sold).

[399] See Committee Print, Joint Publication of the House Committee on Ways and Means and the Senate Committee on Finance, *Tax Reform Studies and Proposals, U.S. Treasury Department* (February 5, 1969), Part 1, p. 28.

[400] See American Bar Association, Task Force on Federal Wealth Transfer Taxes, *Report on Reform of Federal Wealth Transfer Taxes* (2004), p. 183.

Furthermore, the two taxes arguably serve different purposes: the estate and gift taxes impose a tax on transfers across generations, whereas the capital gains tax on deemed realizations taxes accrued gain that has been deferred under rules regarding realizations.[401]

*Reduce or eliminate the "lock-in" effect of present law*.−The Treasury Department next argues that the present-law rules allowing for a step-up in basis at death are inefficient and impede the free flow of capital in the economy:

> [T]he preferential treatment for assets held until death produces an incentive for taxpayers to inefficiently lock in portfolios of assets and hold them primarily for the purpose of avoiding capital gains tax on the appreciation, rather than reinvesting the capital in more economically productive investments.[402]

The Treasury Department also described this lock-in effect of present law in connection with its 1969 deemed-realization proposal:

> When tax liability is allowed to depend on whether or not an appreciated asset is sold or kept until death, not only is there a serious inequity in the tax law, but, particularly in the case of older people, assets become immobilized. Investors become 'locked in' by the prospect of avoiding income tax completely if they hold appreciated assets until death rather than selling them. This freezing of investment positions curtails the essential mobility of capital in our economy and deprives it of the fruits of an unencumbered flow of capital toward areas of enterprise promising the largest rewards.[403]

In other words, the prospect of eliminating gains entirely at death artificially influences economic decisions regarding whether to hold or transfer assets during life.

At least one commentator, however, asserts that the extent of the lock-in effect of present law is unclear; therefore, any advantages of past proposals designed to reduce or eliminate the lock-in effect might be outweighed by the costs of added complexity.[404] The commentator points out that any exceptions that would mitigate the effect of a proposal to tax gains at death − such as the $60,000 deemed-basis rule included in the 1969 proposal − allow for lock-in to

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[401] See David Kamin, *"How to Tax the Rich,"* Tax Notes (January 5, 2015), p. 126.

[402] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals* (February 2015), p. 156.

[403] See Committee Print, Joint Publication of the House Committee on Ways and Means and the Senate Committee on Finance, *Tax Reform Studies and Proposals, U.S. Treasury Department* (February 5, 1969), Part 1, p. 28.

[404] See Graetz, *supra*, p. 836.

occur.[405] As a result, a taxpayer who has an incentive to hold assets until death under present law likely would have an incentive to do so under a deemed-realization regime that provides for significant exceptions. The current proposal includes numerous such exceptions that arguably could reduce the proposal's effectiveness in eliminating the lock-in effect of present law, including: (1) a $100,000 per person (portable to a surviving spouse) exemption; (2) a $250,000 per person (portable to a surviving spouse) residence exclusion that is extended to all residences; and (3) a deferral rule for certain small family-owned and -controlled businesses.

*Complexity*.−As one commentator states, "[a]lthough the existing law which provides a step-up in basis without tax on unrealized gains is inequitable, it is quite simple."[406] Because present law imposes no tax on gains at death, the Administration's deemed-realization proposal necessarily would add complexity to the Code.

Indeed, under present law, any built-in gain in an asset owned by a decedent at the time of his death is wiped away, and the decedent's heir takes a basis equal to fair market value. There is no need to compare the date-of-death value to an historical basis figure; the decedent's basis in the asset becomes irrelevant. By contrast, under the proposal there will be a need to value gain assets as of the decedent's death (or at the time of a gift) to determine the amount of gain that will be deemed realized and thus taxed. This process will in some cases require costly appraisals and lead to valuation disputes, increasing compliance costs for taxpayers and the Service.

One commentator argues that valuation should not be viewed as a major concern, at least for the largest estates, because many assets will need to be valued in any event for estate tax purposes.[407] Furthermore, taxpayers with smaller estates might avoid the new tax on deemed realizations entirely by reason of the various exclusions provided under the proposal, eliminating the need for such taxpayers' representatives to value any assets held at death. Nevertheless, because the exemption from the capital gains tax on deemed realizations ($100,000 per person) falls well below the exclusion from estate tax ($5.43 million for 2015), a substantial number of decedents whose estates need not file an estate tax return will be required to pay tax on gains deemed realized at death. These decedents' personal representatives must, as a result, determine the value of appreciated property owned by the decedent at the time of his death solely for purposes of determining the amount of tax arising from the deemed realization, which could prove especially burdensome if the taxpayer held non-publicly traded stock or other illiquid assets.

Even the Administration's description of the proposal provides a window into the complexity that would be added to the Code by using vague, undefined terms to describe key

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[405] *Ibid*.

[406] *Ibid*., p. 838.

[407] Kamin, *supra*, p. 126 ("[F]rom an administrative point of view, the timing alignment is in fact a major boon. It allows the income tax system to take advantage of the estate tax's valuation requirements, at least for the highest-value estates.").

concepts. For example, the deferral rules for "certain small family-owned and family-operated businesses" -- a term the Administration does not define -- are likely to be highly complex and, because of the attractiveness of the deferral benefit they provide, could become a significant source of disputes with the Service. The exemption rules regarding "household furnishings and personal effects (excluding collectibles)" are likely to present similar problems.

Furthermore, the Administration lists (but does not describe in detail) several legislative rules that would need to be drafted on top of the core elements of the proposal: (1) the allowance of a deduction for the full cost of appraisals of appreciated assets; (2) the imposition of liens; (3) the waiver of penalties for underpayment of estimated tax if the underpayment is attributable to unrealized gains at death; (4) the grant of a right of recovery of the tax on unrealized gains; (5) rules to determine who has the right to select the return filed; (6) rules requiring consistency in valuation for transfer and income tax purposes; and (7) a broad grant of general regulatory authority (including rules and safe harbors for determining the basis of assets in cases where complete records are unavailable). This list likely is not exhaustive.

Alternative proposals

Commentators have described other types of proposals designed to increase equity and reduce the lock-in effect as compared to the present-law basis step-up regime. Each may have advantages or disadvantages relative to the Administration's deemed-realization proposal.

*Mark-to market*.−One option, for example, would be to implement a mark-to-market system, under which taxpayers would be required to account for periodic changes in value and pay tax annually on any gains.[408] A mark-to-market system would have the advantage of making it more difficult for taxpayers to adjust realization behavior based on the income tax realization rules. Administrability, however, likely would be a significant obstacle to enacting such a system. The need to determine value on an annual basis could significantly increase taxpayers' compliance costs and well as the cost to the IRS of administering the law.

*Carryover basis for assets acquired from a decedent*.−A second alternative to a deemed-realization system would be to require that the basis of an asset owned by a decedent at the time of his death be carried over to the decedent's heir. Capital gains tax on any appreciation that accrued before the decedent died would be deferred and paid when the heir sells or disposes of the asset.

On two prior occasions, the Code has been modified to provide for a carryover basis for certain assets acquired from a decedent. First, the Tax Reform Act of 1976[409] replaced the section 1014 basis step-up rules with rules that generally provided for the decedent's basis to be carried over to the heir. The rules were short lived; under the weight of heavy criticism, they were repealed only four years later, in 1980.[410] Second, the Economic Growth and Tax Relief

[408] *Ibid*., pp. 122-123.

[409] Pub. L. No. 94-455 (Oct. 4, 1976), sec. 2005.

[410] Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223 (April 2, 1980), sec. 401(a).

Reconciliation Act of 2001 ("EGTRRA")[411] provided for the phase-out and eventual temporary repeal of the estate tax. For decedents dying in 2010, the one year in which the estate tax was to be repealed, a new basis regime was to take effect. Specifically, taxpayers who acquired assets from a decedent who died during 2010 would take a modified carryover basis under which only a limited, specified amount of "step up" would be allowed for assets in the estate (generally, $1.3 million plus an additional $3 million for assets transferred to a spouse); other assets generally would take a carryover basis. In December 2010, however, the estate tax and step-up in basis rules were restored retroactively for decedents dying during 2010, although an executor was permitted to elect to have the EGTRRA rules apply to the estate and to the decedent's heirs, *i.e.*, no estate tax would apply, but heirs would take a modified carryover basis rather than a stepped-up basis.[412]

A carryover basis regime, like the deemed-realization proposal, would address concerns about equity by limiting opportunities to avoid permanently the tax on gains that accrue prior to a decedent's death.[413] A carryover basis regime would not, however, place bequests completely on par with a sale of an asset during life, because gain still could be deferred indefinitely from one generation to the next. In this respect, bequests would be treated more like gifts, which take a carryover basis under present law.[414] Furthermore, a carryover basis regime for assets acquired from a decedent may not address the lock-in concern that arises under the present-law step-up in basis regime. Instead, a carryover basis requirement arguably would exacerbate the lock-in effect, as heirs in subsequent generations could face an ever increasing tax burden in the event of a sale (as values continue to rise over time, increasing the gap between fair market value and the initial decedent's tax basis).[415]

A carryover basis regime also might increase taxpayers' compliance burdens and the costs to the IRS of administering the law. Executors, for example, would need to consider not only the equitable allocation of asset values across a decedent's heirs, but also the allocation of basis across heirs. In addition, basis would in some cases have to be tracked across multiple generations, raising significant compliance concerns.[416] Finally, such a law would add complexity to the Code, because, to achieve consistency with sales of appreciated property

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[411] Pub. L. No. 107-16 (June 7, 2001), secs. 541 and 542.

[412] Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312 (December 17, 2010), sec. 301.

[413] See Lawrence Zelenak, "Taxing Gains at Death," *Vanderbilt Law Review*, vol. 46, 1993, p. 361, 367.

[414] See Graetz, *supra*, p. 833.

[415] See *ibid*, p. 837.

[416] Zelenak, *supra*, p. 368.

before death, the tax basis in property would need to be increased by the portion of Federal and State death taxes that are attributable to the appreciation.[417]

### C. Implement the Buffett Rule by Imposing a New "Fair Share Tax"

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 99-102. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XI.C, reprinted in the back of this volume.

### D. Impose a Financial Fee

#### Description of Modification

The fiscal year 2016 budget proposal modifies the prior year budget proposal by (1) changing the name of the fee from "Financial Crisis Responsibility Fee" to "Financial Fee"; (2) expanding the types of taxpayers on which the fee is imposed *from* U.S.-based bank holding companies, thrift holding companies, certain broker-dealers, companies that control broker-dealers, and insured depository institutions *to* both US and foreign banks, bank holding companies, insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives, both US based businesses and US subsidiaries and branches of foreign entities that fall into these categories; (3) changing the rate of the fee applied to covered liabilities from 17 basis points to 7 basis points; (4) eliminating the 50% discount applicable to stable sources of funding (5) the basis of the fee remains "covered liabilities" but the definition of that term is changed *from* the consolidated risk-weighted assets of a firm, less capital, insured deposits, and certain loans to small business, with deductions for policy reserves and other policyholder obligations to assets less equity for banks and nonbanks based on audited financial statements with a deduction for separate accounts primarily for insurance companies.

The structure of the fee is stated to be broadly consistent with the principles agreed to by the G-20 leaders.

The fiscal year 2015 budget proposal is substantially identical to the fiscal year 2013 budget proposal described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 432-448. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XI.D, reprinted in the back of this volume.

[417] Such concerns could be mitigated by, for example, requiring estates to provide basis information to heirs.

## Analysis of Modification

The expansion of the types of taxpayers subject to the Financial Fee raises the question of the calculation of the fee base across very different capital structures, such as banks, insurance companies and broker-dealers. In addition, further questions are raised on the effect of the fee on risk-taking by a wider range of financial institutions.

The change in definition of the basis for the fee, "covered liabilities," makes its application less nuanced because of the wider range of financial institutions that fall within its ambit. Simple audited asset and liability aggregates would result in widely differing amounts of tax due depending on the capital structures of various industries and even individual firms within industries. We would expect a distortion of decisions on capital structuring so as to avoid the tax.

The application of the fee to foreign banks is uncertain. If the U.S. subsidiary of a foreign bank were subject to the tax, would the assets and liabilities of the whole group be included? And what if a foreign bank had both a branch and a subsidiary in the U.S., would they both be subject to the fee independently?

In stating that the fee is broadly consistent with "principles agreed to by the G-20 leaders," it is unclear what principles are being referred to, and because the description of the basis for the fee is very broad, more elaboration of the structure being referred to would be important to provide.

## PART XII – LOOPHOLE CLOSERS

### A. Require Current Inclusion in Income of Accrued Market Discount and Limit the Accrual Amount for Distressed Debt

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 111-112. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XII.A, reprinted in the back of this volume.

### B. Require that the Cost Basis of Stock that is a Covered Security Must be Determined Using an Average Cost Basis Method

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 113-117. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XII.B, reprinted in the back of this volume.

### C. Tax Carried (Profits) Interests as Ordinary Income

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 538-552. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XII.C, reprinted in the back of this volume.

### D. Require Non-Spouse Beneficiaries of Deceased Individual Retirement Account or Annuity (IRA) Owners and Retirement Plan Participants to Take Inherited Distributions Over No More than Five Years

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 128-135. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XII.D, reprinted in the back of this volume.

## E. Limit the Total Accrual of Tax-Favored Retirement Plans

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal, which modified a prior proposal. For a description of the modification, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 165. The original fiscal year 2014 budget proposal is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 136-154. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XII.E, reprinted in the back of this volume.

## F. Conform Self-Employment Contributions Act ("SECA") Taxes for Professional Services Businesses

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 166-175. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XII.F, reprinted in the back of this volume.

## G. Limit Roth Conversions to Pre-Tax Dollars

### Present Law

#### Individual retirement arrangements ("IRAs")

##### In general

There are two basic types of IRAs under present law: traditional IRAs, to which both deductible (that is, pretax) and nondeductible (that is, after-tax) contributions may be made, and Roth IRAs, contributions to which are not deductible (and thus are made on an after-tax basis).[418] The principal difference between the two types of IRAs is the timing of income inclusion.

In the case of a traditional IRA, an individual may be able to deduct the contributions made for the year, and distributions are includible in gross income to the extent attributable to earnings on the account and deductible contributions. Any nondeductible contributions to a traditional IRA result in basis (also referred to as "investment in the contract"), and the portion of a distribution attributable to basis is not includible in income.[419] In the case of a Roth IRA, all

[418] Secs. 219, 408 and 408A.

[419] Sec. 408(d). A rollover of after-tax amounts to a traditional IRA also results in basis.

contributions are after-tax and are not taxable when distributed. In addition, if certain requirements are met, distributions attributable to earnings are not includible in gross income.

An annual limit applies to contributions to all IRAs (both traditional and Roth). The limit is the lesser of a certain dollar amount ($5,500 for 2015, plus $1,000 in catch-up contributions for an individual who attains age 50 by the end of the taxable year) or the individual's compensation for the taxable year. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income ("AGI") for the taxable year over certain indexed levels. In the case of an individual who is an active participant in an employer-sponsored plan, the AGI phase-out ranges for 2015 are: (1) for single taxpayers, $61,000 to $71,000; (2) for married taxpayers filing joint returns, $98,000 to $118,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with AGI for 2015 between $183,000 and $193,000.

An individual who cannot make deductible contributions to a traditional IRA may make nondeductible contributions to a traditional IRA regardless of AGI level (that is, no AGI limits apply). In addition, an individual who would be permitted to deduct the contributions to a traditional IRA may choose to make nondeductible contributions.[420]

An individual who has attained age 70½ by the close of a taxable year is not permitted to make contributions to a traditional IRA for that year.

Amounts held in a traditional IRA are includible in income when distributed, except for the portion of the distribution, if any, treated as a return of the individual's basis. Under an aggregation rule applicable in determining the taxable portion of a distribution, all of an individual's traditional IRAs are treated as a single IRA for purposes of recovering basis in the IRAs. That is, the portion of any distribution from a traditional IRA that is treated as a return of basis is the portion that bears the same ratio to the amount of the total distribution as the aggregate basis in all of the individual's traditional IRAs bears to the aggregate balance of all of the individual's traditional IRAs. A distribution from a traditional IRA generally may be rolled over to another traditional IRA or a tax-favored employer-sponsored retirement plan.

[420] Sec. 408(o).

Roth IRAs

Individuals with AGI below certain levels may make contributions to a Roth IRA. As mentioned above, Roth IRA contributions are not deductible, so all are made on an after-tax basis. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels. The AGI phase-out ranges for 2015 are: (1) for single taxpayers, $116,000 to $131,000; (2) for married taxpayers filing joint returns, $183,000 to $193,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70½.

Amounts held in a Roth IRA that are distributed as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.[421]

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings (unless rolled over to another Roth IRA); amounts that are attributable to contributions (which are always after-tax) to the Roth IRA are not includible in income. All Roth IRAs are treated as a single IRA for purposes of determining the amount that is attributable to contributions. To determine the amount includible in income, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions (including contributions rolled over from other Roth IRAs), (2) conversion contributions (on a first-in, first-out basis), and (3) earnings.[422] To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion. Thus, nonqualified distributions from Roth IRAs are excludable from gross income until all amounts attributable to contributions have been distributed.

Roth conversions

Contributions to traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Generally amounts cannot be transferred or rolled over between the two types of IRAs, with an exception in the case of a conversion.[423]

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

[422] Sec. 408A(d)(4)(B).

[423] An exception applies also in the case of a recharacterization. Under section 408A(d)(6), if an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize (in a trustee-to-trustee transfer) the amount of that contribution as a contribution to the other type of IRA (traditional or Roth) before the due date for the individual's income tax return for that year. In the case of a recharacterization, the contribution will be treated as having been made to the transferee plan (and not the transferor plan). The amount

An individual generally may convert an amount in a traditional IRA into a Roth IRA, referred to as a "Roth conversion." The amount converted is includible in the individual's income to the same extent as if a distribution had been made.[424] The conversion is accomplished by a trustee-to-trustee transfer of the amount from the traditional IRA to the Roth IRA, or by a distribution from the traditional IRA and contribution to the Roth IRA within 60 days.[425]

Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, if the individual has no existing traditional IRA, the individual can make a nondeductible contribution to a traditional IRA (which results in basis in the IRA) and convert the traditional IRA to a Roth IRA.[426] If the conversion is made before any (or any significant) pretax earnings accrue, the conversion results in no (or little) income inclusion. However, if an individual has an existing traditional IRA that includes a significant amount of pretax funds (that is, amounts attributable to deductible contributions or earnings), under the aggregation rule described above, any amount converted is considered to consist partly of basis and partly of pretax amounts, in proportion to the aggregate basis and pretax funds in all the individual's traditional IRAs, and the pretax portion of the converted amount is included in income.[427]

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transferred must be accompanied by any net income allocable to the contribution and no deduction is allowed with respect to the contribution to the transferor plan.

[424] Under section 72(t), subject to certain exceptions, an additional 10-percent tax (referred to as the "early withdrawal" tax) applies to the portion of a distribution before age 59½ that is included in income. The early withdrawal tax does not apply to an amount included in income as a result of a Roth conversion. However, the early withdrawal tax is imposed if the individual withdraws the amount converted within five years of the conversion.

[425] Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA. Even if a recharacterization is accomplished by transferring a specific asset, net income is generally calculated as a pro rata portion of the income on the entire account rather than income allocable to the specific asset transferred. However, when doing a Roth conversion of an amount for a year, an individual may divide up the amount being converted and establish multiple Roth IRAs (for example, Roth IRAs with different investment strategies) and select which Roth IRA to recharacterize as a traditional IRA by transferring the entire amount in the account to a traditional IRA (for example, the entire amount in the account of any IRA for which the value of the assets in the account declines during the year). See Treas. Reg. sec. 1.408A-5, Q&A A-2(b). The individual may then later convert that traditional IRA to a Roth IRA, including the lower value in income, subject to Treas. Reg. sec. 1.408A-5, Q&A A-9, which requires a minimum period to elapse before the reconversion of an amount previously contributed to a Roth IRA in a Roth conversion and then recharacterized as a contribution to a traditional IRA. Generally the reconversion cannot occur earlier than the later of 30 days after the recharacterization or a date during the taxable year following the taxable year of the original conversion.

[426] Before 2010, individuals with AGI exceeding $100,000 and married individuals filing separate returns were not permitted to make Roth conversions. The repeal of these limits on Roth conversions had the effect of indirectly repealing the AGI limits on Roth IRA contributions in some cases.

[427] Under section 408(d)(3)(A)(ii), the pretax portion of funds in a traditional IRA may be rolled over to an employer-sponsored retirement plan on a nontaxable basis. If an individual is covered by an employer-sponsored plan that accepts a rollover from a traditional IRA, the individual may be able to roll the pretax portion of any existing traditional IRA to an employer-sponsored retirement plan. If, after the rollover, only after-tax amounts (or basis) remain in the traditional IRA, the individual may then convert those amounts to a Roth IRA without any income inclusion.

## Employer-sponsored defined contribution plans

### In general

Tax-favored employer-sponsored retirement plans under which individual accounts are maintained for employees include qualified defined contribution plans, tax-deferred annuity plans (referred to as "section 403(b)" plans), and eligible deferred compensation plans of State and local government employers (referred to as "governmental section 457(b)" plans).[428]

As discussed further below, contributions to these plans are generally made on a pretax basis, and distributions are includible in income when received.[429] Some plans provide for after-tax employee contributions (other than designated Roth contributions, discussed below). After-tax employee contributions result in basis, and the portion of a distribution attributable to basis is not includible in income.[430]

In some cases, employees may have the option of making after-tax contributions designated as Roth contributions, which must be maintained in a separate account (a "designated Roth account") with earnings.[431] Similar to the treatment of distributions from Roth IRAs, a qualified distribution from a designated Roth account under an employer-sponsored plan is not includible in income.[432] A distribution from a designated Roth account that is not a qualified distribution is included in income to the extent attributable to pretax earnings on the account.

### Qualified defined contribution plans - contributions

Contributions to a qualified defined contribution plan may include some or all of the following types of contributions:

- pretax contributions made at the election of an employee under a qualified cash-or-deferred arrangement,
- after-tax designated Roth contributions,
- after-tax employee contributions (other than designated Roth contributions),

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[428] Secs. 401(a), 403(a), 403(b), 457(b) and (e)(1)(A).

[429] Secs. 402(a), 403(b)(1), 457(a)(1).

[430] If after-tax employee contributions and earnings thereon are separately accounted for under a plan, the taxable portion of a distribution attributable to such contributions and earnings may be determined without regard to amounts held in an employee's account under the plan that are attributable to pretax contributions and earnings.

[431] Sec. 402A.

[432] Sec. 402A(d). For this purpose, a qualified distribution is generally defined the same as a qualified distribution from a Roth IRA, but does not include a distribution made for first-time homebuyer expenses.

- pretax employer matching contributions (that is, employer contributions made as a result of an employee's elective deferrals, designated Roth contributions, or after-tax contributions), and
- pretax employer nonelective contributions (that is, employer contributions made without regard to whether an employee makes elective deferrals, designated Roth contributions, or after-tax contributions).

The total contributions made to a defined contribution for an employee are subject to an annual limit of (for 2015) $53,000 (plus catch-up contributions as described below, if applicable) or, if less, the employee's compensation.[433]

If a qualified defined contribution plan includes a qualified cash or deferred arrangement (referred to as a "section 401(k)" plan), an employee may elect to have pretax contributions made to the plan in lieu of receiving cash compensation (referred to as "elective deferrals").[434] An employee's elective deferrals are subject to an annual limit of (for 2015) $18,000 (plus catch-up contributions of $6,000 for an employee who attains age 50 by the end of the year) or, if less, the employee's compensation.[435]

A section 401(k) plan is permitted to include a "qualified Roth contribution program" that permits an employee to elect to have all or a portion of the employee's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the employee designates as not excludable from gross income. The annual limit on an employee's designated Roth contributions is the same as the limit on elective deferrals, reduced by any elective deferrals that are not designated Roth contributions.

Section 403(b) plans and governmental 457(b) plans

Section 403(b) plans are generally similar to qualified defined contribution plans, but may be maintained only by (1) tax-exempt charitable organizations,[436] and (2) educational institutions of State or local governments (that is, public schools, including colleges and universities). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans. Section 403(b) plans may provide for employees to make elective deferrals (including catch-up contributions), designated Roth contributions, or other after-tax employee contributions, and employers may

[433] Sec. 415(c). Employee contributions to a defined benefit plan are also taken into account in applying this limit. Nondiscrimination requirements applicable to qualified retirement plans of private employers may have the effect of preventing contributions up to the limit for highly compensated employees.

[434] Sec. 401(k).

[435] Sec. 402(g) and 414(v). Elective deferrals are also taken into account in applying the annual limit on total contributions. As in the case of the limit on total contributions, nondiscrimination requirements applicable to qualified retirement plans of private employers may have the effect of preventing elective deferrals up to the elective deferral limit for highly compensated employees.

[436] These are organizations exempt from tax under section 501(c)(3).

make nonelective or matching contributions on behalf of employees. Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the limits on elective deferrals.[437]

A governmental section 457(b) plan is generally similar to a qualified cash-or deferred arrangement under a section 401(k) plan in that it consists of elective deferrals, that is, pretax contributions made at the election of an employee. Deferrals under a governmental section 457(b) plan are generally subject to the same limits as elective deferrals under a section 401(k) plan or a section 403(b) plan.[438] A governmental section 457(b) plan may include a qualified Roth contribution program, allowing an employee to elect to have all or a portion of the employee's deferrals under the plan treated as designated Roth contributions.

Rollovers and Roth conversions

A distribution from an employer-sponsored retirement plan generally may be rolled over on a nontaxable basis to another such plan or to an IRA, either by a direct transfer to the recipient plan or IRA or by contributing the distribution to the new plan or IRA within 60 days of receiving the distribution.[439] A distribution from a nonRoth account, that is a distribution attributable to pretax or after-tax employee contributions (other than designated Roth contributions) and earnings, generally must be rolled over to a traditional IRA or to a nonRoth account under another employer-sponsored plan. However, such a distribution may be rolled over to a Roth IRA, subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, the amount rolled over to a Roth IRA is includible in gross income, except to the extent it represents a return of basis resulting from after-tax employee contributions.[440]

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[437] If elective deferrals are made to both a qualified defined contribution plan and a section 403(b) plan for the same employee, a single limit applies to the elective deferrals under both plans. Special contribution limits apply to certain employees under a section 403(b) plan maintained by a church. In addition, under a special catch-up rule, an increased elective deferral limit applies under a plan maintained by an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches in the case of employees who have completed 15 years of service. Catch-up contributions under this rule may be made in addition to catch-up contributions under the general rule for section 401(k) and section 403(b) plans.

[438] The limit on deferrals under a section 457(b) plan applies separately from the combined limit applicable to section 401(k) and 403(b) plan contributions, so that an employee covered by a governmental section 457(b) plan and a section 401(k) or 403(b) plan can contribute the full amount to each plan. In addition, a special catch-up rule may apply under a section 457(b) plan for an employee's last three years before normal retirement age. If a higher catch-up limit applies under this special rule than under the general catch-up rule, the general catch-up rule does not apply.

[439] Secs. 402(c), 403(b)(8), 457(e)(16). Under section 402A(c)(3), a distribution from a designated Roth account is permitted to be rolled over only to a Roth IRA or another designated Roth account.

[440] Under Notice 2014-54, 2014-41 I.R.B. 670, if the balance in an employee's account under a qualified retirement plan or a section 403(b) plan includes both after-tax and pretax amounts, the employee may roll the pretax amount over to another plan or a traditional IRA on a nontaxable basis and roll the after-tax amount over to a Roth IRA, achieving a Roth conversion of the after-tax amount without having to include any amount in income.

A section 401(k) plan, section 403(b) plan or governmental section 457(b) plan that includes a qualified Roth contribution program may permit employees to transfer amounts from a nonRoth account under the plan to a designated Roth account under the plan, whether or not the amounts in the nonRoth account are permitted to be distributed from the plan at the time of the transfer.[441] In effect, this transfer is a Roth conversion (with related income recognition) of nonRoth amounts held within the plan (referred to as an "in-plan" Roth conversion).

## Description of Proposal

Under the proposal, amounts held in a traditional IRA may be converted to a Roth IRA (or rolled over from a traditional IRA to a Roth IRA) only to the extent a distribution of those amounts would be includible in income if they were not rolled over. Thus, after-tax amounts (that is, amounts attributable to basis) held in a traditional IRA cannot be converted to a Roth IRA. A similar rule applies to amounts held in employer-sponsored retirement plans.

Effective date.−The proposal applies to distributions occurring after December 31, 2015.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XII.G, reprinted in the back of this volume.

## Analysis

The proposal notes that some individuals who, based on AGI level, are ineligible to make Roth IRA contributions, have made Roth IRA contributions indirectly by making nondeductible contributions to a traditional IRA (resulting in basis in the amount of the contributions) and then have converted the traditional IRA to a Roth IRA. The proposal thereby suggests that the ability to make nondeductible contributions to a traditional IRA and transfer them to a Roth IRA in a Roth conversion, without any income recognition as a result of the conversion, is an improper avoidance of the AGI limits on making Roth contributions. However, this ability is an inherent - and recognized - result of the lack of AGI limits on Roth conversions. Moreover, the proposal is not limited to IRAs, but also precludes after-tax amounts held in an employer-sponsored plan from being converted to Roth form.

Some propose repealing the AGI limits on the ability to make Roth IRA contributions because the current structure creates inequities across taxpayers. Many taxpayers with AGI above the Roth IRA contribution limits are able to make indirect Roth contributions by means of nondeductible contributions to a traditional IRA, which is then converted to Roth form without additional income inclusion. However, for others, as described in Present Law, a conversion to Roth form would involve current income inclusion of pretax amounts in a preexisting traditional IRA. In addition, the lack of AGI limits on making designated Roth contributions to an employer-sponsored plan means that individuals with access to an employer-sponsored plan can not only make Roth contributions, but in much larger amounts than Roth IRA contributions.

[441] Sec. 402A(c)(4).

Moreover, some employer-sponsored plans may allow employees to make after-tax contributions that can be converted into Roth form, in addition to designated Roth contributions. Some therefore argue that the AGI limits on the ability to make Roth IRA contributions have a comparatively small effect on total retirement savings in Roth form. They propose repeal of the AGI limits on Roth IRA contributions in order to provide more consistent treatment of taxpayers.

Some view Roth arrangements as providing a greater tax subsidy than traditional arrangements. However, the after-tax return on retirement savings through traditional accounts and Roth accounts is generally considered to be economically equivalent. The following examples illustrate the economic equivalence of saving the same amount through Roth accounts versus through pretax accounts.

Assume that a taxpayer's marginal tax rate is 20 percent and the taxpayer saves $1,000 of his income using an IRA. In the case of a deductible contribution to a traditional IRA, the $1,000 of savings gives the taxpayer a $1,000 deduction and thereby reduces the taxpayer's tax liability by $200 (20 percent of $1,000). Assume that the taxpayer (over age 59½) withdraws the savings (plus interest) one year later. If the account yields a five percent rate of return, the taxpayer withdraws $1,050. The withdrawal is included in the tax base and is taxed at the 20-percent rate, for an additional tax liability of $210, leaving the taxpayer with net proceeds of $840. If, instead, the taxpayer pays tax of $200 on the $1,000 set aside from current consumption, contributes the remaining $800 to a Roth IRA, and withdraws $840 as a qualified distribution in the following year (the $800 put in the account plus a five-percent return), none of that amount is included in the tax base and there is no tax liability.

In both examples, the taxpayer earns a rate of return on deferred consumption equal to the full pretax rate of return on saving. Specifically, in both cases, the taxpayer trades $800 of first period consumption (or current compensation) for $840 in second period consumption (future consumption). The combination of a deduction for saving and inclusion of all proceeds in the base upon withdrawal from the pretax savings account has the same result as exempting from tax the return on saving.[442]

Although the after-tax return on retirement savings through traditional accounts and Roth accounts is economically equivalent, the effect of applying the same limits to traditional and Roth IRA contributions - and to pretax elective deferrals and designated Roth contributions under an employer-sponsored plan - allows a greater amount of tax-favored retirement savings through Roth accounts than through pretax accounts. A dollar contributed to a Roth IRA or designated Roth account represents an after-tax contribution and therefore requires a greater

[442] This result is an analog of the "Cary Brown theorem," which holds that, assuming constant tax rates, permitting an immediate deduction for the cost of a marginal asset that ordinarily would be purchased with after-tax dollars is equivalent to exempting the yield from the asset from tax. Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen* 300 (1948). See also Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II* (JCX-63-07), September 4, 2007, pages 6-7, for a related discussion.

reduction in current consumption (since the contribution is not deductible).[443] As a result, an after-tax contribution to a Roth account represents more saving than a contribution to a pretax account in the same amount. Under present law, the ability to convert a pretax traditional IRA, or pretax amounts in an employer-sponsored plan, to Roth form effectively allows an individual to increase the amount saved in the account by the amount of the tax due on the conversion. In general, this means the individual will have increased the amount saved to the same level had the contributions been made to the Roth account initially, including pretax employer contributions that, under present law, are not permitted to be made in Roth form. The proposal does not change this effect because it continues to allow the conversion of pretax amounts held in traditional accounts to Roth form.

Some raise concerns about the long-term fiscal impact of Roth conversions generally, not only conversions of after-tax amounts. They suggest that looking only at the cash-flow effect during the 10-year budget planning period of increased revenues associated with the conversion of pretax amounts fails to reflect the impact of lower future revenues when excludable Roth distributions are received 20 or more years later. Some note that the exclusion of Roth distributions from income will also have the effect of reducing income for purposes of tax provisions that vary with AGI, such as the taxation of social security benefits, as well as eligibility for spending programs that vary with income, such as Medicare premiums. Some further note that these longer-term fiscal effects will occur as more and more baby boomers retire and begin to draw on entitlement programs.

Some argue that the ability to make after-tax employee contributions to an employer-sponsored plan, then convert them to Roth form, undermines the present-law limitations on designated Roth contributions. By limiting Roth conversions to pretax amounts, the proposal eliminates this effect.

### H. Eliminate Deduction for Dividends on Stock of Publicly-Traded Corporations Held in Employee Stock Ownership Plans

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal, which modified a prior proposal. For a description of the modification, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 183. The original fiscal year 2014 budget proposal is described in Joint Committee on Taxation, *Description of*

[443] As the above examples show, a taxpayer in the 20-percent tax bracket must reduce current consumption by $1,000 to contribute $1,000 to a Roth account, but only by $800 to contribute $1,000 to a pretax account, because the $1,000 contribution reduces current tax liability by 20 percent of $1,000, or $200. For taxpayers not constrained by a limit on retirement savings, the proper economic comparison of the tax benefits of the two types of tax-favored saving for a taxpayer with a 20-percent marginal rate is the comparison of a Roth contribution of 80 cents for each pretax dollar contribution to retirement savings because each requires the same reduction in current consumption. The equivalence is easily seen mathematically: the final after-tax value of the contribution to the deductible IRA is given by $C * (1+r)^n * (1-t)$, where C equals the contribution, r the annual rate of return, n the number of years the investment is held, and $t$ the tax rate. The final after-tax value of the equivalent Roth IRA contribution is $(1-t) * C * (1+r)^n$. Note that $(1-t) * C$ represents the reduced amount that can be contributed to the Roth IRA since tax must be paid first. The expressions are mathematically equivalent when $t$ is unchanged.

*Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 53-58. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XII.H, reprinted in the back of this volume.

## I. Repeal Exclusion of Net Unrealized Appreciation in Employer Securities

### Present Law

**Employer stock as an asset in qualified defined contribution plans**

Qualified defined contribution plans consist of three basic types: money purchase pension plans, profit-sharing plans, and stock bonus plans.[444] Although any of these plans may hold employer securities, including stock, a stock-bonus plan is a qualified retirement plan under which benefits are distributable in stock of the employer. Under a stock bonus plan, an employee generally must be entitled to receive distributions in employer stock.[445] In the case of employer stock that is not publicly traded, participants generally must be given the right to require the employer to repurchase the stock under a fair valuation formula.

Special rules under the Code and the Employee Retirement Income Security Act of 1974 ("ERISA") are provided with respect to employee stock ownership plans ("ESOPs"). An ESOP is a stock bonus plan that is designated as an ESOP and is designed to invest primarily in employer stock.[446]

ESOPs are subject to additional requirements that do not apply to other plans that hold employer stock. However, certain benefits are available with respect to ESOPs that are not available to other types of qualified retirement plans, including an exception to the prohibited transaction rules for certain loans to acquire employer stock and, in the case of a C corporation, higher deduction limits and the deduction of certain dividends.[447] ESOPs maintained by S corporations are subject to special rules, including exemption from unrelated business taxable income for S Corporation income with respect to the employer stock held by the ESOP and some restrictions on the grant of stock options (or the provision of other "synthetic equity") by the S corporation.[448]

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[444] See Treas. Reg. sec. 1.401-1(a) and (b). These types of plans predate the Internal Revenue Code of 1954. See sec. 165(a) of the Internal Revenue Code of 1942.

[445] Secs. 401(a)(23) and 409(h). Section 409(h) provides an exception to this requirement in the case of a plan maintained by an S corporation (defined in section 1361(a)(1)) or an employer whose charter or bylaws restrict the ownership of substantially all outstanding stock to a trust holding the assets of a qualified retirement plan.

[446] Sec. 4975(e)(7). An ESOP can be an entire plan or it can be a portion of a defined contribution plan.

[447] Secs. 4975(d)(3) and 404(a)(9).

[448] Secs. 512(e) and 409(p).

**Diversification out of employer securities**

If employer securities are allocated to participants' accounts under a defined contribution plan, participants must be given at certain times, and in certain circumstances, diversification rights, that is, the right to have the participant's account invested in assets other than employer securities. In the case of an ESOP, a participant age 55 or older with at least 10 years of participation generally must be permitted to diversify up to 25 percent of his account each year in a six-year-period (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.[449] In general, in the case of a defined contribution plan that holds publicly traded employer securities and is not an ESOP (or is an ESOP that includes a qualified cash or deferred arrangement, referred to as a "section 401(k) plan"), a participant must be permitted to diversify amounts attributable to elective deferrals and employee contributions.[450] In the case of amounts attributable to nonelective employer contributions and employer matching contributions, a participant with three years of service must be permitted to diversify.

**Taxation of distributions from qualified retirement plans**

A distribution from a qualified retirement plan is generally includable in gross income, except to the extent that a portion of the distribution is a return of the employee's investment in the contract, generally as a result of after-tax contributions by the employee.[451] If a qualified retirement plan distributes property, the general rule is that the amount of the distribution is the fair market value of the property on the date of the distribution.[452] As in the case of distributions generally, the amount of the distribution is includable in gross income except to the extent that a portion of the distribution is a return of the employee's investment in the contract. After distribution, the employee's basis in the distributed property includes the amount included in gross income.

However, if employer securities are distributed by a qualified retirement plan and either the distribution is a lump sum distribution or the employer securities are attributable to after-tax employee contributions, the net unrealized appreciation in the securities is excluded from the recipient's gross income.[453] Net unrealized appreciation is defined as the excess of the market value of the securities at the time of distribution over the cost or other basis of the securities to

[449] Sec. 401(a)(28).

[450] Sec. 401(a)(35).

[451] Secs. 402(a) and 72.

[452] Treas. Reg. sec. 1.402(a)-1(a)(1)(iii).

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

the trust holding the assets of the qualified retirement plan ("qualified trust").[454] In other words, net unrealized appreciation generally is the amount by which the value of the securities increased while held by the qualified trust. The participant's basis in the employer securities after distribution does not include the amount of net unrealized appreciation excluded from gross income.[455]

The exclusion for net unrealized appreciation is not available upon subsequent distribution after the securities are contributed to another eligible retirement plan (including to an individual retirement arrangement ("IRA") in a tax-free rollover (as discussed below).[456] When the securities are received as part of a lump sum distribution, the recipient may elect not to exclude net unrealized appreciation.[457]

**Rollovers**

General rules

An eligible rollover distribution from a qualified retirement plan may be rolled over to another qualified retirement plan, a tax-deferred annuity plan ("section 403(b) plan"), an eligible deferred compensation plan of a State or local government ("governmental section 457(b) plan"), or an IRA. The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution ("60-day rollover"). Amounts that are rolled over are usually not included in gross income. Generally, any distribution to a participant is an eligible rollover distribution with exceptions, for example, certain periodic payments, required minimum distributions, and hardship distributions.[458] Qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans are required to offer a direct rollover with respect to any eligible rollover distribution before paying the amount to the participant or beneficiary.[459]

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

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

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

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

[458] Section 402(c)(4).

[459] Sec. 401(a)(31). Unless a participant elects otherwise, a mandatory cash out of more than $1,000 must be directly rolled over to an IRA chosen by the plan administrator or the payor. Under section 3405(c), if an eligible rollover distribution is not directly rolled over into an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20-percent income tax withholding. A distribution not directly rolled over is

Roth conversions

Distributions from qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans may be rolled into a Roth IRA.[460] Distributions from these plans that are rolled over into a Roth IRA and that are not distributions from a designated Roth account must be included in gross income. A plan that includes a designated Roth program may permit participants to transfer amounts from a nonRoth account under the plan to a designated Roth account, whether or not the amounts in the nonRoth account are permitted to be distributed from the plan at the time of the transfer. If employer securities with net unrealized appreciation are included in a distribution that is rolled into a Roth IRA or transferred from a nonRoth account under a plan to a designated Roth account, the entire fair market value of the employer securities including any net unrealized appreciation is includable in gross income unless a portion of the distributions is attributable to investment in the contract.[461]

## Description of Proposal

The proposal repeals the exclusion for net unrealized appreciation in employer securities in the year of distribution for participants in qualified retirement plans who have not attained age 50 before January 1, 2016. The exclusion is retained for participants who have attained age 50 before January 1, 2016.

Effective date.−The proposal applies to distributions made after December 31, 2015.

The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XII.I, reprinted in the back of this volume.

## Analysis

The present law exclusion for net unrealized appreciation was added to the Code in 1951 with respect to lump sum distributions of employer securities[462]and in 1952 with respect to employer securities attributable to employee contributions.[463] In 1951, the concern expressed was that taxing the full fair market value of the stock distributed as compared to distributions under an annuity contract caused all the accumulated value of the employer's contributions to the

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nevertheless not subject to 20-percent income tax withholding to the extent that the distribution consists of employer securities.

[460] Sec. 408A(d) and (e).

[461] See Notice 2009-75, 2009-2 C.B. 436; Q&A-7 of Notice 2010-84, 2010-2 C.B. 872; and Q&A-9 of Notice 2013-74, 2013-2 C.B. 819.

[462] Sec. 335 of the Revenue Act of 1951, Pub. L. No. 82-183, Oct. 20, 1951.

[463] Pub. L. No. 82-588, July 15, 1952.

plan to be bunched into one year.[464] In 1952, the concern expressed was that the tax treatment of stock purchased by an employee through a qualified retirement plan should not be different from stock purchased outside the plan.[465] However, since that time, the Code has been changed to allow the tax-free rollover of most distributions from qualified retirement plans to IRAs and all types of tax-favored employer-sponsored plans.

Under the current statutory scheme, which allows continued tax deferral (through tax-free rollover) for most distributions from qualified retirement plans, many argue that providing an exclusion for net unrealized appreciation no longer serves the original purpose for the exclusion and instead may have a detrimental effect on retirement savings. The exclusion for net unrealized appreciation may encourage employees to keep more of their retirement savings invested in employer securities than may be prudent. As advocates of the proposal point out, investment of an individual's retirement savings in securities of the company where the individual is employed may put the employee at greater risk than investment in securities of another company that otherwise has the same risk profile. With respect to retirement savings invested in employer securities, a downturn in the company that employs the individual puts both the individual's job at risk and the individual's retirement savings at risk. To the extent that an employee can make investment choices, the Code should not encourage an employee to invest a greater portion of his or her retirement savings in employer securities than would be prudent, taking this risk into account.

Others may argue that longstanding Code rules relating to the investment of defined contribution plan assets in employer securities are intended to encourage ownership by employees and the exclusion for net unrealized appreciation facilitates this ownership. Particularly for employees who purchase employer securities through a qualified retirement plan with after-tax employee contributions, similar to the original reason for the exclusion for net unrealized appreciation for these employer securities, employees should not have a worse tax result than if they purchased the securities directly.

Others respond that, even after the individual has left employment with the employer maintaining the plan, so that the individual's job and retirement benefits are not subject to the same risk, depending on the individual's other investments, continued concentration of the individual's retirement savings in employer securities may not be prudent. Generally the best way to maximize retirement savings and minimize risk is to diversify investments.[466] In the case of assets held within a tax-favored retirement plan, there generally are no tax consequences from changing investments. However, the desire to preserve the exclusion and potential capital gains treatment for the net unrealized appreciation (and any post-distribution appreciation in the securities) may discourage the rollover of plan distributions of employer securities to other tax-

[464] S. Rept. 82-781, Revenue Act of 1951, pp. 49-50.

[465] H. Rept. 82-2181, pp. 1-2.

[466] See discussion of potential reductions in investment return due to lack of diversification and over-investment in employer stock in Lisa Muelbroek, "Company Stock in Pension Plans: How Costly Is It?," *Journal of Law and Economics*: Vol. 48: No. 2, Article 6 (2005).

favored retirement plans. Once the employer securities are rolled over, the exclusion for net unrealized appreciation does not apply to any subsequent distribution. After a distribution of employer securities without a rollover, the employee is no longer able to change the investment of the retirement savings out of employer securities without income tax inclusion of the net unrealized appreciation (and any post-distribution appreciation), albeit at long-term capital gains rates.

Further, once employer securities have been distributed, the potential for consumption of the retirement savings attributable to the distributed employer securities may increase. The amount of the net unrealized appreciation is taxed at long-term capital gains rates and there is no 10-percent additional tax on realization of the appreciation before age 59½. Thus, compared with savings in an employer-sponsored retirement plan or IRA, an employee may have less tax incentive to delay consumption of the retirement savings. In fact, unless the plan's basis in the securities is completely attributable to after-tax employee contributions, and thus no portion of the value is includable in gross income upon distribution, the loss of tax deferral for the plan's basis in the securities may only be outweighed by capital gains treatment if the stock is held for a relatively short period after distribution.[467]

The proposal does not apply to participants who attain age 50 before January 1, 2016. Otherwise, the proposal applies to distributions made after December 31, 2015. Presumably this grandfather rule for participants at least age 50 is provided because these participants may have made retirement plans and investment decisions with respect to their retirement savings, relying on the exclusion for net unrealized appreciation. However, some argue that the period between age 50 and ages 65 or 70 is a period during which diversification of the investment of an individual's retirement savings to minimize risk of loss is critically important.[468] In the event of significant investment loss, the participant will not have sufficient time to recover from the losses. At older ages, such as 65 or 70, the participant is more likely to be consuming a portion of retirement assets in the near term and is therefore more likely to sell the employer securities. In that case, for some taxpayers, the tax savings from capital gains treatment for net unrealized appreciation may better balance the risk of investment losses from lack of diversification.

[467] Robert J. DiQuolio, "A 401(k) Tax Break That's Often No Break," *Journal of Accountancy*, March 2008, available at http://www.journalofaccountancy.com/issues/2008/mar/a401ktaxbreakthatsoftennobreak.html.

[468] As discussed under present law, section 401(a)(28) requires an ESOP to provide employees who have attained age 55 with 10 years of service with an opportunity to diversify a specified potion of the employee's account over a specified time period.

## J. Disallow the Deduction for Charitable Contributions that are a Prerequisite for Purchasing Tickets to College Sporting Events

### Present Law

#### Deduction for charitable contributions

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

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.*, an organization or entity described in section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.*, not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.[469] Fourth, the transfer must be of money or property—contributions of services are not deductible.[470] Finally, the transfer must be substantiated and in the proper form.

#### College athletic seating rights

In general, where a taxpayer receives or expects to receive a substantial return benefit for a payment to charity, the payment is not deductible as a charitable contribution. If, however, a payment to charity exceeds the fair market value of any benefit received by the payor, the excess portion may be deductible if the payor can demonstrate that the donor intended to make a gift of the excess.[471] The donor must reduce the amount of the charitable contribution by the value of the benefits received.

Special rules apply to certain payments to institutions of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event. The payor may treat 80 percent of a payment as a charitable contribution where: (1) the amount is paid to or for the benefit of an institution of higher education (as defined in section 3304(f)) described in section (b)(1)(A)(ii) (generally, a school with a regular faculty and curriculum and meeting certain other requirements), and (2) such amount would be allowable as a charitable deduction but for the fact that the taxpayer receives (directly or indirectly) as a result of the payment the

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

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

[471] *United States v. American Bar Endowment*, 477 U.S. 105 (1986). Treas. Reg. sec. 1.170A-1(h).

right to purchase tickets for seating at an athletic event in an athletic stadium of such institution.[472]

## Description of Proposal

The proposal denies a deduction for contributions that entitle donors to a right to purchase tickets to sporting events.

Effective date.−The proposal is effective for contributions made in taxable years beginning after December 31, 2015.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XII.J, reprinted in the back of this volume.

## Analysis

Many colleges and universities require a contribution in connection with the purchase of certain athletic event tickets. The contribution might, for example, be a prerequisite to purchasing tickets, or it might instead give the purchaser priority purchasing rights.

Where a contribution to charity entitles a taxpayer to privileges or benefits, the contribution generally is assumed not to be a gift, unless the taxpayer can demonstrate that any excess amount paid was intended as a charitable contribution. Prior to the enactment of section 170(l), the IRS had issued guidelines concerning whether payments to athletic scholarship programs constitute deductible charitable contributions when the payments afford the right to purchase preferred seating at home football games. Under the guidelines, no deduction was allowable where the games regularly are sold out in advance such that no ticket would have been readily available to the taxpayer had the taxpayer not made a payment to the college's athletic scholarship program.[473]

In considering the language that ultimately became section 170(l), the House Committee on Ways and Means stated:

> The committee believes that to eliminate otherwise unavoidable valuation controversies between the IRS and many individual taxpayers, a statutory rule should be adopted to determine the proper treatment of payments to universities (*e.g.*, to a college athletic scholarship program that is eligible to receive tax-deductible charitable contributions) where the payment entitles the payor to purchase seating at university athletic events.

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[472] Sec. 170(l).

[473] Rev. Rul. 86-63, 1986-1 C.B. 6.

> Under the provision, a specified percentage of certain payments to or for the benefit of a university (other than amounts paid for tickets) is treated as if constituting a charitable contribution, without the need to examine in each particular case whether the payor should be viewed as making a gift, or to determine the value of the right to purchase seating received by the payor in return for his or her payment. The committee emphasizes that adoption of this special rule for administrative convenience with respect to certain payments to or for the benefit of universities does not affect the general principles . . . concerning the tax treatment of payments to charitable organizations in connection with which the payor becomes entitled to admissions, free or discounted merchandise, subscriptions to magazines, or other privileges or benefits.[474]

Section 170(l) thus was enacted to avoid valuation controversies between taxpayers and the IRS where contributions entitle taxpayers to ticket purchasing rights, thereby simplifying compliance with the law and easing administrative burdens on the IRS. Section 170(l) accomplishes this by allowing the ticket purchaser to disregard the value of the ticket purchasing rights when determining the deductible portion of the contribution. Instead, the purchaser/donor is permitted to assume that 80 percent of the payment to the college or university is a charitable contribution that is deductible under section 170. In other words, the purchaser/donor is permitted to assume that only 20 percent of the payment relates to the ticket purchasing rights and thus is nondeductible.

Since the enactment of section 170(l), concern has arisen that the value of the ticket purchasing rights often far exceeds 20 percent of the total amount paid to the college or university. In such cases, section 170(l) allows taxpayers and educational organizations to convert all or a portion of the value of a ticket purchase into a deductible payment, effectively lowering the cost of the ticket purchase to the payor at the expense of the Federal government.

Assume, for example, that to purchase seasons tickets to University X's football games, University X requires purchasers to make a $2,000 payment to its athletic scholarship fund, contributions to which are deductible under section 170, and that the fair market value of the ticket purchasing rights received in exchange for the payment is $1,500. In the absence of section 170(l), the taxpayer would have the burden to demonstrate that the $500 excess payment is deductible as a charitable contribution; the remaining $1,500 (*i.e.*, the portion of the $2,000 payment that relates to the ticket purchasing rights) is not deductible. Section 170(l) allows the same taxpayer to disregard the true fair market value of the ticket purchasing rights and to assume that only 20 percent of the $2,000 payment − or $400 − relates to the ticket purchasing rights and that 80 percent − or $1,600 − is deductible as a charitable contribution. In this example, section 170(l) allows the taxpayer to deduct as a charitable contribution $1,100 that was in fact a portion of the taxpayer's ticket purchase ($1,600 total deduction − $500 excess payment).

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[474] Report of the Committee on Ways and Means, U.S. House of Representatives, "Miscellaneous Revenue Act of 1988," H. Rep. No. 100-795 (100th Cong. 2d Sess.), sec. 331, p. 523.

The proposal seeks to address this concern by repealing the 80-percent deductibility rule currently included in section 170(l) and enacting in its place a rule that denies a charitable deduction for a contribution that entitles the donor to the right to purchase tickets to a sporting event. If enacted, the proposal would have the effect of preventing situations where the value of ticket purchases is improperly converted into a deductible contribution.

In addition, the proposal addresses the simplification and administrability concerns expressed by the Congress when it enacted section 170(l) by providing that *no portion* of a contribution that entitles the donor to ticket purchasing rights is deductible as a charitable contribution. Such a rule would have the beneficial effect of ensuring that the IRS is not burdened with a large number of valuation disputes relating to payments to university athletic programs.

Notwithstanding concerns about administrability, some might argue that such a rule is unnecessarily strict in that it denies a deduction altogether in situations where a taxpayer legitimately pays an excess amount with the intention of making a charitable contribution (*e.g.*, in the above example, even the excess contributions of $500 would not be deductible). In this respect, such contributions would be treated less favorably than other charitable contributions.[475]

[475] For an alternative proposal relating to payments in exchange for ticket purchasing rights, see H.R. 1, the "Tax Reform Act of 2014" (113th Cong., 2d Sess.), sec. 1403 (repealing section 170(l), but not providing for an affirmative rule of complete nondeductibility).

## PART XIII – INCENTIVES FOR JOB CREATION, CLEAN ENERGY, AND MANUFACTURING

### A. Designate Promise Zones

The fiscal year 2015 budget proposal is modified by removing certain requirements necessary for an area to be eligible to apply for a zone designation. Under the current proposal, an area only need to have: (i) a continuous boundary, (ii) a population of 200,000 or less, and (iii) to the extent the applicant is an urban area, a portion of at least one government jurisdiction with a population of at least 50,000.

For a description of the President's fiscal year 2015 budget proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p 125. That proposal modified proposals from prior years, described in both Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 60 and Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 152. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIII.A, reprinted in the back of this volume.

### B. Provide a Tax Credit for the Production of Advanced Technology Vehicles

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 126. That proposal modified a proposal from prior years, which is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 117-123. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIII.B, reprinted in the back of this volume.

### C. Provide a Tax Credit for Medium- and Heavy-Duty Alternative-Fuel Commercial Vehicles

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 126-127. That proposal modified a proposal from prior years, which is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 117-123. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the*

*President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIII.C, reprinted in the back of this volume.

### D. Modify and Extend the Tax Credit for the Construction of Energy-Efficient New Homes

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 131-133. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIII.D, reprinted in the back of this volume.

### E. Reduce Excise Taxes on Liquefied Natural Gas to Bring Into Parity with Diesel

The President's fiscal year 2016 budget proposal would lower the 24.3 cents per gallon excise tax on liquefied natural gas (LNG) to 14.1 cents per gallon beginning after December 31, 2015. Subsequent to the publication of the President's budget proposal, a similar proposal was enacted.[476] Beginning after December 31, 2015, LNG is be taxed at 24.3 cents per energy equivalent of a gallon of diesel, defined as the quantity of liquefied natural gas having a Btu content of 128,700 (lower heating value), which the statute defines as 6.06 pounds of liquefied natural gas.

For a description of the President's fiscal year 2016 proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 134-135. The estimated budget effect of the fiscal year 2016 budget proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal (JCX-50-15), March 6, 2015, Item XIII.E, reprinted in the back of this volume.

### F. Enhance and Modify the Conservation Easement Deduction

The fiscal year 2016 budget proposal combines three separate prior-year proposals into a single proposal, modifies the proposal that enhances the deduction for donations of easements (described in part 1 below), and adds a new proposal establishing a pilot credit program for conservation contributions (described in part 2 below). The prior-year proposals that are combined for fiscal year 2016 are: (1) a proposal to enhance and make permanent certain incentives for charitable contributions of conservation easements; (2) a proposal to eliminate the deduction for contributions of conservation easements on golf courses; and (3) a proposal to restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation.

[476] Surface Transportation and Veterans Health Care Choice Improvements Act of 2015, Pub. L. No. 114-41, sec. 2008, July 31, 2015.

**1. Enhance and make permanent incentives for the donation of easements**

**Description of Modification**

The proposal to enhance and make permanent the incentives for charitable contributions of easements is modified by adding several reforms that are designed to prevent abuse and to promote effective, high-value conservation efforts.

First, the proposal imposes new minimum standards for conservation organizations that receive tax-deductible donations of conservation easements. The minimum standards, which would be specified in regulations, would be based on experiences and best practices developed in States and by voluntary accreditation programs. The Treasury Department states that the regulations could, for example provide that a "qualified organization": (1) must not be related to the donor or to any person that is or has been related to the donor for at least ten years; (2) must have sufficient assets and expertise to be reasonably able to enforce the terms of all easements it holds; and (3) must have an approved policy for selecting, reviewing, and approving conservation easements that fulfill a conservation purpose. An organization jeopardizes its status as a "qualified organization" if it accepts contributions that it knows or should know are substantially overvalued or do not further an appropriate conservation purpose.

Second, the proposal modifies the definition of eligible "conservation purpose" (in section 170(h) of the Code) for which deductible contributions may be made to require that all contributed easements (1) further a clearly delineated Federal conservation policy or an authorized State or tribal government policy and (2) yield significant public benefit.

Third, the donor of a conservation easement must provide a detailed description of the conservation purpose or purposes furthered by the contribution and of any significant public benefits that will result from the easement. The donee organization must attest to the accuracy of the conservation purpose, public benefits, and fair market value of the easement reported to the IRS. Penalties will apply on organizations or organization managers that attest to values that they know or should know are substantially overstated or that receive contributions that do not serve an eligible conservation purpose.

Fourth, the proposal requires additional reporting of information about donated easements. Section 6033 (relating to annual information returns by tax-exempt organizations) will be amended to require electronic reporting and public disclosure by donee organizations regarding deductible contributions of easements, including: (1) a detailed description of the property and restrictions placed on the property; (2) the conservation purpose served by the easement; (3) any rights retained by the donor or related persons; (4) the fair market value of both the easement and the full fee interest in the property at the time of the easement contribution; and (5) a description of any easement modifications or actions taken to enforce the easement during the taxable year. As under present law, personally identifying information regarding the donor would not be subject to public disclosure.

The fiscal year 2015 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 177-182. The estimated budget effect of the fiscal

year 2016 proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), Item XIII.F.1, reprinted in the back of this volume.

**2. Pilot an allocable credit for conservation contributions and report to Congress**

The proposal modifies the prior-year proposal by adding a new pilot credit program. The pilot credit program included in the fiscal year 2016 proposal provides for non-refundable credits to be offered for contributions of conservation easements as an alternative to the present-law deduction. Donors taking a deduction are not eligible for a credit.

Under the pilot program, credits totaling $100 million per year are to be allocated by a Federal interagency board to qualified charitable organizations and governmental entities that hold and enforce conservation easements. These conservation organizations then reallocate the credits to donors of conservation easements. Donors may receive up to a maximum of 50 percent of the fair market value of the contributed easement in credits and may use the credits to offset up to 100 percent of their income tax liability. Unused credit amounts may be carried forward for up to 15 years.

The proposal also requires the Secretary of the Treasury (in collaboration with the Secretaries of Agriculture and Interior) to file a report to Congress on the relative merits of the new proposed new credit and the present-law deduction, including an assessment of the benefits and costs of each.

The estimated budget effect of the fiscal year 2016 pilot credit proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIII.F.2, reprinted in the back of this volume.

**3. Eliminate the deduction for contributions of conservation easements on golf courses**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 565-573. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIII.F.3, reprinted in the back of this volume.

**4. Restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation**

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 121-127. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the*

*Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIII.F.4, reprinted in the back of this volume.

## PART XIV – MODIFY ESTATE AND GIFT TAX PROVISIONS

### A. Restore the Estate, Gift, and Generation-Skipping Transfer (GST) Tax Parameters in Effect in 2009

The fiscal year 2016 proposal modifies the fiscal year 2015 budget proposal by accelerating the effective date. Whereas the fiscal year 2015 proposal was effective for estates of decedents dying, and for transfers made, after December 31, 2017, the fiscal year 2016 proposal is effective for estates of decedents dying, and for transfers made, after December 31, 2015.

The proposal is otherwise substantially similar to a fiscal year 2013 budget proposal, as modified by a fiscal year 2014 proposal. The fiscal year 2015 proposal is substantially similar to the fiscal year 2014 proposal. The fiscal year 2013 budget proposal is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 769-796. The fiscal year 2014 modification is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 103. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal (JCX-50-15), Item XIV.A, reprinted in the back of this volume.

### B. Require Consistency in Value for Transfer and Income Tax Purposes

A proposal similar to the President's fiscal year 2016 budget proposal to require consistency in value for transfer and income tax purposes was enacted subsequent to publication of the President's fiscal year 2016 budget.[477] Accordingly, present law now generally requires consistency between the estate tax value of property and the basis of property acquired from a decedent. If the value of the property has been finally determined for estate tax purposes, the basis in the hands of the recipient can be no greater than the value of the property as finally determined. If the value of the property has not been finally determined for estate tax purposes, then the basis in the hands of the recipient can be no greater than the value reported in a required statement. This requirement does not apply to any property the inclusion of which in the decedent's estate increased the liability for estate tax on such estate, but does not include any property of an estate if the liability for such tax does not exceed the credits allowable against such tax.

An executor of a decedent's estate that is required to file an estate tax return under section 6018(a) is required to report to both the recipient and the IRS the value of each interest in

[477] Surface Transportation and Veterans Health Care Choice Improvements Act of 2015, Pub. L. No. 114-41, sec. 2004, July 31, 2015. Present law is not changed to reflect the portion of the President's fiscal year 2016 budget proposal that requires consistency between the basis of property received by gift and the donor's basis determined under section 1015. In addition, the enacted provision differs from the budget proposal in that the budget proposal would not exclude from the consistency requirement property the inclusion of which in the decedent's estate would increase the liability for estate tax on such estate.

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

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

The provision applies the penalty for failure to file correct information returns under section 6721, and failure to furnish correct payee statements under section 6722, to failure to file the new information returns required under the provision. Additionally, the provision applies the accuracy-related penalty under section 6662 to any inconsistent estate basis. For this purpose, there is an inconsistent estate basis if the basis of property claimed on a return exceeds the basis as determined under the above-described new rules that generally require consistency between the estate tax value of property and the basis of property acquired from a decedent under section 1014.

The estimated budget effect of the President's fiscal year 2016 budget proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIV.B, reprinted in the back of this volume.

### C. Modify Transfer Tax Rules for Grantor Retained Annuity Trusts (GRATs) and Other Grantor Trusts

The fiscal year 2016 budget proposal combines two separate prior-year proposals into a single proposal and modifies one of the prior-year proposals. The two separate prior-year proposals are: (1) a proposal to require a minimum term for grantor retained annuity trusts ("GRATs") and (2) a proposal to coordinate certain income and transfer tax rules applicable to grantor trusts. In addition, for fiscal year 2016, the prior-year budget proposal relating to GRATs is modified by adding two new rules: (1) a requirement that the remainder interest in a GRAT at the time the interest is created must have a minimum value equal to the greater of 25 percent of the value of the assets contributed to the GRAT or $500,000 (but no more than the value of the assets contributed); and (2) a prohibition on the grantor engaging in a tax-free exchange of any asset held in the trust.

The proposal to require a minimum term for GRATs is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 269-273. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget*

*Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIV.C, reprinted in the back of this volume.

The proposal to coordinate certain income tax and transfer tax rules applicable to grantor trusts is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of this proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 282-293, and a modification described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 104-105. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIV.C, reprinted in the back of this volume.

### D. Limit Duration of Generation-Skipping Transfer (GST) Tax Exemption

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 274-281. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIV.D, reprinted in the back of this volume.

### E. Extend the Lien on Estate Tax Deferrals Where Estate Consists Largely of Interest in Closely Held Business

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 294-298. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIV.E, reprinted in the back of this volume.

### F. Modify Generation-Skipping Transfer (GST) Tax Treatment of Health and Education Exclusion Trusts

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 106-110. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIV.G, reprinted in the back of this volume.

## G. Simplify Gift Tax Exclusion for Annual Gifts

### Description of Modification

The fiscal year 2016 proposal modifies the fiscal year 2015 proposal by indexing for inflation the $50,000 per donor annual limit on certain transfers that will qualify for the gift tax annual exclusion. Under the fiscal year 2016 proposal, the $50,000 annual limit is increased for inflation beginning in 2017.

This proposal modifies a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 155-162. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIV.G, reprinted in the back of this volume.

## H. Expand Applicability of Definition of Executor

### Description of Modification

The fiscal year 2016 proposal modifies the fiscal year 2015 proposal to clarify that the proposal is designed to allow an authorized party (executor) to act on behalf of a decedent in all matters relating to the decedent's tax liabilities, regardless of when the liabilities arise, *i.e.*, whether the liabilities arise before, on, or after the death of the decedent.

This proposal modifies a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 162-163. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XIV.H, reprinted in the back of this volume.

## PART XV – OTHER REVENUE RAISERS

### A. Increase Oil Spill Liability Trust Fund Financing Rate (to Nine Cents per Barrel Effective 2016 and Ten Cents per Barrel Effective 2017) and Update the Law to Include Other Sources of Crudes

#### Description of Modification

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal (JCS-2-12), June 2012, pp. 506-507. The fiscal year 2016 budget proposal also would place a prohibition on the drawback of the Oil Spill Liability Trust Fund financing rate tax. This prohibition would be effective for periods after December 31, 2015. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XV.A, reprinted in the back of this volume.

### B. Reinstate and Extend Superfund Excise Taxes and Reinstate Superfund Environmental Income Tax

These proposals are substantially similar to the proposals found in the President's fiscal year 2013 budget proposal. For a description, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 508-510. In addition to extending the Superfund excise tax to crude oil produced from bituminous deposits, the fiscal year 2016 budget proposal would extend the Superfund excise tax to other crudes, including those produced from kerogen-rich rock.

The estimated budget effect of the current proposals can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XV.B, reprinted in the back of this volume.

### C. Increase Tobacco Taxes and Index for Inflation

#### Present Law

**Excise taxes on tobacco products and cigarette papers and tubes**

Excise taxes are imposed on tobacco products and cigarette papers and tubes that are manufactured or imported into the United States.[478] The tax liability comes into existence when the domestic tobacco products are manufactured and is determined and payable when the tobacco products or cigarette papers and tubes are removed in packages from the bonded premises of the manufacturer. These excise taxes are administered and enforced by the Secretary

[478] Sec. 5701.

of the Treasury through the Alcohol and Tobacco Tax and Trade Bureau ("TTB"), with the exception of the taxes on imported tobacco products and cigarette papers and tubes. Authority to collect those taxes is delegated to U.S. Customs and Boarder Protection ("CBP"), except where such imported products are transferred in bond to the bonded premises of a manufacturer of tobacco products or cigarette papers and tubes or export warehouse proprietor.

Tobacco products and cigarette papers and tubes manufactured in the United States or imported into the United States are subject to Federal excise tax at the following rates:[479]

- Cigars weighing not more than three pounds per thousand ("small cigars") are taxed at the rate of $50.33 per thousand;

- Cigars weighing more than three pounds per thousand ("large cigars") are taxed at the rate equal to 52.75 percent of the manufacturer's or importer's sales price but not more than 40.26 cents per cigar;

- Cigarettes weighing not more than three pounds per thousand ("small cigarettes") are taxed at the rate of $50.33 per thousand ($1.0066 per pack);

- Cigarettes weighing more than three pounds per thousand ("large cigarettes") are taxed at the rate of $105.69 per thousand, except that, if they measure more than six and one-half inches in length, they are taxed at the rate applicable to small cigarettes, counting each two and three-quarter inches (or fraction thereof) of the length of each as one cigarette;

- Cigarette papers are taxed at the rate of 3.15 cents for each 50 papers or fractional part thereof, except that, if they measure more than six and one-half inches in length, they are taxable by counting each two and three-quarter inches (or fraction thereof) of the length of each as one cigarette paper;

- Cigarette tubes are taxed at the rate of 6.30 cents for each 50 tubes or fractional part thereof, except that, if they measure more than six and one-half inches in length, they are taxable by counting each two and three-quarter inches (or fraction thereof) of the length of each as one cigarette tube;

- Snuff is taxed at the rate of $1.51 per pound, and proportionately at that rate on all fractional parts of a pound;

- Chewing tobacco is taxed at the rate of 50.33 cents per pound, and proportionately at that rate on all fractional parts of a pound;

- Pipe tobacco is taxed at the rate of $2.8311 per pound, and proportionately at that rate on all fractional parts of a pound; and

[479] *Ibid.*

- Roll-your-own tobacco is taxed at the rate of $24.78 per pound, and proportionately at that rate on all fractional parts of a pound.

Tobacco products and cigarette papers and tubes may be exported from the United States without payment of tax. Special tax and duty rules apply with respect to foreign trade zones. Foreign trade zones are areas within U.S. territory that are licensed to permit domestic activity with respect to foreign items without the necessity of formal entry to the United States. Such zones are intended to facilitate international trade.[480] In general, merchandise may be brought into a foreign trade zone without being subject to the general customs laws of the United States. Such merchandise may be stored in a foreign trade zone or may be subjected to manufacturing or other processes there. CBP may determine internal revenue taxes and liquidate duties imposed on foreign merchandise in such foreign trade zones. Articles on which such taxes and applicable duties have already been paid, or which have been admitted into the United States free of tax, that have been taken into a foreign trade zone from inside the United States, may be held under the supervision of a CBP officer. Such articles may later be released back into the United States free of further taxes and duties.[481]

**Definitions applicable to tobacco excise taxes**

Several definitions applicable to tobacco excise taxes are included in the Internal Revenue Code. The definitions of tobacco products determine the tax rate that will apply as well as the licensing and record keeping requirements that may apply to a manufacturer or importer of the products. Other definitions determine the time the tax liability arises or the timing of its payment.

The term "cigarette" is defined as (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco; and (2) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in (1).[482] A "small cigarette" is any cigarette weighing not more than three pounds per thousand and a "large cigarette" is any cigarette weighing more than three pounds per thousand.[483]

The term "cigar" is defined as any roll of tobacco wrapped in leaf tobacco or in any substance containing tobacco other than any roll of tobacco which is a cigarette as defined

[480] Foreign trade zones are licensed by the U.S. Foreign-Trade Zones Board, chaired by the Secretary of Commerce, and under the supervision of the CBP. See 19 U.S.C. secs. 81a-81u and 15 C.F.R. Part 400.

[481] 19 U.S.C. sec. 81c(a).

[482] Sec. 5702(b).

[483] See secs. 5701(b)(1) and (b)(2). The definitions of small and large cigarette are not part of the cigarette definition in section 5702(b), instead, they are found in section 5701(b) with the applicable tax rates.

above.[484] A "small cigar" is any cigar weighing not more than three pounds per thousand and a "large cigar" is any cigar weighing more than three pounds per thousand.[485]

The term "roll-your-own tobacco" is defined as any tobacco, which because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes or cigars, or for use as wrappers.[486]

The term "pipe tobacco" is defined as any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco to be smoked in a pipe.[487]

The term "cigarette paper" is defined as paper, or any other material except tobacco, prepared for use as a cigarette wrapper.[488]

A "cigarette tube" is defined as cigarette paper made into a hollow cylinder for use in making cigarettes.[489]

"Smokeless tobacco" means any snuff or chewing tobacco.[490] The term "snuff" means any finely cut, ground, or powdered tobacco that is not intended to be smoked. The term "chewing tobacco" means any leaf tobacco that is not intended to be smoked.

The term "removal" or "remove" means the removal of tobacco products or cigarette papers and tubes, or any processed tobacco, from the factory or from internal revenue bond, or release from customs custody, and includes smuggling or other unlawful importation of these products into the United States.[491]

A "manufacturer of tobacco products" is any person who manufactures cigars, cigarettes, smokeless tobacco, pipe tobacco, or roll-your-own tobacco.[492] A person who produces tobacco products solely for the person's own personal consumption or use is not a manufacturer of tobacco products. There is also an exception for a proprietor of a customs bonded manufacturing warehouse with respect to the operation of the warehouse. The term "manufacturer of tobacco products" includes any person who for commercial purposes makes available for consumer use (including a consumer's personal use) a machine capable of making cigarettes, cigars, or other

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[484] Sec. 5702(a).

[485] See secs. 5701(a)(1) and (a)(2). As with cigarettes, the definitions of small and large cigars are not part of the cigar definition in section 5702(a), instead, they are found in sec 5701(a) with the applicable tax rates.

[486] Sec. 5702(o).

[487] Sec. 5702(n).

[488] Sec. 5702(e).

[489] Sec. 5702(f).

[490] Sec. 5702(m).

[491] Sec. 5702(j).

[492] Sec. 5702(d).

tobacco products. A person making such a machine available for consumer use is deemed the person making the removal with respect to any tobacco products manufactured by the machine. This provision does not apply to a person who sells a machine directly to a consumer at retail for a consumer's personal home use if the machine is not used at a retail premises and is designed to produce tobacco products only in personal use quantities.

A "manufacturer of processed tobacco" is any person who processes any tobacco other than cigars, cigarettes, smokeless tobacco, pipe tobacco or roll-your-own tobacco.[493] The processing of tobacco does not include farming or growing tobacco or handling tobacco solely for sale, shipment, or delivery to a manufacturer of tobacco products or processed tobacco. Manufacturers and importers of processed tobacco are subject to regulation, but no Federal excise tax is imposed on processed tobacco.

An "importer" is any person in the United States (1) to whom nontaxpaid tobacco products or cigarette papers or tubes, or processed tobacco, manufactured in a foreign country, Puerto Rico, the Virgin Islands, or a U.S. possession are shipped or consigned; (2) who removes cigars or cigarettes for sale or consumption in the United States from a customs bonded manufacturing warehouse; or (3) who smuggles or otherwise unlawfully brings tobacco products or cigarette papers or tubes into the United States.[494]

**Large cigars and excise tax *ad valorem* pricing rules**

The Internal Revenue Code and TTB regulations provide rules for determining the tax price on large cigars.[495] In determining the tax price of a large cigar, any cost incident to placing the cigar in condition ready for use is included. The Federal excise tax and any retail sales tax (if stated as a separate charge) imposed by any State or political subdivision or the District of Columbia is excluded from the tax price. Constructive sale price rules similar to the rules applicable to other manufacturer excise taxes found in section 4216(b) apply. The tax is computed based on the sale price for which the large cigars are sold by the manufacturer or importer. In addition to money, the sale price includes any goods or services exchanged for cigars.

The constructive sales price rules apply when a taxable article is sold by the manufacturer, or importer at retail, on consignment, or sold (other than through an arm's-length transaction) for less than the fair market price. The tax is computed on the price for which the articles are sold, in the ordinary course of trade, by manufacturers or importers, as determined by the Secretary.[496]

Section 4216(b) provides that in the case of an article sold at retail, the price for tax purposes is the lower of (1) the price for which the article is sold, or (2) the highest price for

[493] Sec. 5702(p).

[494] Sec. 5702(k).

[495] See sec. 5702(l) and sec. 27 CFR sec. 40.22.

[496] See sec. 4216(b).

which such articles are sold to wholesale distributors, in the ordinary course of trade, by manufacturers or producers, as determined by the Secretary; however, these rules do not apply if the special rule applies. The special rule for a retail sale or a sale directly to a retailer applies if the manufacturer, producer, or importer, in an arm's-length transaction (1) regularly sells such articles at retail or to retailers, and (2) regularly sells such articles to one or more wholesale distributors in arm's-length transactions (and the price is determined without regard to any tax benefit). In such case the price of the article for tax purposes is the lower of (1) the price for which the article is sold, or (2) the highest price for which the articles are sold by the manufacturer, producer, or importer to wholesale distributors.

Other constructive sale price rules apply where a manufacturer, producer, or importer sells articles to a related-party distributor. If the manufacturer, producer, or importer regularly sells such articles to related-party distributors and the related-party distributor regularly sells such articles to independent retailers, but not wholesale distributors, the tax price is 90 percent of the lowest price for which such distributor regularly sells in arm's-length transactions to independent retailers. For purposes of these rules, the lowest price is determined without regard to quantity discounts, and any fixed amount to which the purchaser has a right as a result of any contractual arrangement at the time of sale.

**Requirements for manufacturers and importers**

Manufacturers and importers of tobacco products or cigarette papers or tubes, processed tobacco, and export warehouse proprietors, must obtain a permit before commencing business as a manufacturer or importer of these products. Additionally these manufactures and importers are required to make an inventory,[497] prepare certain reports,[498] and keep certain records,[499] all as prescribed by the Secretary. Manufacturers and importers of taxable products and export warehouse proprietors may also be required to file a bond.[500] The Internal Revenue Code also contains certain labeling requirements, imposition of occupational taxes and various fines and penalties for noncompliance with the laws.

Permit

Manufacturers and importers of tobacco products, processed tobacco, and proprietors of export warehouses must obtain a permit to engage in such businesses.[501] A permit is obtained by application to the Secretary. The Secretary may deny the application if (1) the business premises are inadequate to protect the revenue; (2) the activity to be carried out at the business premises does not meet such minimum capacity or activity requirements as prescribed by the Secretary; (3) the applicant is, by reason of his business experience, financial standing, or trade connections, or by reason of previous or current legal proceedings involving a felony violation of

[497] Sec. 5721.

[498] Sec. 5722.

[499] Sec. 5741.

[500] Sec. 5711.

[501] Sec. 5713(a).

another provision of Federal criminal law relating to tobacco products, processed tobacco, cigarette paper or cigarette tubes, not likely to maintain operations in compliance with the applicable provisions of the Internal Revenue Code; (4) the applicant has been convicted of a felony violation of any provision of Federal or State criminal law relating to tobacco products, processed tobacco, cigarette paper, or cigarette tubes; or (5) such applicant has failed to disclose any material information required or made any material false statement in the application.[502] In the case of a corporation, an applicant includes any officer, director, or principal stockholder and, in the case of a partnership, a partner.

A permit is conditioned upon compliance with the rules of the Internal Revenue Code and related regulations pertaining to taxes and regulation of tobacco products, processed tobacco, and cigarette papers and tubes. The Secretary may suspend or revoke a permit after a notice and hearing if the holder (1) has not in good faith complied with those rules or has violated any other provision of the Internal Revenue Code involving intent to defraud; (2) has violated the conditions of the permit; (3) has failed to disclose any material information required or made any material false statement in the permit application; (4) has failed to maintain the business premises in such a manner as to protect the revenue; (5) is, by reason of previous or current legal proceedings involving a felony violation of any other provision of Federal criminal law relating to tobacco products, processed tobacco, cigarette paper, or cigarette tubes, not likely to maintain operations in compliance with this chapter; or (6) has been convicted of a felony violation of any provision of Federal or State criminal law relating to tobacco products, processed tobacco, cigarette paper, or cigarette tubes.[503]

Packaging and labels

All tobacco products, processed tobacco, and cigarette papers and tubes must be packaged and labeled as required by the secretary.[504] Indecent or immoral pictures, prints, or representations are not permitted on packaging or labels. There is an exception to the packaging and labeling requirements for products furnished to employees for personal use or consumption, for experimental purposes, and for product transferred to the bonded warehouse of another manufacturer.

Occupational tax

An occupational tax of $1,000 per year is imposed on manufacturers of tobacco products, cigarette papers and tubes, and export warehouse proprietors.[505] A reduced rate of $500 per year applies to taxpayers with excise tax liability in the prior year of less than $500,000.[506] Controlled groups are treated as a single person. Any person engaged in business subject to the

[502] Sec. 5712.

[503] Sec. 5713(b).

[504] Sec. 5723.

[505] Sec. 5731(a).

[506] Sec. 5731(b).

occupational tax who willfully fails to pay the tax imposed is subject to a fine of not more than $5,000 or imprisonment of not more than two years, or both, for each such offense.

Fines and penalties

The Internal Revenue Code contains various provisions related to the purchase, receipt, possession, sale, or disposal of certain tobacco products and cigarette papers and tubes as well as imposes restrictions on importation of previously exported tobacco products. Civil and criminal penalties and forfeiture provisions apply for failure to comply with the tobacco provisions.

Civil penalties apply to certain actions including the willful failure to comply with the duties imposed (such as record keeping and labeling), failure to pay tax, and for the illegal sale of tobacco products.[507] Criminal penalties apply to certain actions including engaging in business unlawfully, failing to furnish certain information or furnishing false or fraudulent information, tax evasion, unlawful removal of tobacco products or cigarette papers or tubes, and for purchasing, receiving, possessing, or selling tobacco products or cigarette papers or tubes unlawfully.[508] Tobacco products and cigarette papers and tubes are subject to forfeiture if they are possessed with the intent to defraud the United States, or are not in packaging as required under the law.[509] Additional property may also be subject to forfeiture if it is used to engage in the manufacturing business unlawfully, or if the proprietor makes false or fraudulent records or reports with the intent to defraud the United States.

## Description of Proposal

The proposal establishes a more uniform tax base by taxing most tobacco types at a similar implied per-pound tax rate. Under the proposal cigarettes and small cigars would be taxed at $97.50 per 1,000 units ($1.95 per pack of cigarettes). Large cigars are taxed at an approximately equivalent rate (using five per-unit rates that vary according to the cigar's weight). Pipe tobacco and roll-your-own tobacco are be taxed at $44.23 per pound, which is approximately equal to the implied per-pound tax rate applied to both cigarettes and small cigars. This rate-per-pound implies that cigarettes and small cigars weigh approximately 2.2 pounds per thousand, such that most products are taxed at $44.23 per pound. Snuff and chewing tobacco are both taxed at $10.00 per pound.

The proposal includes a one-time floor stocks tax that generally applies to tobacco products that are held for sale on January 1, 2016. The floor stocks tax is payable on or before April 1, 2016.

Additionally, the Administration clarifies that roll-you-own tobacco includes any processed tobacco that is removed or transferred for delivery to anyone without a proper permit, but does not include export shipments of processed tobacco.

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[507] Sec. 5761.

[508] Sec. 5762.

[509] Sec. 5763.

The proposal indexes the new tax rates for inflation beginning with the first adjustment applicable to sales on or after January 1, 2017.

Effective date.−The proposal applies to articles removed after December 31, 2015.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XV.C, reprinted in the back of this volume.

## Analysis

### Economics of cigarette tax and consumption and health

According to the Centers for Disease Control and Prevention, as of 2013, 17.8 percent of adults in the U.S. smoke cigarettes and tobacco use is estimated to cause one out of five deaths every year. An increase in the excise tax on tobacco products increases the cost of production. Some or all of the increased production cost may be passed on to consumers in the form of higher prices. As a result, consumers may consume less of these products. Many studies document smoking declines in the face of higher excise taxes on tobacco products, though the magnitude of these effects is in question.[510] Some argue that current prices of tobacco products do not fully account for the private and external costs of consumption (*e.g.*, the negative health effects on the user and others). They argue that tobacco products are over consumed because the price paid does not reflect all of the costs to society. If true, then an increase in tobacco taxes may increase efficiency by more closely reflecting the full social costs of tobacco use in the price of tobacco products. However, others suggest that the present excise taxes have already raised the price on tobacco products above the total private and external costs of tobacco consumption such that any additional tax increases the gap between price and costs, exacerbating the efficiency losses associated with the taxation of tobacco.[511]

For many consumers, the demand for tobacco products is relatively unresponsive to changes in prices, and an increase in the tax may lead to a relatively modest decrease in the size of the demand for tobacco products. However, as a result of this relatively unresponsive demand, a significant share of the tax increase may be passed on to consumers in the form of higher prices. In other words, the incidence of the tax may be borne disproportionately by consumers relative to producers. If tobacco taxes are passed on to consumers in the form of higher prices, an increase in the tax on tobacco products is likely to have differential impacts on various groups of taxpayers as tobacco products are not consumed equally across the population. The use of tobacco products is higher among those with lower income levels, leading some to argue that much of the burden of increased tobacco taxes will be borne by those with the least

[510] William Evans, Jeanne S. Ringel, Diana Stech, "Tobacco Taxes and Public Policy to Discourage Smoking," in James M. Poterba, ed., *Tax Policy and the Economy*, Vol 13, January 1999.

[511] Jane Gravelle and Dennis Zimmerman, Congressional Research Service, *Cigarette Taxes to Fund Health Care Reform: An Economic Analysis*, March 8, 1994, available at http://www.crs.gov/pdfloader/94-214.

ability to pay.[512] Others suggest that since young consumers are more sensitive to the price of tobacco than older consumers, increasing tobacco taxes helps to curb youthful smoking, and therefore reduces the number of future smokers.[513]

**Establishing a uniform tax base**

The Administration argues that the existing rate structure imposes wide disparity across similar types of tobacco products which may erode the tax base and detract from the beneficial effects of the cigarette tax on consumption and health. The Children's Health Insurance Program Reauthorization Act of 2009 ("CHIPRA"),[514] increased the Federal excise taxes on tobacco products[515] and cigarette papers and tubes. The CHIPRA rate structure, although attempting to equalize the tax rates on small cigars and roll-your-own tobacco with the rate on small cigarettes, introduced other disparities across similar types of tobacco products. Specifically, as noted in a recent U.S. Government Accountability Office ("GAO") report,[516] the disparities between tax rates for small and large cigars and roll-your-own and pipe tobacco resulted in significant market shifts in consumer demand to the lower-taxed products. Some may argue that the shift in consumer demand, resulting from the disparate rate structure on similar products, reduces the amount of tax that would otherwise be collected on higher-taxed products. Additionally, the ability of consumers to shift to lower-taxed products results in higher tobacco use than would be achieved with more uniform tax rates.

The discussion below provides specific details regarding the pre- and post-CHIPRA rates as well as how the Administration's proposal addresses the tax-rate disparities.

Small and large cigars

Prior to CHIPRA, small cigars were taxed advantageously compared to both cigarettes and all but the most inexpensive large cigars. Small cigars were taxed at the rate of $1.828 per thousand (about four cents per pack of 20 or 2/10$^{ths}$ of a cent per cigar); large cigars were taxed at the rate of 20.719 percent of the manufacturer's or importer's sales price but not more than $48.75 per thousand (about five cents per cigar); and small cigarettes were taxed at the rate of

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[512] Ahmed Jamal et al, "Current Cigarette Smoking Among Adults - United States, 2005-2013," *Morbidity and Mortality Weekly Report*, vol. 63, no. 47, November 28, 2014, pp. 1108-1112, available at http://www.cdc.gov/mmwr/pdf/wk/mm6347.pdf.

[513] Hana Ross and Frank Chaloupka, "The Effect of Public Policies and Prices on Youth Smoking," *Southern Economic Journal*, vol. 70, no. 4, April 2004, pp. 796-815.

[514] Pub. L. No. 111-3, Feb. 4, 2009.

[515] The term "tobacco products" means cigars, cigarettes, smokeless tobacco (snuff and chewing tobacco), pipe tobacco, and roll-your-own tobacco. Secs. 5702(c) and 5702(m).

[516] GAO Testimony Before the Committee on Finance, U.S. Senate, *Tobacco Taxes: Disparities in Rates for Similar Smoking Products Continue to Drive Market Shifts to Lower-Taxed Options* (GAO-14-811T), July 29, 2014. For background information, see Joint Committee on Taxation, *Present Law and Background Relating to Tobacco Excise Taxes* (JCX-93-14), July 25, 2014.

$19.50 per thousand (about 39 cents per pack of 20 or two cents per cigarette). Thus pre-CHIPRA, small cigars were taxed at a substantially lower rate than cigarettes and were taxed at a lower rate than large cigars with a manufacturer's or importer's sales price of more than 0.88 cents per cigar.

After CHIPRA, inexpensive large cigars face a lower tax than either cigarettes or small cigars. Under present law, both small cigars and cigarettes are taxed at the rate of $50.33 per thousand ($1.0066 per pack, or just more than five cents per cigar or cigarette) while large cigars are taxed at the rate of 52.75 percent of the manufacturer's or importer's sales price but not more than 40.26 cents per cigar. Thus, small cigars are taxed equivalently to cigarettes and at a higher rate than large cigars with a manufacturer's or importer's sales price of less than 9.5 cents per cigar.[517] There is a maximum tax for large cigars of 40.26 cents, but no minimum tax. The absence of a minimum tax provides an incentive to manufacturers of small cigars to increase the weight of the cigars to more than three pounds per thousand such that the cigars may be classified, and taxed at lower rates, as large cigars.

The Administration's proposal addresses the disparity between taxes on small and large cigars by establishing five per-unit rates (based on the cigar's weight), taxed at rates that are approximately equivalent to the rates on cigarettes and small cigars, and in line with the $44.23 per pound on most tobacco products. In order to fully address the disparity between the taxation on large and small cigars, the tax rate on the smallest weight band should be no less than the tax rate applicable to cigarettes and small cigars ($97.50 per 1,000 units). Taxation of large cigars is discussed in more detail below.

Roll-your-own and pipe tobacco

Prior to CHIPRA, roll-your-own and pipe tobacco were taxed at the same rate, $1.0969 per pound. Therefore, there was no need to distinguish between the two types of tobacco and the tobacco manufacturers faced no tax incentive to favor one type of tobacco over the other.

CHIPRA raised the tax rate on roll-your-own tobacco to an amount that is approximately equivalent to the rate imposed on manufactured cigarettes,[518] while the tax rate on pipe tobacco increased in the same proportion that the tax rate on cigarettes increased.[519] CHIPRA increased

[517] The tax per small cigar post-CHIPRA is 5.033 cents. This rate equals the tax paid on a large cigar with a taxable price of 9.5412 cents (52.75 percent of 9.5412 cents is 5.033 cents). Large cigars with a taxable price of less than 9.5412 cents per cigar are subject to a lower tax than the tax applicable to small cigars. Large cigars with a taxable price of more than 9.5412 cents per cigar are subject to a greater tax than the tax imposed on small cigars.

[518] The definition of "cigarette" found in section II(m) of the Tobacco Master Settlement Agreement generally uses 0.0325 ounces of roll-your-own tobacco as the equivalent to one individual cigarette. This is not inconsistent with the information and packaging provided to consumers by roll-your-own manufacturers. Using this equivalency, 1,000 cigarettes contain 32.5 ounces, or 2.03125 pounds, of tobacco. In order for the tax on roll-your-own tobacco to equal that on commercially manufactured cigarettes, the tax applied to 2.03125 pounds of roll-your-own tobacco should yield $50.33 (the same rate applied to 1,000 commercially manufactured cigarettes). This implies a tax rate of $24.78 on one pound of roll-your-own tobacco.

[519] The tax rates on both cigarettes and pipe tobacco increased by 158 percent.

the tax rate on roll-your-own tobacco from just less than $1.10 per pound to $24.78 per pound while the tax rate on pipe tobacco increased from just less than $1.10 per pound to about $2.83 per pound. Consequently, the tax rate applicable to pipe tobacco is approximately one-ninth the tax rate applicable to roll-your-own tobacco. This disparate tax treatment created both the need to differentiate between the two types of tobacco as well as a strong tax incentive for manufacturers to shift production, or change product labeling, from roll-your-own to pipe tobacco where feasible.

The Internal Revenue Code distinguishes roll-your-own and pipe tobacco by its appearance, type, packaging or labeling. Where these characteristics make the tobacco "suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes or cigars, or for use as wrappers thereof," the tobacco is classified as roll-your-own and subject to the higher tax rate. Where these characteristics make the tobacco "suitable for use and likely to be offered to, or purchased by, consumers as tobacco to be smoked in a pipe," the tobacco is classified as pipe tobacco and subject to the lower tax rate. The use of characteristics such as packaging and labeling to distinguish two products, which are similar in appearance and type, provides manufacturers with a tax incentive to package and label products as pipe tobacco even if they recognize that many customers will use the product as roll-your-own tobacco.

The Administration's proposal addresses the disparity between the tax rate on roll-your-own and pipe tobacco by equalizing the rates. Opponents may argue that raising the rates on pipe tobacco unfairly targets pipe smokers who may be subject to a higher tax per use. Some may argue that the higher rate on pipe tobacco is not warranted as pipe use may not be as great a risk to health as is other tobacco use.

Uniform tax base

The Administration's proposal attempts to establish a more uniform tax base for tobacco use based on an implied per-pound tax rate of $44.23 per pound. Present law tobacco rates are not uniform by weight as demonstrated by the variance between roll-your-own, pipe, and smokeless tobacco, which carry different tax rates by pound. Cigarettes and cigars are taxed per stick, not by pounds of tobacco. Some may argue that uniformity could be achieved by applying a single tax rate of tax to the weight of tobacco used in a product. However, this could be very difficult to administer as similar products could vary in weight. This is discussed in more detail in the section on taxation of large cigars below. Another way to achieve a uniform tax base is to tax products at the equivalent rates on a "per-use" basis. This is conceptually achieved in the attempt to tax roll-your-own tobacco at a rate that equates to the tax rate applied to cigarettes, and in the taxation of small cigars at the rate equivalent to that of cigarettes without regard to the actual amount of tobacco contained in the products. Under the proposal, snuff and chewing tobacco are taxed at rates lower per pound than that of roll-your-own and pipe tobacco, reflecting the different per-use equivalents of smokeless tobacco. Some may argue that other tobacco products, currently within the definition of the smokeless tobacco categories, are lightly taxed on a per-uses basis as compared to cigarettes or small cigars. They may argue that taxing snuff and chewing tobacco at lower rates per pound than other tobacco products is not justified given the health risks associated with snuff and chewing tobacco products.

**Taxation of large cigars**

Pre-CHIPRA, the tax rate on large cigars was 20.719 percent of the manufacturer's or importer's sales price, but not more than $48.75 per thousand cigars (4.9 cents per cigar). Any cigar with a manufacturer's or importer's sales price of 23.6 cents or more was subject to the maximum tax on large cigars. For cigars subject to the maximum tax, any change in price, so long as the price was at least 23.6 cents per cigar, had no effect on the manufacturer's or importer's tax liability.

After CHIPRA, the tax rate on large cigars increased to 52.75 percent of the manufacturer's or importer's sales price, and the maximum tax increased to just over 40 cents per cigar. A cigar with a manufacturer's or importer's sales price of 76.3 cents or more per cigar is subject to the maximum tax. For cigars subject to the maximum tax, any change in price, so long as the price is at least 76.3 cents per cigar, has no effect on the tax liability. However, for cigars with a sales price of less than 76.3 cents per cigar, each reduction of one cent in price results in a tax reduction of 0.5275 cents per cigar. Therefore, there is a considerable incentive for manufacturers of cigars not subject to the maximum tax to lower the price on which the excise tax is computed.

The Administration's proposal moves the taxation of large cigars away from *ad valorem* taxation to a per-unit tax, similar to that of cigarettes and small cigars. The proposal attempts parity by introducing five per-unit rates that vary according to the cigar's weight. Some may argue that these price bands maintain some of the progressivity of the present-law taxing structure; however, it is not clear that the pricing of premium cigars is highly correlated with the cigar's weight. The introduction of additional weight bands to the taxation of cigars adds additional complexities and incentives for manufacturers to fit their products into the lowest rate possible. Whereas under present law there is an incentive for low-priced cigars to add weight to meet the definition of large cigar, under the proposed regime the incentive would be to decrease the cigar weight in order to fit within a lower band. The incentives will be greater depending on the variance in pricing of each of the five bands.

Treasury has indicated that the five per-unit rates may be set with the tax rate determined at the roll-your-own rate based on the mid-point of the band. For example, cigars between, three and five pounds per thousand would be taxed at $176.92 per thousand, five and 10 pounds per thousand would be taxed at $331.73 per thousand, 10 and 25 pounds per thousand would be taxed at $774.03 per thousand, 25 and 40 pounds per thousand would be taxed at $1,437.48 per thousand, and above 40 pounds per thousand would be taxed at $2,211.50 per thousand. The tax rate nearly doubles at each price band, providing great incentive to shed weight. For example, a cigar weighing 2.9 pounds per thousand would be taxed at about 10 cents, but a cigar weighing 3.1 pounds per thousand would carry a tax of nearly 18 cents; a cigar weighing 39.9 pounds per thousand would be taxed at about 14 cents while a cigar weighing 40.1 pounds per thousand would be taxed at about 22 cents.

Eliminating these tax rate cliffs could be accomplished by eliminating the weight bands and taxing cigars at the rate for roll-your-own tobacco with a minimum tax equal to the tax on cigarettes and small cigars. Under a straight-weight scheme with a minimum tax, the 2.9 pounds per thousand cigar and 3.1 pounds per thousand cigar are both be taxed at about 10 cents per

cigar; while the 39.9 pounds per thousand cigar and the 40.1 pounds per thousand cigar are both taxed at about 18 cents per cigar. Some may argue that taxing cigars based on their actual weight might be difficult to administer and that the weight of individual cigars, especially cigars that are not produced by machine, could vary widely. However, TTB could develop tolerances for cigar band weights similar to the tolerances developed for measuring proof gallons for alcohol products.[520]

**Processed tobacco**

CHIPRA also created a new category of manufacturers and importers who are subject to regulation but not to Federal excise tax. Under CHIPRA, manufacturers and importers of processed tobacco are subject to the permit, inventory, reporting, packaging, and recordkeeping requirements. Processed tobacco is regulated under the Internal Revenue Code, but Federal excise tax is not imposed and no limitations are placed on the removal, distribution or sale of processed tobacco. The Administration's proposal would not limit the removal, distribution or sale of processed tobacco, but it imposes tax at the roll-your-own rate on processed tobacco removed or transferred for delivery to anyone without a proper permit.

**Other issues**

Floor-stocks tax

The Administration's proposal imposes a floor-stocks tax on tobacco products that are held for sale on January 1, 2016, the day the new tax rates take effect. Without the imposition of a floor-stocks tax, a holder of untaxed tobacco stock may benefit from a windfall as the price in the market rises to adjust for the increased tax. Floor-stocks taxes are one-time tax events and are administratively time intensive for both taxpayers and for the Internal Revenue Service. They are justified when there is a significant rate increase to prevent the accumulation of inventory just prior to the imposition of the new tax rates. Some may argue that this proposal may merit application of a floor-stocks tax as it significantly raises the tax on most tobacco products.

Indexing

Inflation erodes the value of the fixed dollar amounts utilized to determine tax liability. As a result, if nominal tax rates remain unchanged, over time, inflation erodes the magnitude of the overall tax. Indexing the dollar amounts in the tax rates to inflation prevents the size of the tax from diminishing to zero over time.

The amount of the adjustment to provisions applicable to taxable years beginning in a given calendar year will depend on the percentage by which the average of the levels of the Consumer Price Index ("CPI") for all urban consumers for the 12 months ending with September of the preceding calendar year (*i.e.*, for the 12 months comprising the preceding fiscal year)

[520] See, *e.g.*, 27 CFR 4.36 describing wine labeling requirements related to the alcoholic content including allowable tolerance standards.

exceeds the average of the levels of the CPI for the 12 months from October 2014 through September 2015, inclusive (*i.e.* fiscal year 2015). The percentage by which this average exceeds the similar average of the levels for the 12 months of fiscal year 2014 will be the rate of increase used in deriving the new tax rates. A new computation will be made each calendar year, always using the percentage increase in the CPI between the preceding fiscal year and the base period of fiscal year 2014. Note that it is possible for these adjustments to provide tax decreases in future years if prices levels fall. This is the same methodology that is used in other sections of the tax code, including in indexing income tax brackets and personal exemptions.

This proposal modifies a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 118-120. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XV.C, reprinted in the back of this volume.

### D. Make Unemployment Insurance Surtax Permanent

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 511-512. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XV.D, reprinted in the back of this volume.

### E. Expand Federal Unemployment Tax Act (FUTA) Base

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 513-515. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XV.E, reprinted in the back of this volume.

## PART XVI – REDUCE THE TAX GAP AND MAKE REFORMS

### A. Expand Information Reporting

### 1. Improve information reporting for certain businesses and contractors

The proposal combines two separate prior-year proposals into a single proposal, as described below. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.A.1, reprinted in the back of this volume.

The proposal to require a certified taxpayer identification number from contractors and allow certain withholding is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 574-576. The proposal to require information reporting for private separate accounts of life insurance companies is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 576-579.

### 2. Provide an exception to the limitation on disclosing tax return information to expand TIN matching beyond forms where payments are subject to backup withholding

#### Present Law

#### In general

Section 6103 provides that returns and return information are confidential and may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to the information except as provided in the Code.[521] A "return" is any tax or information return, declaration of estimated tax, or claim for refund required by, or permitted under, the Code, that is filed with the Secretary by, on behalf of, or with respect to any person.[522] "Return" also includes any amendment or supplement thereto, including supporting schedules, attachments, or lists which are supplemental to, or part of, the return so filed. A Form W-2 is an information return and therefore, a return for purposes of section 6103. The Form W-2 is considered the return of both the employer and the employee to whom it relates.

The definition of "return information" is very broad and includes any information gathered by the IRS with respect to a person's liability or possible liability under the Code.[523]

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[521] Sec. 6103(a).

[522] Sec. 6103(b)(1).

[523] Sec. 6103(b)(2). Return information is a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld,

"Taxpayer return information" is a subset of return information. Taxpayer return information is return information filed with or furnished to the IRS by, or on behalf of, the taxpayer to whom the information relates. For example, information submitted to the IRS by a taxpayer's accountant on behalf of the taxpayer is "taxpayer return information."

Section 6103 contains a number of exceptions to the general rule of confidentiality, which permit disclosure in specifically identified circumstances when certain conditions are satisfied.[524] Section 6103(k) includes exceptions for disclosure of certain tax returns and tax return information for tax administration purposes.

Backup withholding for reportable payments is required in certain circumstances, such as when the payee fails to furnish a taxpayer identification number (TIN) to the payor in the manner required, or if the IRS notifies the payor that the TIN furnished by the payee is incorrect. Current reportable payments (and related IRS forms) include:

- Real Estate Brokers and Barter Exchange Transactions (Form 1099-B);
- Dividends and Distributions (Form 1099-DIV);
- Interest Income (Form 1099-INT);
- Merchant Card Third Party Network Payments (Form 1099-K);

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deficiencies, overassessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense,

- any part of any written determination or any background file document relating to such written determination (as such terms are defined in section 6110(b)) which is not open to public inspection under section 6110,
- any advance pricing agreement entered into by a taxpayer and the Secretary and any background information related to such agreement or any application for an advance pricing agreement, and
- closing agreement under section 7121, and any similar agreement, and any background information related to such an agreement or request for such an agreement,

Return information does not include data in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer.

[524] Sec. 6103(c) - (o). Such exceptions include disclosures by consent of the taxpayer, disclosures to State tax officials, disclosures to the taxpayer and persons having a material interest, disclosures to Committees of Congress, disclosures to the President, disclosures to Federal employees for tax administration purposes, disclosures to Federal employees for nontax criminal law enforcement purposes and to the Government Accountability Office, disclosures for statistical purposes, disclosures for miscellaneous tax administration purposes, disclosures for purposes other than tax administration, disclosures of taxpayer identity information, disclosures to tax administration contractors and disclosures with respect to wagering excise taxes.

- Miscellaneous Income (Form 1099-MISC);
- Original Issue Discount (Form 2099-OID); and
- Taxable Distributions Received from Cooperatives (Form 1099-PATR).

Persons required to file information returns with respect to such payments are eligible to participate in a TIN matching program, under which the payor is able to confirm with the IRS the validity of a name and TIN provided by a payment recipient.[525] Under that program, participants must comply with standards for safeguarding information under employment tax regulations, rules concerning e-services, and provide information to the Service that will enable it to monitor the effectiveness of the program.

## Description of Proposal

The proposal would amend section 6103(k) to permit the IRS to disclose to any person required to provide the TIN of another person to the Secretary whether the information matches the records maintained by the Secretary.

The proposal would be effective on the date of enactment.

The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal (JCX-50-15), March 6, 2015, Item XVI.A.2, reprinted in the back of this volume.

## Analysis

The proposal is very broad in that it would permit the IRS to disclose whether the TIN information provided by one person matches the information in the records maintained by the IRS. Thus, any payor required to file an information return related to a third party (such as a Form W-2 for wage income) would be eligible to participate in an online program to check whether the payor's information matches the IRS information. In explaining its rationale for expanding the existing online TIN matching program, the Administration offers the rationale that it is desirable to enable all payors to avoid penalties for failure to have obtained valid TIN information from payees, and that earlier accurate information reporting is beneficial to IRS compliance efforts. To the extent that participation in the online program remains subject to the criteria similar to the current program, it is not clear how broad an expansion this would be in practice. If, instead, the proposal is accompanied by a relaxation of those criteria in order to facilitate participation by the broader community of information return filers, several concerns arise about attendant risks.

First, in the current context of identity theft, some may argue it is inappropriate to have a widespread program by which persons could check the TIN of third parties and have the IRS

[525] Treas. Reg. sec. 31.3406(j)-1(c); IRS Publication 2108A, "On-Line Taxpayer Identification Number (TIN) Matching Program, (Rev. 1-2013).

confirm that the TIN submitted is valid. Such a program would seem to require advance screening and approval of payors who would access the system, at least as stringent as existing rules. The large number of information return filers raises concerns that the more authorized users there are, the more points of opportunity exist for abuse of taxpayer information and inappropriate access.

Second, some may question whether the IRS has the capacity to implement a program that requires screening every person that would file an information return. This issue may be ameliorated somewhat by limiting access to persons that file information returns above a certain threshold, or limiting how many times a person would be allowed to query the system to determine if a TIN was valid.

Finally, without further detail about how this proposal is expected to be implemented, the need for broader availability of the online matching program is difficult to evaluate. Such an evaluation would include information about the extent to which errors in the information provided to the payors, rather than inadequate efforts to obtain the information, is the basis for the errors that lead to failure to file information return penalties.

### 3. Provide for reciprocal reporting of information in connection with the implementation of the Foreign Account Tax Compliance Act (FATCA)

**Description of Modification**

The fiscal year 2016 budget proposal is substantially similar to an earlier proposal first offered for fiscal year 2015, with one change. The proposal adds the requirement that any financial institution required to report with respect to a financial account, under either FATCA or the reciprocal reporting requirement of this proposal, must provide a copy of the report to the account holder, with an exception for foreign financial institutions that are located in a jurisdiction that provides FATCA information directly to the IRS under an intergovernmental agreement with the United States. A description and analysis of the prior proposal can be found in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, at pages 184-190.

Effective date.−The proposal is effective for returns filed after December 31, 2016.

The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.A.3, reprinted in the back of this volume.

### 4. Improve mortgage interest deduction reporting

A proposal similar to the President's fiscal year 2016 budget proposal was enacted subsequent to publication of the President's fiscal year 2016 budget.[526] Accordingly, present law

[526] Surface Transportation and Veterans Health Care Choice Improvements Act of 2015, Pub. L. No. 114-41, sec. 2003, July 31, 2015.

now provides that with respect to returns required to be made, and statements required to be furnished, after December 31, 2016, the following additional information is required to be included: (i) the amount of outstanding principal on the mortgage as of the beginning of such calendar year, (ii) the date of the origination of the mortgage, and (iii) the address (or other description in the case of property without an address) of the property which secures the mortgage.

The President's budget proposal contained two additional reporting requirements not enacted into law. Under the proposal, the Form 1098 would contain information relating to whether the mortgage is a refinancing of an existing mortgage during the calendar year, and the amount of property taxes, if any, paid from escrow.

The estimated budget effect of the President's fiscal year 2016 budget proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.A.4, reprinted in the back of this volume.

### 5. Require Form W-2 reporting for employer contributions to defined contribution plans

#### Present Law

#### Contributions to employer-sponsored defined contribution plans

A qualified defined contribution plan may provide for pretax elective deferrals, that is, contributions made to the plan on behalf of an employee pursuant to an election by an employee between cash compensation and a contribution to the plan (referred to as a "section 401(k)" plan).[527] A section 401(k) plan may also provide for elective deferrals to be made on an after-tax basis ("designated Roth contributions").[528] An employee's elective deferrals, including designated Roth contributions, for a taxable year (generally the calendar year for an individual) are subject to a limit of $18,000 (for 2015), plus catch-up contributions of $6,000 (for 2015) for an employee who attains age 50 by the end of the year, or, if less, the employee's compensation.[529] Elective deferrals are contributions for the year in which deferred (that is, withheld from an employee's pay), even if actually contributed to the plan after the end of the year. An employee's right to his or her elective deferrals and related earnings must be fully vested at all times.

Qualified defined contribution plans may also provide for after-tax employee contributions (other than designated Roth contributions), pretax employer matching contributions (that is, employer contributions made as a result of an employee's elective deferrals, designated Roth contributions, or after-tax contributions), and pretax employer nonelective contributions

[527] Sec. 401(a) and (k).

[528] Sec. 402A.

[529] Sec. 402(g) and 414(v).

(that is, employer contributions made without regard to whether an employee makes elective deferrals, designated Roth contributions, or after-tax contributions).

The total contributions made to a qualified defined contribution plan on behalf of an employee for a plan year are subject to a limit of $53,000(for 2015), plus catch-up contributions as described above, if applicable, or, if less, the employee's compensation.[530]

Contributions to a qualified defined contribution plan for a plan year may be actually made to the plan and allocated to a participant's account after the end of the year. For example, employer contributions for a year may generally be made up to 8½ months after the end of the year.[531] Contributions made after the end of the year are taken into account in applying the limit for the plan year for which they are made, not the year when they are made.[532]

A qualified defined contribution plan may impose a vesting requirement under which an employee must perform service for a minimum number of years in order for the employee to have a nonforfeitable (or vested) right to employer matching or nonelective contributions allocated to the employee's account (and related earnings). In the case of a plan of a private employer, the portion of an employee's account balance attributable to employer contributions generally must become vested under one of two options: full vesting after three years of service or two-to-six-year graduated vesting under which a specified percentage is vested after each year of service in this period.[533]

A tax-deferred annuity plan (referred to as a "section 403(b)" plan) is generally similar to a qualified defined contribution plan, but may be maintained only by (1) tax-exempt charitable organizations,[534] and (2) educational institutions of State or local governments (that is, public schools, including colleges and universities).[535] Similar to a qualified defined contribution plan, a section 403(b) plan may provide for pretax elective deferrals, designated Roth contributions, after-tax employee contributions, employer matching contributions or employer nonelective contributions. An employee's right to contributions to a section 403(b) plan and related earnings must be fully vested at all times. The total contributions made to a section 403(b) plan on behalf of an employee for a year are generally subject to the same limit as total contributions to a

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[530] Sec. 415(c). Employee contributions to a defined benefit plan are also taken into account in applying this limit.

[531] Sec. 404(a)(6).

[532] Treas. Reg. sec. 1.415(c)-1(b)(6).

[533] Sec. 411(a)(2)(B) and sec. 203(a)(2)(B) of the Employee Retirement Income Security Act of 1974 ("ERISA"). Under the vesting rules, an employee's right to his or her after-tax employee contributions and related earnings must be fully vested at all times. Section 411 and ERISA generally do not apply to a plan maintained by a governmental entity or a church.

[534] These are organizations exempt from tax under section 501(c)(3).

[535] Sec. 403(b).

qualified defined contribution plan, that is, $53,000 (for 2015), plus catch-up contributions, if applicable, or, if less, the employee's compensation.

**Form W-2**

An employer is required to furnish each employee with a statement of the wages paid by the employer to the employee during the calendar year and the taxes withheld from such wages.[536] The statement, made on the Form W-2, generally must be provided to employees by January 31 of the succeeding year. Information from Form W-2 is also provided to the IRS.

Certain information relating to employer-sponsored retirement plans must also be reported on Form W-2, including whether the employee is an active participant in an employer-sponsored retirement plan and the amount of an employee's elective deferrals under a plan. The amount of employer matching or nonelective contributions to a defined contribution plan is not required to be reported on Form W-2. After-tax employee contributions (whether made to a defined contribution plan or a defined benefit plan) are included in taxable wages reported on Form W-2, but are not required to be separately stated.

**Benefit statements**

Under ERISA, the administrator of a defined contribution plan maintained by a private employer generally is required to provide a benefit statement to a participant (1) at least quarterly if the participant has the right to direct the investment of the assets in his or her account, and (2) at least annually to any other participant with an account under the plan.[537] The information provided on a benefit statement must include the participant's account balance and the vested portion of the account balance (or the earliest date on which vesting will occur).

Providing benefit statements at least annually is a common practice among defined contribution plans, even if not legally required under ERISA. In addition to a participant's account balance and the extent of vesting in the account balance, benefit statements often show the amount of contributions to the participant's account for the period covered by the benefit statement, as well as earnings on the account for that period.

## Description of Proposal

The proposal requires an employer to report the amounts contributed to an employee's account under a defined contribution plan on the employee's Form W-2.

Effective date.−The proposal is effective for information returns due for calendar years beginning after December 31, 2015.

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[536] Sec. 6051(a).

[537] Sec. 105 of ERISA.

The estimated budget effect of this proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.A.5, reprinted in the back of this volume.

## Analysis

Discussions of retirement savings often focus on employees' lack of understanding of both the amount of income they will need during retirement and whether they are saving enough to accumulate that amount by the time they retire.[538] By requiring information on employer contributions to defined contribution plans to be reported on Form W-2 (in addition to the current information on elective deferrals), the proposal seeks to provide employees with a better understanding of their overall retirement savings and compensation and to facilitate compliance with the annual limits on contributions to defined contribution plans.

Employer contributions are an important component of an employee's compensation, of which many employees are not fully aware. In some cases, therefore, the proposal will give employees a better understanding of the amount of their total compensation. However, practical issues may impede achievement of the goals of improving employee understanding of their retirement savings and facilitating compliance with the contribution limits.[539]

As discussed above, Form W-2 is provided on a calendar-year basis, generally by January 31 of the following year. However, employer contributions for the year may be made after that date, making it impossible to report them on Form W-2. In that case, the information provided on Form W-2 would be incomplete, possibly causing confusion for employees (for example, if expected matching contributions are not shown). Incomplete information also reduces the usefulness of the information for purposes of compliance with the limits on contributions to defined contribution plans. Moreover, although the proposal requires employer contributions to be reported on Form W-2, it does not require after-tax employee contributions (whether made to a defined contribution plan or a defined benefit plan) to be separately stated on Form W-2. Failure to reflect after-tax employee contributions, which are taken into account in applying the limits on contributions to defined contribution plans, reduces the compliance value of the reporting required under the proposal.

Alternatively, contributions could be reported on Form W-2 for the calendar year during which the contributions are actually made. However, under that approach, in many cases the amount shown would differ from the amount required to be taken into account for purposes of applying the limits on contributions. Moreover, a discrepancy between the amount reported on

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[538] These discussions sometimes occur in connection with the broader issue of lack of financial literacy.

[539] Reporting of employer contributions to defined contribution plans on Form W-2 may provide additional data with respect to tax-favored retirement savings that would be useful in the analysis of issues and proposals involving retirement savings and tax subsidies. However, the primary purpose of tax reporting requirements, which create additional administrative responsibility for the public and for the Internal Revenue Service, is increased tax compliance, not merely additional data.

Form W-2 and the amount shown on a benefit statement provided to an employee could also cause confusion for the employee.

Even if the proposal is implemented in a manner that avoids confusion as to what contributions are shown on Form W-2, the reported information will in many cases merely duplicate information already provided on a benefit statement (as discussed under present law). In addition, the proposal does not include a requirement that Form W-2 indicate the extent to which contributions are vested. Reporting nonvested contributions without identifying them as such could give employees a false understanding of their retirement savings, undermining the goal of increasing employees' understanding of their overall retirement savings.

The proposal would require changes to an employer's payroll system and possibly additional information-sharing between the payroll system and the administrator of the employer's defined contribution plan. This may increase the cost of maintaining the plan. The proposal would also involve some changes to the Government's processing of Forms W-2. The proposal does not discuss whether the related improvement in compliance with the limits on contributions to defined contribution plans justifies the administrative costs associated with the proposal.[540] In addition, the effective date of the proposal may not allow employers sufficient time for making the administrative changes needed to comply.

## B. Improve Compliance By Businesses

### 1. Increase certainty with respect to worker classification

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal (JCS-2-12), June 2012, pp. 591-610. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal (JCX-50-15), March 6, 2015, Item XVI.B.2, reprinted in the back of this volume.

### 2. Increase information sharing to administer excise taxes

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal (JCS-2-14), December 2014, pp. 201-202. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue

[540] See, for example, http://www.irs.gov/Retirement-Plans/Plan-Sponsor/Fix-It-Guides-Common-Problems-Real-Solutions, containing links to "fix-it guides" for different types of plans, with each guide including a list of the most frequent errors found in each plan type and tips on how to find, fix and avoid these mistakes. The fix-it guide for section 401(k) plans does not list failure to comply with the limits on contributions to defined contribution plans among the most frequent errors: http://www.irs.gov/Retirement-Plans/401(k)-Plan-Fix-It-Guide.

Provisions Contained in the President's Fiscal Year 2016 Budget Proposal (JCX-50-15), March 6, 2015, Item XVI.B.2, reprinted in the back of this volume.

### 3. Provide authority to readily share information about beneficial ownership of U.S. companies with law enforcement

The fiscal year 2016 budget proposal is substantially similar to an earlier proposal first offered for fiscal year 2015.[541] The proposal clarifies that U.S. entities includes entities formed in U.S. territories and information that is shared under the proposal is responsible party information. In additional to the four elements of the earlier proposal, the fiscal year 2016 proposal also includes both civil and criminal penalties. First, it imposes a $10,000 penalty for failure of a U.S. entity formed on or after the effective date to obtain an identifying number unless the entity had reasonable cause for the failure. The proposal also imposes a $100 penalty for failure to update information provided to the Secretary when applying for an identifying number. This penalty could also be waived for reasonable cause. The penalty is increased to $1,000 for intentional failures (such as a pattern of failing to update information). Under the proposal, the penalty for failure to update information is not imposed for the same calendar year in which the penalty for failure to obtain an identifying number is imposed. If the entity fails to pay either penalty within 60 days of notice and demand for payment of the penalty, any person who is or was a responsible party for the entity is jointly and severally liable for the penalty. The Secretary has broad authority to prescribe regulations necessary to carry out these provisions. Additionally, under the proposal, a willful failure to obtain an employer identification number ("EIN") for the purposes of hiding the existence of the entity or the identity of its responsible party, or evading or defeating tax, is a felony.

A description and analysis of the fiscal year 2015 proposal can be found in Joint Committee on Taxation, Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal (JCS-2-14), December 2014, at pages 191 to 200.

Effective date.−The proposal requiring that all U.S. entities obtain an EIN applies to all entities formed on or after 180 days after the date of enactment. Under the proposal, the Secretary has up to three years to implement the requirement that all U.S. entities obtain an EIN. The proposal imposing penalties applies to failures occurring after the date of enactment. The proposal permitting disclosures of information to law enforcement applies after the date of enactment.

The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal (JCX-50-15), March 6, 2015, Item XVI.B.3, reprinted in the back of this volume.

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[541] The fiscal year 2015 proposal is not included in the Department of the Treasury's *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*. However, it was included in the Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government for Fiscal Year 2015,* pp. 168-169.

## C. Strengthen Tax Administration

### 1. Impose liability on shareholders to collect unpaid income taxes of applicable corporations

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 203-205. That proposal modified a proposal from the fiscal year 2014 proposal, which is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 163-171. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.1, reprinted in the back of this volume.

### 2. Increase levy authority for payments to Medicare providers with delinquent tax debt

The President's fiscal year 2016 budget proposal was enacted subsequent to publication of the President's fiscal year 2016 budget.[542] Present law now allows the Secretary to levy up to 100 percent (increased from up to 30 percent) of a payment to Medicare providers and suppliers to collect unpaid taxes, effective for payments made after 180 days after the date of enactment. At the time the proposal was published, payments to Medicare providers and suppliers were subject to levy of only up to 15 percent, which was scheduled to increase to up to 30 percent for payments made 180 days after the date of enactment.[543] The 2016 budget proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of this proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 734-737. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.2, reprinted in the back of this volume.

### 3. Implement a program integrity statutory cap adjustment for tax administration

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 205-206. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.3, reprinted in the back of this volume.

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[542] Medicare Access and CHIP Reauthorization Act of 2015, Pub. L. No. 114-10, sec. 413, April 16, 2015.

[543] Tax Increase Prevention Act of 2014, Pub. L. No. 113-295, sec. 209, December 19, 2014.

## 4. Streamline audit and adjustment procedures for large partnerships

### Present Law

### General framework for partnership audit rules

There are three sets of rules for tax audits of partners and partnerships. First, for partnerships with more than 100 partners and that so elect, the electing large partnership audit rules enacted in 1997 apply.[544] Relatively few partnerships have made this election. Second, for partnerships with more than 10 partners (and that are not electing large partnerships), the TEFRA partnership audit rules enacted in 1982 apply.[545] Under these two sets of rules, partnership items generally are determined at the partnership level under unified audit procedures. Third, for partnerships with 10 or fewer partners that have not elected the TEFRA audit rules, audit rules applicable generally to taxpayers subject to the Federal income tax apply.[546]

For the partnership with few partners that does not elect to be governed by TEFRA rules,[547] the tax treatment of an adjustment to a partnership's items of income, gain, loss, deduction, or credit is determined for each partner in separate proceedings, both administrative and judicial. In the case of a partnership with partners located in different audit districts, adjustments to items of income, gains, losses, deductions, or credits of the partnership are made in separate actions for each partner, possibly in separate jurisdictions. Prior to the 1982 enactment of TEFRA, these had been the rules for all partnership audits, regardless of the number of partners.

### TEFRA partnership audit rules

#### Unified audit rules

TEFRA established unified audit rules. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.[548] The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve issues with respect to all partners.

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[544] Secs. 6240-6256.

[545] Secs. 6221-6234. TEFRA refers to the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248), in which these audit rules were enacted.

[546] Secs. 6231 and 6201 *et seq*.

[547] Prior to 1982, these rules applied regardless of the number of partners in the partnership.

[548] Sec. 6231(a)(3). Any item that is affected by a partnership item (for example, on the partner's return) is an "affected item." Affected items of a partner are subject to determination at the partner level. Sec. 6231(a)(5).

The rationale stated in 1982 for adding new audit rules for partnerships was that "[d]etermination of the tax liability of partners resulted in administrative problems under prior law due to the fragmented nature of such determinations. These problems became excessively burdensome as partnership syndications have developed and grown in recent years. Large partnerships with partners in many audit jurisdictions result in the statute of limitations expiring with respect to some partners while other partners are required to pay additional taxes. Where there are tiered partnerships, identifying the taxpayer is difficult."[549]

The TEFRA rules do not, however, change the process for collecting deficiencies at the partner (not the partnership) level, though a settlement agreement with respect to partnership items binds all parties to the settlement.[550]

Tax Matters Partner

The TEFRA rules establish the Tax Matters Partner as the primary representative of a partnership in dealings with the IRS. The Tax Matters Partner is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no Tax Matters Partner is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the Tax Matters Partner.

Notice requirements: notice required to partners separately

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than one percent.

Partners must report items consistently with the partnership

Partners are required to report partnership items consistently with the partnership's reporting, unless the partner notifies the IRS of inconsistent treatment. If a partner fails to notify the IRS of inconsistent treatment, the IRS can assess that partner under its math error authority. That is, the IRS may make a computational adjustment and immediately assess any additional

[549] See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), December 31, 1982, p. 268. Additional reasons for the 1982 change mentioned include the problems of duplication of administrative and judicial effort, inconsistent results, difficulty of reaching settlement, and inadequacy of prior-law filing and recordkeeping requirements for foreign partnerships with U.S. partners.

[550] Sec. 6224(c). The IRS has set forth procedures for entering into such partnership audit settlement agreements, which are summarized in Part F of Chief Counsel Notice 2009-27, "Frequently Asked Questions Regarding The Unified Partnership Audit And Litigation Procedures Set Forth In Sections 6221-6234," IRS CC Notice 2009-027, August 21, 2009.

tax that results.[551] Additional tax attributable to an adjustment of a partnership item is assessed against each of the taxpayers who were partners in the year in which the understatement of tax liability arose.

Partners' limited ability to challenge partnership treatment

Partners have rights to participate in administrative proceedings at the partnership level, and can request an administrative adjustment or a refund for the partner's own separate tax liability. To the extent that a settlement is reached with respect to partnership items, all partners are entitled to consistent treatment. [552]

Statute of limitations

Absent an agreement to extend the statute of limitations, the IRS generally cannot adjust a partnership item for a partnership taxable year if more than three years have elapsed since the later of the filing of the partnership return, or the last day for the filing of the partnership return (without extensions). The statute of limitations is extended in specified circumstances such as in the case of a false return, a substantial omission of income, or no return.

One year to assess

If the administrative adjustment is timely made within the limitations period described above, the tax resulting from that adjustment, as well as tax attributable to affected items, including related penalties or additions to tax, must be assessed against the partners within one year after the conclusion of the period during which a final partnership administrative adjustment may be the subject of a petition to U.S. Tax Court.[553]

Adjudication of disputes concerning partnership items

After the IRS makes an administrative adjustment, the Tax Matters Partner (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Court of Federal Claims.

**Electing large partnership audit rules**

Definition of electing large partnership

In 1997, a new audit system was enacted for electing large partnerships.[554] The 1997 legislation also enacted specific simplified reporting rules for electing large partnerships.[555] The

[551] Secs. 6222 and 6230(b).

[552] Sec. 6224.

[553] Sec. 6229(d) and (g).

[554] The Taxpayer Relief Act of 1997, Pub. L. No. 105-34.

provisions define an electing large partnership as any partnership that elects to be subject to the specified reporting and audit rules, if the number of partners in the partnership's preceding taxable year is 100 or more.[556]

The rationale stated in 1997 for adding new audit rules for large partnerships was that "[a]udit procedures for large partnerships are inefficient and more complex than those for other large entities. The IRS must assess any deficiency arising from a partnership audit against a large number of partners, many of whom cannot easily be located and some of whom are no longer partners. In addition, audit procedures are cumbersome and can be complicated further by the intervention of partners acting individually."[557]

Unified audit rules

As under the TEFRA partnership audit rules, electing large partnerships and their partners are subject to unified audit rules. Thus, the tax treatment of partnership items is determined at the partnership, rather than the partner, level.

Partnership representative

Each electing large partnership is required to designate a partner or other person to act on its behalf. If an electing large partnership fails to designate such a person, the IRS is permitted to designate any one of the partners as the person authorized to act on the partnership's behalf. After the IRS's designation, an electing large partnership may still designate a replacement for the IRS-designated partner.

Notice requirements: separate partner notices not required

Unlike the TEFRA partnership audit rules, the IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS is authorized to send notice of a partnership adjustment to the partnership itself by certified or registered mail. The IRS may give proper notice by mailing the notice to the last known address of the partnership, even if the partnership had terminated its existence.

Partners must report items consistently with the partnership

Under the electing large partnership audit rules, a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS

[555] Secs. 771-777.

[556] Sec. 775.

[557] See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, p. 363.

of the inconsistency. The IRS may adjust a partnership item that was reported inconsistently by a partner and immediately assess any additional tax without first auditing the partnership.[558]

Adjustments flow through to persons that are partners in the adjustment year

Unlike the TEFRA partnership audit rules, partnership adjustments generally flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners' share of current-year partnership items of income, gains, losses, deductions, or credits are adjusted to reflect partnership adjustments that take effect in that year. The adjustments generally do not affect prior-year returns of any partners (except in the case of changes to any partner's distributive shares).

Partnership-level payment of underpayment permitted

In lieu of passing through an adjustment to its partners, the partnership may elect to pay an imputed underpayment. The imputed underpayment generally is calculated by netting the adjustments to the income and loss items of the partnership and multiplying that amount by the highest tax rate (whether individual or corporate). A partner may not file a claim for credit or refund of his allocable share of the payment. A partnership may make this election only if it meets requirements set forth in Treasury regulations designed to ensure payment (for example, in the case of a foreign partnership).

Regardless of whether a partnership adjustment passes through to the partners, an adjustment must be offset if it requires another adjustment in a year that is after the adjusted year and before the year the adjustment that was takes effect.

For example, assume that an electing large partnership expenses a $1,000 item in year one. However, on audit in year four, it is determined that the item should have been capitalized and amortized ratably over 10 years rather than deducted in full in year one. The $900 adjustment for the improper deduction ($1,000 minus the year one amortization of $100) is offset by $200 of adjustments for amortization deductions in years two and three. The adjustment in year four is $700 (that is, $1,000 minus $300, the sum of the first three years' ratable amortization of $100 per year), apart from any interest or penalty. The year four partners are required to include an additional $700 in income for that year. The partnership ratably amortizes the $700 in years four to 10.

Partnership, not partners separately, are liable for any penalties and interest

The partnership, rather than the partners individually, generally is liable for any interest and penalties that result from a partnership adjustment. Interest is computed for the period beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment. Thus, in the above example, the partnership is liable for four years' worth of interest (on a declining principal amount).

[558] Sec. 6241(b).

Penalties (such as the accuracy and fraud penalties) are determined on a year-by-year basis (without offsets) based on an imputed underpayment. All accuracy penalty criteria and waiver criteria (such as reasonable cause or substantial authority) are determined as if the partnership were a taxable individual. Accuracy and fraud penalties are assessed and accrue interest in the same manner as if asserted against a taxable individual.

Any payment (for Federal income taxes, interest, or penalties) that an electing large partnership is required to make is nondeductible.

If a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to take the adjustment into account, as provided by regulations. Regulations are also authorized to prevent abuse and to enforce efficiently the audit rules in circumstances that present special enforcement considerations (such as partnership bankruptcy).

Partners cannot request refunds separately

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike the TEFRA partnership audit rules, however, partners have no right individually to participate in settlement conferences or to request a refund.

Timing of K-1s to partners

An electing large partnership is required to furnish copies of information returns (Schedule K-1, Partner's Share of Income, Deductions, Credits, etc.) to partners by March 15 following the close of the partnership's taxable year (often a calendar year).[559] This differs from the timing rule applicable to other partnerships, which are required to furnish copies of Schedule K-1 to partners on or before the day on which the partnership return for the taxable year is required to be filed. This is generally the 15th day of the fourth month after the end of the partnership taxable year. For a partnership with a taxable year that is the calendar year, for example, the partnership return due date and the date by which Schedules K-1 must be furnished to partners is April 15. However, such a partnership can request a five-month extension of time to file the partnership return and the Schedule K-1 (to September 15 in the foregoing example).[560]

Statute of limitations

Absent an agreement to extend the statute of limitations, the IRS generally cannot adjust a partnership item for a partnership taxable year if more than three years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return. The statute of limitations is extended in specified circumstances such as in the case of a false return, a substantial omission of income, or no return.

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[559] Sec. 6031(b).

[560] Sec. 6031(b), and see Department of the Treasury, Internal Revenue Service, *2011 Instructions for Form 1065, U.S. Return of Partnership Income*, p. 3.

Adjudication of disputes concerning partnership items

As under the TEFRA partnership audit rules, an administrative adjustment can be challenged in the Tax Court, the district court in which the partnership's principal place of business is located, or the Court of Federal Claims. However, only the partnership, and not partners individually, can petition for a readjustment of partnership items.

If a petition for readjustment of partnership items is filed by the partnership, the court with which the petition is filed has jurisdiction to determine the tax treatment of all partnership items of the partnership for the partnership taxable year to which the notice of partnership adjustment relates, and the proper allocation of such items among the partners. Thus, the court's jurisdiction is not limited to the items adjusted in the notice.

## Description of Proposal

### Scope

The proposal repeals both the TEFRA partnership audit rules (enacted in 1982) and the electing large partnership audit and reporting rules (enacted in 1997).

In lieu of those regimes, the proposal sets forth new audit rules that apply to any partnership that has 100 or more direct partners, or that has at least one partner that is a passthrough partner.

For this purpose, a passthrough partner means a partner that is, itself, a partnership, estate, trust, S corporation, nominee, or similar person. The determination of whether a partnership has 100 or more partners or has a passthrough partner and therefore comes within the new audit rules is made for the taxable year to which the adjustment relates (not the year of the audit). A partnership subject to the new audit rules because it has at least one passthrough partner can elect out of the new audit rules if the total number of direct and indirect partners is less than 100 for the year to which the adjustment relates.

The proposal does not specify whether reporting is required with respect to the number of partners or the number of indirect partners through a passthrough partner, although regulatory authority is provided.

### Retention of generally applicable deficiency rules for partners of other partnerships

In the case of a partner of any other partnership, the applicable audit rules are the deficiency rules that apply generally to taxpayers subject to the Federal income tax. As under present law, adjustments to items of income, gains, losses, deductions, or credits of the partnership are made in separate actions for each such partner. The proposal does not provide for such partnerships to elect into the proposed partnership-level audit rules.

### Audit at partnership level

The proposed audit rules provide for partnership-level audit. Any adjustment is made at the partnership level. Adjustments flow through to those partners that held partnership interests

in the year to which the adjustment relates (not those partners who hold interests in the year the audit takes place and the adjustments are determined).

**Assessment and collection at partner level**

Additional tax due as a result of the adjustment flows through to the direct partners in the year to which the adjustment relates. The mechanism for flow through is not specified in the proposal. However, the proposal provides that additional tax due as a result of the adjustment is assessed and collected from the direct partners (not the partnership). The amount of the tax is assessed based on the direct partners' ownership interest in the partnership for the year to which the adjustment relates.

Passthrough partners, however, must pay the tax on behalf of their partners (the indirect partners of the audited partnership). A 180-day period is provided for the passthrough partners to challenge the assessment based on the tax attributes of their partners, direct and indirect, for the year to which the adjustments relate.

**Notice to partners eliminated**

The proposal eliminates the present-law requirement that the IRS provide notice to partners of the beginning of an administrative proceeding or of an adjustment. Thus, unlike present law, under the proposed audit rules, whether a partner has a less than one percent interest in the partnership is not relevant.

**Notice to authorized person required**

Rather, under the proposed audit rules, the IRS notifies the partnership of partnership adjustments. Only the partnership can participate in the audit through an authorized person; the partners do not participate. An authorized person is a U.S. individual who is designated by the partnership to act on its behalf and is identified on the partnership's tax return. The proposal does not specify that the person must be a partner. If a partnership fails to designate an appropriate person, the IRS may designate a person to act on behalf of the partnership under regulations contemplated by the proposal. The proposal is not specific about whether the IRS may designate any person, or whether the person must be a U.S. individual or is otherwise restricted.

**Refund requests made at partnership level**

Similarly, only the partnership may request a refund; partners do not participate in this partnership-level proceeding. It is understood that the delivery of a refund is made to the partnership, and that any allocation of the refund to a partner is treated as a distribution to the partner to be reflected on the Schedule K-1. By contrast to the proposed assessment and collection process following an audit, the proposal does not require the IRS to deliver refunds separately to direct partners and to any passthrough partner on behalf of its direct and indirect partners.

**Consistent reporting requirement retained**

Partners are required to report partnership items consistently with the partnership's reporting, unless the partner notifies the IRS of inconsistent treatment. If a partner fails to notify the IRS of inconsistent treatment, the IRS has authority to assess a computational adjustment (as under the present-law TEFRA rules). However, if the partner notifies the IRS of the inconsistent position, the proposal provides that for the IRS to audit the partner, the IRS must also audit the partnership.[561]

**Regulatory authority**

In addition to authority for guidance necessary and appropriate to carry out the purposes of the proposal, specific regulatory authority is provided to (1) designate a an authorized person to act on behalf of the partnership including when the partnership fails to do so, (2) ensure that taxpayers do not transfer partnership interest with a principal purpose of utilizing the proposed audit rules to alter the taxpayers' aggregate tax liability, (3) address foreign passthrough partners including treating them as a partnership subject to the proposed audit rules, and (4) provide rules for passthrough partners to challenge an assessment.

Effective date.−The proposal is effective for partnership taxable years ending on or after the date that is two years from the date of enactment.

This proposal modifies a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 616-626. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.4, reprinted in the back of this volume.

## Analysis

**In general**

The stated rationale for the proposal is that "… few large partnerships have elected into the ELP regime. In addition, there has been substantial growth in the number and complexity of large partnerships, magnifying the difficulty of auditing large partnerships under TEFRA partnership procedures."

The changes to be made under the proposal are directed at several of the difficulties of the present-law TEFRA rules for auditing and resolving the tax treatment of partnership items. Difficulties arise under present law in the case of partnerships with a great number of partners or

[561] This approach differs from the present-law electing large partnership audit rules, under which the IRS may adjust a partnership item that was reported inconsistently by a partner and immediately assess any additional tax, whether or not the partner notifies the IRS of the inconsistency, and without first auditing the partnership.

in the case of tiered partnerships or partnerships with other types of passthrough partners. A principal challenge in these circumstances is finding all the partners so that required notice of the beginning of an examination can be given, and tax can be assessed and collected or refunds delivered. A related question is the cost effectiveness of collecting a tiny amount from each one of numerous partners or of delivering a refund of a miniscule portion of a partnership item to each of many partners. A further difficulty for the government is obtaining the necessary information for assessment within the one-year time limit established by the TEFRA audit rules. For taxpayers, participation in partnership level audit proceedings by minority partners, though permitted under TEFRA rules, may prove cumbersome and possibly contentious, as the Tax Matters Partner must also be a partner but may have opposing interests. Further, several of the defined terms and requirements imposed under the TEFRA rules give rise to largely procedural disputes that could be characterized as inefficient, such as whether an item is a partnership item or whether the a person designated as Tax Matters Partner meets qualification requirements and can sign an extension of the statute of limitations.

The proposal differs from the TEFRA audit rules in several key respects. A principal change is to provide that audits and refund requests are conducted at the partnership level without partner involvement (other than the authorized partnership representative). The proposal eliminates the TEFRA requirement that the IRS notify partners separately. The proposal also treats passthrough partners (such as other partnerships) in the audited partnership differently from direct partners.

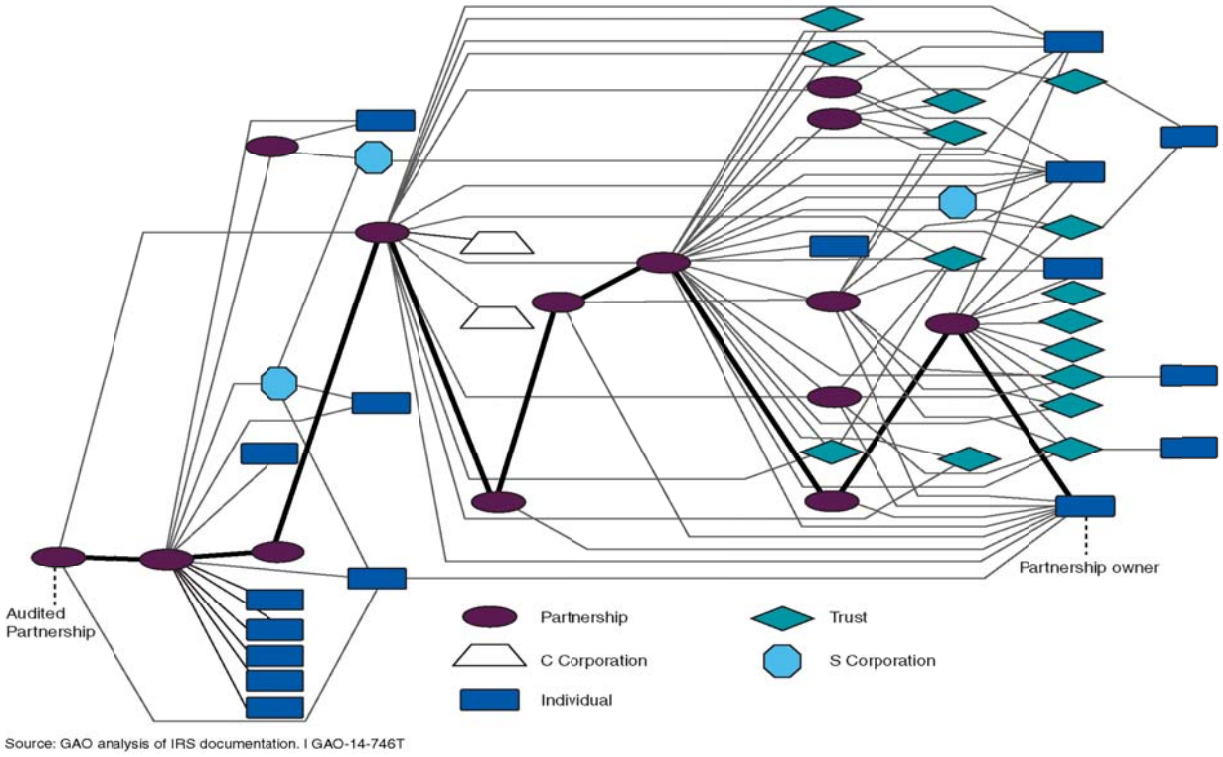
However, the proposal resembles the TEFRA rules in that it retains the approach that assessment and collection is made from each partner rather than from the partnership, at least in the case of direct partners. The proposal further resembles the TEFRA rules (and differs from the electing large partnership rules) in that assessment and collection is from partners in the year to which the adjustment relates, not the partners in the year when the audit takes effect. The rules of present law are retained with respect to judicial review of the audit proceeding. Overall, the proposal incorporates some elements of both the TEFRA rules and the electing large partnership rules of present law, and adds several new elements.

**Partnerships with numerous partners, and tiered partnerships**

Assessment, collection, and refunds

Recent GAO testimony on the topic of partnership audits before a Congressional committee illustrates the complex structures of tiered partnerships used in today's business arrangements. The testimony states that the number of large partnerships tripled from tax year 2002 to 2011; that in 2011, there were more than 10,000 large partnerships; and that the IRS has

difficulty auditing large partnerships.[562] The testimony provides a diagram illustrating the complexity of a tiered partnership structure:[563]




The proposal addresses a core challenge under the partnership audit rules today -- identifying all the direct and indirect partners -- by conducting more of the administrative process at the partnership level, not the partner level. Notice of the beginning of an administrative proceeding and notice of an adjustment is made to the partnership, not to partners; refund requests can be made only by the partnership without partner participation, and refunds are issued to the partnership itself; auditing a partner who takes a position inconsistent with the partnership's position is allowed only if the partnership is also audited; and passthrough partners are assessed on behalf of their partners, obviating the need for the government to assess and collect from those indirect partners.

It can be argued that these changes will make the audit process more efficient and cost-effective. For example, the notice to partners under present law generally must be sent to their addresses shown on the partnership return for the year under review, which may be out of date, so the notice could be ineffectual under present law. Rather than changing the way the partner notice requirement works, the proposal eliminates it in favor of a simpler partnership notice,

[562] Testimony before the U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs of James R White, U.S. Government Accountability Office, "Large Partnerships: Growing Population and Complexity Hinder Effective IRS Audits," GAO-14-746T, July 22, 2014, page 6. Large partnerships are defined for this purpose as those with 1,000 or more direct and indirect partners.

[563] Figure 3, Example of Partnership Structure, *ibid.*, page 9.

allowing for more timely initiation and completion of examinations. One possible result may be that the partnership might voluntarily take on the role of notifying partners of an audit, doing so possibly more efficiently than the IRS. Opponents, however, might point to potential difficulties for partners, who (if not notified by the partnership) might be still more likely than under the TEFRA rules to first hear of a deficiency when they receive a notice of assessment from the IRS after the conclusion of the partnership level audit. Further, just as under present law, minority partners may be likely to have interests adverse to the designated partnership representative.

Rules permitting the assessment of deficiencies and the delivery of refunds at the partnership level apply only at the election of the partnership (an electing large partnership) under present law. The IRS cannot choose to invoke these rules; only a partnership can elect them. The proposal, by contrast, takes a mandatory rather than an elective approach to assessment and collection at the partnership level. The mandatory approach could be considered as simplifying both for taxpayers and for the government in that it removes a contingency or uncertainty of present law.

However, to collect a deficiency under the proposal, the government must still seek out persons that were direct partners in the audited year, and collect tax from them. Only in the case of passthrough partners does the government not need to find ultimate, taxpaying partners, but rather may collect from the partner that is a passthrough entity under the proposal.[564] The proposal could be criticized for failing to fully address the problem of collecting from numerous partners. A significant inefficiency of the TEFRA rules remains under the proposal, in which a tiny amount must be assessed against and collected from each of hundreds or thousands, even tens of thousands, of direct partners. The mechanism for avoiding this collection problem does not differ from the one used under present law: a settlement agreement at the partnership level. In this situation, collection may be resolved by agreement between the partnership and the IRS that the partnership will pay in lieu of the partners paying.

Further, one might question why it is appropriate to collect from passthrough partners − which may themselves be partnerships − yet not to collect from the audited partnership under the proposal. If a mechanism for collecting from partnerships is developed, arguably it could apply to the audited partnership itself. Similarly, refunds are made to the partnership rather than to partners (whether they are direct or indirect partners) under the proposal. If refunds can be made at the partnership level, the asymmetry and potential administrative difficulty of collecting tax from numerous direct partners is further highlighted.

The proposal also does not adopt the currently elective rule that assessment is made with respect to the partners in the adjustment year (not the partners in the reviewed year). Because the proposal retains the TEFRA rule of assessment and collection at the partner level in the case of direct partners, arguably, little efficiency would be gained and additional abuse potential could be introduced if the proposal were to provide for assessment only with respect to adjustment year

[564] Presumably the passthrough partner could in turn adjust its partners' shares of overall partnership income or loss to reflect the assessed amount. This approach to collection is applied to the audited partnership itself in H.R. 1, the "Tax Reform Act of 2014," discussed further below.

partners. As a comparison, H. R. 1 (113th Congress), the "Tax Reform Act of 2104," introduced December 10, 2014, by then-Chairman of the Ways and Means Committee Dave Camp, proposes to make both changes, that is, both to assess and collect at the partnership level (rather than the partner level), as well as to pass the adjustment through to adjustment year partners, not to partners in the reviewed year. Under H.R. 1, the partnership must pay any imputed underpayment. Similarly, under H.R. 1, refunds are managed at the partnership level: a positive adjustment is treated by the partnership as a reduction in non-separately stated income (or an increase in non-separately stated loss) and these adjustments are taken into account by the partners in the adjustment year. Thus, the H.R. 1 approach addresses the issue of assessment and collection from numerous partners by shifting assessment and collection fully to the partnership level. This approach may improve the efficiency of partnership audits, collection of underpayments, and distribution of refunds. Critics could argue, however, that the rights of minority partners are reduced under the H.R. 1 approach, or that abuse opportunities for shifting tax liability to later-year tax-indifferent partners are increased. However, these concerns may be addressed by complementary provisions of H.R. 1 providing for (1) administrative modification of an imputed underpayment if some or all of the partners in the reviewed year file amended returns and pay any tax due and (2) joint and several liability of any partner and the partnership. These provisions are not included in the President's proposal. These H.R. 1 provisions may encourage indemnity agreements among buying and selling partners, so that the pricing of partnership interests is more likely to take into account potential tax adjustments giving rise to deferred tax liability or future tax refunds associated with the partnership interests.

Partnerships subject to the proposal

The proposal applies the partnership level audit rules to any partnership that has 100 or more direct partners, or that has at least one partner that is a passthrough partner, for the reviewed year. Partnerships with at least one passthrough partner can elect out if the total number of direct and indirect partners is less than 100 for the reviewed year. The proposal does not specifically provide a rule to elect in. Thus, under the proposal, partners in partnerships with fewer than 100 direct partners are always subject to separate audits under deficiency proceedings. Partnerships with fewer than 100 direct and indirect partners can choose whether their partners are to be subject to separate audits under deficiency proceedings.

By contrast, under the TEFRA rules, partnership level audit rules apply to partnerships with more than 10 partners; partnerships with 10 or fewer partners may elect in.

The effect is that under the proposal, the general deficiency rules are mandatory for partners of partnerships with fewer than 100 partners, even though today, these partnerships fall within the TEFRA unified partnership audit rules (either mandatorily, or by electing in). As under the law prior to the 1982 enactment of TEFRA, in the case of such a partnership with partners located in different audit districts, adjustments to items of income, gains, losses, deductions, or credits of the partnership are made in separate actions for each partner, possibly in separate jurisdictions and with potentially inconsistent results. If unified audit rules for partnerships are considered more efficient for taxpayers and the government, then the proposal could be criticized for excluding partners of partnerships that are included in unified audit proceedings under present law and that could benefit from this efficiency. Either allowing small partnerships (*i.e.*, those with fewer than 100 direct partners and no indirect partners) to elect in,

or applying the proposal to all partnerships and allowing some category of small partnerships to elect out, might be preferable to excluding them entirely.

For further comparison, the H.R. 1 partnership audit proposal has a broader scope than the TEFRA rules, in that it applies to all partnerships that do not elect out. A partnership may elect out for a taxable year if it has 100 or fewer partners, none of which is itself a partnership, and each of which is (or if domestic would be) a taxable person (individual, estate, taxable C corporation, or foreign entity that would be taxed as a C corporation if domestic). As another comparison, the President's fiscal year 2013 budget proposal included a narrower proposal applying (on a mandatory basis) the present-law electing larger partnership rules to very large partnerships, that is, those with more than 1,000 direct or indirect partners. A partnership with 100 or more partners may elect in. The fiscal year 2013 budget proposal did not repeal the TEFRA and electing large partnership rules. The fiscal year 2013 budget proposal included a reporting requirement for purposes of ascertaining whether a partnership has 1,000 or more direct and indirect partners. Although the current proposal does not specifically mention an information reporting requirement for purposes of ascertaining whether a partnership has 100 or more direct and indirect partners, it could be assumed that some form of reporting may be needed.

**Designating the authorized person**

The proposal modifies the present-law rules for the designation of a Tax Matters Partner, who must be a partner under the TEFRA rules. If the Tax Matters Partner designation does not meet requirements, a settlement agreement executed by the Tax Matters Partner potentially may not bind the partners. The proposal eliminates time-consuming procedural issues under present law by providing that the partnership may designate any U.S. person as an authorized person (new term for the Tax Matters Partner function), and the IRS may also designate the authorized person if the partnership does not. Critics may argue that the authorized person should be a partner and have knowledge of the partnership's affairs, and that allowing a nonpartner to be the authorized person could be overly broad. On the other hand, persons who are not partners, but rather, have professional expertise in managing partnership audits might serve the partnership and its partners with respect to the audit and litigation process, perhaps better than a partner with little or no knowledge of the process. Further, a partner as authorized person may have interests counter to other partners and may not represent them as impartially as an independent representative. Nothing in the proposal prevents a partner from being authorized person. The proposal's restriction against foreign persons serving as authorized representative arguably quashes potential attempts to avoid U.S. jurisdiction to audit or litigate the issues.

**Other definitional and procedural issues**

The proposal would have the effect of eliminating pieces or aspects of the TEFRA rules that have proved complex or inefficient in application. For example, failure to provide required notice to partners under present law can cause partnership items to become nonpartnership items in some circumstances, or the notice may be merely ineffectual if the partner has moved since the reviewed year. The proposal's elimination of the partner notice requirement, as described above, arguably improves the efficiency of partnership audits and subsequent judicial review.

There are other areas of the TEFRA rules where procedural bottlenecks can arise. One involves the determination of whether an item is a partnership item to be addressed in the partnership audit, or an item that is to be addressed in a separate proceeding only with respect to the partner. Whether a determination that an entity is a partnership is a partnership item (subject to TEFRA rules), or not, has been the subject of litigation, for example. The proposal does not explicitly address the definition of a partnership item or the need for the concept.

The proposal does not make specific changes with respect to the three-year statute of limitations on adjustments nor with respect to the one-year time limit on assessments under present law. Specifically, present law requires tax, penalties, interest and additions to tax to be assessed against the partners within one year after the conclusion of the 90-day period during which a final partnership administrative adjustment may be the subject of a petition to U.S. Tax Court. Because the proposal requires assessment against direct partners (including passthrough partners that are direct partners), arguably any difficulties in meeting the one-year deadline have been alleviated only to the extent they arise from finding and assessing indirect partners -- that is, those who hold interests, directly or indirectly, in passthrough entities that are partners in the audited partnership. For example, assume an audited partnership has 100 partners, 40 of which are partnerships with 50 partners each (at least 2,000 indirect partners). Only 100 notices of assessment must be issued because the proposal provides for assessment and collection from direct partners (such as individuals and corporations) and passthrough entities even though they may not themselves be taxpayers (such as partnerships). The proposal does not, however, address difficulties in meeting the one-year time limit if the partnership has numerous direct partners, for example, 1,000 partners, or 50,000 partners, some of which are passthrough entities and the rest of which are direct partners. In these cases, the IRS would have to issue 1,000 or 50,000 notices of assessment with respect to partners in the reviewed year, some of which may no longer be partners. Arguably, the proposal only partially addresses the core problem of finding partners for assessment and collection, and does not specifically address issues relating to the one-year period for assessment.

This proposal modifies a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 616-626. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.4, reprinted in the back of this volume.

**5. Revise offer-in-compromise application rules**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 626-631. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.5, reprinted in the back of this volume.

**6. Expand IRS access to information in the National Directory of New Hires for tax administration purposes**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 631-632. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.6, reprinted in the back of this volume.

**7. Make repeated willful failure to file a tax return a felony**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 633-635. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.7, reprinted in the back of this volume.

**8. Facilitate tax compliance with local jurisdictions**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 635-637. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.8, reprinted in the back of this volume.

**9. Extend statute of limitations for assessment for overstated basis and State adjustments**

This proposal combines two separate proposals into a single proposal, as described below. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.9, reprinted in the back of this volume.

The first proposal extends the limitations period for basis overstatements. For a description of that proposal, see below. The second proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 637-640.

## Present Law

Taxes are generally required to be assessed within three years after a taxpayer's return is filed, whether or not it was timely filed.[565] There are several circumstances under which the general three-year limitations period does not begin to run. If no return is filed,[566] if a false or fraudulent return with the intent to evade tax is filed, if private foundation status is terminated, or a gift tax for certain gifts is not properly disclosed, the tax may be assessed, or a proceeding in court for collection of such tax may commence without assessment, at any time.[567]

Other exceptions to the general rule result in an extension of the limitations period otherwise applicable. For example, the limitation period may be extended by taxpayer consent.[568] Failure to disclose or report certain information may also result in extensions of the statute of limitations. For example, failure to disclose a listed transaction as required under section 6011 on any return or statement for a taxable year will result in an extension that ensures that the limitations period remains open for at least one year from the date the requisite information is provided. The limitation period with respect to such transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is provided the information so required, or (2) the date that a "material advisor" (as defined in section 6111) makes its section 6112(a) list available for inspection pursuant to a request by the Secretary under section 6112(b)(1)(A).[569] In addition to the exceptions described above, there are also circumstances under which the three-year limitations period is suspended.[570]

A separate limitations period of six years from the date a return is filed is established for substantial omissions of items from gross income. An omission from gross income is substantial if the omission exceeds 25 percent of the gross income reported on the return or if the amount omitted exceeds $5,000 and is attributable to a foreign financial asset within the meaning of section 6038D (without regard to dollar thresholds and regulatory exceptions to reporting based on existence of duplicative disclosure requirements).[571] Amounts that are disclosed on a return, even if not reflected in the amount recorded as gross income, are generally not considered to

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[565] Sec. 6501(a). Returns that are filed before the date they are due are deemed filed on the due date. See sec. 6501(b)(1) and (2).

[566] Sec. 6501(c)(3).

[567] Sec. 6501(c)(1) and (2).

[568] Sec. 6501(c)(4).

[569] Sec. 6501(c)(10).

[570] For example, service of an administrative summons triggers the suspension either (1) beginning six months after service (in the case of John Doe summonses) or (2) when a proceeding to quash a summons is initiated by a taxpayer named in a summons to a third-party record-keeper. Judicial proceedings initiated by the government to enforce a summons generally do not suspend the limitation period.

[571] Sec. 6501(e)(1). Similar six year limitations periods are established for estate and gift taxes as well as excise taxes, based on 25 percent omissions from items required to be reported on the relevant tax returns. See secs. 6501(e)(2) and 6501(e)(3).

have been omitted for purposes of determining whether the 25 percent threshold was exceeded. For a trade or business, the threshold for determining a substantial omission is 25 percent of the gross receipts. For all others, an amount is considered to have been disclosed on a return if it is presented in a manner that is "adequate to apprise the Secretary of the nature and amount of such item."[572] An overstatement of basis that contributes to an understatement of income due is not itself considered to be an omission of income, without regard to whether the return reveals the computation of basis.[573]

## Description of Proposal

In determining whether an amount greater than 25 percent of gross income was omitted from a return, the proposal provides that an understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission of gross income, without regard to whether or not the amount of unrecovered cost or basis claimed is disclosed on the return.

Effective date.−The proposal applies to returns required to be filed after December 31, 2015.

## Analysis

As the Supreme Court noted, "Congress has regarded it as ill-advised, to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values, and recall details of all that goes into an income tax contest. Hence, a statute of limitation is an almost indispensible element of fairness as well as of practical administration of an income tax policy."[574] Based on this strong policy interest in permitting finality with respect to tax periods, the exceptions to the general three-year statute of limitations are relatively few and the burden of proving that an exception applies rests with the government to overcome the bar on assessment. These exceptions are predicated on the theory that the statute of limitations should not run in cases of taxpayer misconduct or lack of candor or if the failure to identify an issue was due to factors outside the control of either the taxpayer or the government. For example, there is no statute of limitations in the case of a false or fraudulent return. In that case, the taxpayer who has filed a fraudulent return with intent to evade tax hardly is in a position to complain of the fairness of a rule that facilitates the IRS's collection of the tax due. Similarly, in cases in which a taxpayer has omitted substantial items of income, the IRS is provided with an additional three years to make an assessment.

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[572] Sec. 6501(e)(1)(B).

[573] *Home Concrete & Supply, LLC. v. United States*, 132 S. Ct. 1836; 182 L. Ed. 2d 746 (2012). In deciding in favor of the taxpayer, the Supreme Court followed its interpretation of the word "omits" in a predecessor to section 6501. See, *The Colony Inc., v. Commissioner*, 357 U.S. 28 (1958). Having previously interpreted an unambiguous term in the statute, the Court held that a contrary interpretation by the Secretary in Treas. Reg. sec. 301.6501(e)-1 was invalid.

[574] *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 300 (1946).

Proponents of the proposal would argue that an overstatement of basis that contributes to an understatement of income due should be considered to be within the scope of an omission of income in order for the six year statute of limitations statute to work as intended. As with other exceptions to the general three-year statute of limitations, proponents would argue the exception in this case reflects an appropriate balance between providing certainty to taxpayers by allowing limitations periods to expire and not rewarding taxpayers who were less than complete and candid in preparing returns or claiming aggressive positions. Here, a basis overstatement can have the same ultimate effect of understating a taxpayer's income and therefore should be treated as such.

On the other hand, opponents would argue that there is a strong policy reason to limit the exceptions to the three year statute of limitations period. They would argue that the purpose of periods of limitations generally is to enable the best available evidence to be presented in the pursuit of the action. As time expires, evidence may become lost or otherwise unavailable; additionally, witnesses may no longer be available. Because of this reality, prosecuting such untimely actions, as well as defending such actions, becomes very difficult. Accordingly, an additional exception to the three year statute should not be created in every case where income is understated.

**10. Improve investigative disclosure statute**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 640-641. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.10, reprinted in the back of this volume.

**11. Allow the IRS to absorb credit and debit card processing fees for certain tax payments**

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 644-646. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.11, reprinted in the back of this volume.

**12. Provide the IRS with greater flexibility to address correctable errors**

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 208-210. That proposal modified a proposal from prior years, which is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June

2012, pp. 642-644. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.12, reprinted in the back of this volume.

**13. Enhance electronic filing of returns**

This proposal combines multiple prior-year proposals into a single proposal, with modifications in some cases, as described below. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.13, reprinted in the back of this volume.

The proposal to require all corporations and partnerships with $10 million or more in assets to file their tax returns electronically and to expand regulatory authority to allow the reduction of the 250-return electronic filing threshold in the case of certain information returns is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 580-582. In addition, under the current proposal, regardless of asset size, corporations with more than ten shareholders and partnerships with more than ten partners would be required to file their tax returns electronically. Preparers that expect to prepare more than 10 corporation income tax returns or partnership returns would be required to file these returns electronically.

The proposal to make e-filing mandatory for exempt organizations is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 210. That proposal modified a proposal from 2014, which is described in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 157-160.

The proposal to authorize the Department of Treasury to require additional information to be included in electronically filed Form 5500 annual reports is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-2-12), June 2012, pp. 582-585.[575]

The proposal to require taxpayers who prepare their returns electronically but file their returns on paper to print their return with a scannable code is substantially similar to a proposal

[575] For a description of a modification to that proposal, relating to electronic filing of Form 8955-SSA, that is not contained in the current proposal, see *Joint Committee on Taxation, Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 161-162. Note that Form 8955-SSA, is now included in the proposal mentioned above to expand regulatory authority to allow reduction of the 250-return electronic filing threshold for certain information returns.

found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 207-208. That proposal modified a proposal from prior years, which is described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 642-644.

The proposal to impose a penalty on failure to comply with electronic filing requirements is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, p. 211. That proposal modified a proposal found in the fiscal year 2013 budget proposal, described in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 654-656.

**14. Improve the whistleblower program**

This proposal combines two separate prior-year proposals into a single proposal, as described below. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.14, reprinted in the back of this volume.

The proposal to protect whistleblowers from retaliatory action is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, p. 175.

The proposal to provide stronger protection from improper disclosure of taxpayer information in whistleblower actions is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 176-177.

**15. Index all civil tax penalties for inflation**

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 178. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.15, reprinted in the back of this volume.

**16. Extend IRS authority to require a truncated Social Security number on Form W-2**

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 184-185. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.16, reprinted in the back of this volume.

**17. Combat tax-related identity theft**

This proposal combines two separate prior-year proposals into a single proposal, as described below. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.17, reprinted in the back of this volume.

The proposal to add tax crimes to the aggravated identity theft statute is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 212-214.

The proposal to impose a civil penalty on tax identity theft crimes is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 212-214.

**18. Allow States to send notices of intent to offset Federal tax refunds to collect State tax obligations by regular first-class mail instead of certified mail**

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 215-216. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.18, reprinted in the back of this volume.

**19. Rationalize tax return filing due dates so they are staggered**

**Description of Modification**

The fiscal year 2016 budget proposal is substantially similar to the proposal first offered in the budget proposal for fiscal year 2015, with one change that explicitly addresses the due dates for returns of entities that base their taxable year on a fiscal year rather than the calendar

year. Subsequent to publication of the President's fiscal year 2016 budget, a proposal substantially similar to this proposal to rationalize income tax return due dates was enacted.[576] Accordingly, present law now generally provides that with respect to returns for taxable years beginning after December 31, 2015, partnership and S corporation returns are required to be filed on or before the 15th day of the third month following the close of the taxpayer's taxable year, or March 15 in the case of a calendar year taxpayer, and the C corporation return are required to be filed on or before the 15th day of the fourth month after the close of a taxable year, or April 15 in the case of a calendar year taxpayer.[577]

However, present law is not changed to reflect the President's fiscal year 2016 budget proposal to change the due dates for filing the Form 1099 and W-2 information returns and to eliminate the extended due date for electronically filed returns. A description and analysis of the proposal can be found in Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, at pages 222-227.

The estimated budget effect of the President's fiscal year 2016 budget proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.19, reprinted in the back of this volume.

**20. Increase oversight and due diligence of paid tax return preparers**

The proposal combines three separate prior-year proposals into a single proposal, as described below. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.20, reprinted in the back of this volume.

The proposal to extend paid preparer earned income tax due diligence requirements to the child tax credit is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 179-183.

The proposal to explicitly provide that the Department of the Treasury and the Internal Revenue Service ("IRS") have authority to regulate all paid return preparers is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions*

[576] Surface Transportation and Veterans Health Care Choice Improvements Act of 2015, Pub. L. No. 114-41, sec. 2006, July 31, 2015.

[577] Present law also provides special rules for certain June 30 fiscal year C corporations and for certain calendar year C corporations.

*Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 216-222.

The proposal to increase the penalty applicable to paid tax preparers who engage in willful or reckless conduct is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 227-228.

**21. Enhance administrability of the appraiser penalty**

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 228-231. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVI.C.21, reprinted in the back of this volume.

## PART XVII ─ SIMPLIFY THE TAX SYSTEM

### A. Modify Adoption Credit to Allow Tribal Determination of Special Needs

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 186-187. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.A, reprinted in the back of this volume.

### B. Repeal Non-Qualified Preferred Stock Designation

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 683-692. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.B, reprinted in the back of this volume.

### C. Repeal Preferential Dividend Rule for Publicly Traded and Publicly Offered Real Estate Investment Trusts

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 693-698. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.C, reprinted in the back of this volume.

### D. Reform Excise Tax Based on Investment Income of Private Foundations

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 699-703. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.D, reprinted in the back of this volume.

### E. Remove Bonding Requirements for Certain Taxpayers Subject to Federal Excise Taxes on Distilled Spirits, Wine, and Beer

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation,

*Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 704-706. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.E, reprinted in the back of this volume.

### F. Simplify Arbitrage Investment Restrictions

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 707-710. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.F, reprinted in the back of this volume.

### G. Simplify Single-Family Housing Mortgage Bond Targeting Requirements

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 710-713. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.G, reprinted in the back of this volume.

### H. Streamline Private Business Limits on Governmental Bonds

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 713-716. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.H, reprinted in the back of this volume.

### I. Repeal Technical Terminations of Partnerships

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 190-193. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.I, reprinted in the back of this volume.

## J. Repeal Anti-Churning Rules of Section 197

This proposal is substantially similar to a proposal found in the President's fiscal year 2014 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal* (JCS-4-13), December 2013, pp. 194-196. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.J, reprinted in the back of this volume.

## K. Repeal Special Estimated Tax Payment Provision for Certain Insurance Companies

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 610-615. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.K, reprinted in the back of this volume.

## L. Repeal the Telephone Excise Tax

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp 242-245. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.L, reprinted in the back of this volume.

## M. Increase Standard Mileage Rate for Automobile Use by Volunteers

This proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal. For a description of that proposal see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp 245-248. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.M, reprinted in the back of this volume.

## N. Consolidate Contribution Limitations for Charitable Deductions and Extend the Carryforward Period for Excess Charitable Contribution Deduction Amounts

### Present Law

**Deduction for charitable contributions**

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

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.*, an organization or entity described in section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.*, not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.[578] Fourth, the transfer must be of money or property—contributions of services are not deductible.[579] Finally, the transfer must be substantiated and in the proper form.

**Percentage limits on charitable contributions and carryforwards of excess contributions**

Percentage limits for individual taxpayers

Charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's adjusted gross income ("AGI") for a taxable year, disregarding any net operating loss carryback to the year under section 172.[580] In general, more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

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

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

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

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

deducted up to the lesser of 30 percent of the taxpayer's contribution base or the excess of (i) 50 percent of the contribution base over (ii) the amount of contributions subject to the 50 percent limitation.

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

Finally, more favorable percentage limits sometimes apply to contributions to the donee charity than to contributions that are for the use of the donee charity. Contributions of capital gain property for the use of public charities and other organizations described in section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's contribution base.[581] In contrast to property contributed directly to a charitable organization, property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization.[582] Charitable contributions of income interests (where deductible) also generally are treated as contributions for the use of the donee organization.

## O. Exclude from Gross Income Subsidies from Public Utilities for Purchase of Water Runoff Management

### Present Law

An exclusion from gross income is provided for the value of any subsidy provided by a public utility to a customer for the purchase or installation of any energy conservation measure, meaning any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit.[583]

No deduction or credit is allowed for any expenditure to the extent of the exclusion taken for any subsidy received, and the adjusted basis of the property is reduced by the amount excluded.

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

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

[583] Sec. 136.

A "public utility" means a person engaged in the sale of electricity or natural gas to residential, commercial, or industrial customers for use by such customers, and such term includes the Federal Government, a State or local government, or any political subdivision or instrumentality thereof. The exclusion does not apply with respect to any payment to or from a qualified cogeneration facility or qualifying small power production facility pursuant to section 210 of the Public Utility Regulatory Policy Act of 1978.

No exclusion from income is permitted for subsidies relating to water conservation or storm water management measures.

## Description of Proposal

The proposal excludes from the gross income of individuals the value of any subsidy provided by a public utility for the purchase or installation of any water conservation measure or storm water management measure. Water conservation measures are any installation, modification, or water-use evaluation primarily designed to reduce consumption of water or to improve the management of water demand with respect to a dwelling unit. Storm water management measures are any installation or modification of property to offset or manage the amounts of storm water runoff associated with a dwelling unity. Public utilities are any entity engaged in the sale of water to customers or in sewage treatment and may include the Federal, State, or local government.

Effective date.–The proposal is effective for subsidies provided after December 31, 2015.

The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVII.O, reprinted in the back of this volume.

## Analysis

To the extent the cost to secure and deliver water resources to the public is not adequately reflected in the price paid by consumers, consumers may overuse those resources. As a consequence, the value to consumers for investing in water saving technologies is lower than if water prices were higher. The most efficient way to address this issue would be to charge consumers the proper price for water, and allow them to decide which, if any, water saving technologies make economic sense. Such a price mechanism does not exist in the case of storm water runoff because storm water retention generally does not yield private benefits.

In some parts of the country, local water districts have taken steps to mitigate the overconsumption of water by encouraging or subsidizing water saving and storm water management measures. Excluding from gross income the value of these subsidies provides an additional incentive to invest in this type of conservation.

One possible criticism of the proposal is that the exclusion is limited to the gross income of individual taxpayers. Thus, under the proposal, a home owned by an individual would qualify, but the same home held by a trust or owned by a corporate landlord would not. The

present law exclusion for energy conservation measures at dwelling units is available to all customers of a public utility, without limitation as to the type of taxpayer.

### P. Provide Relief for Certain Accidental Dual Citizens

#### Present Law

The United States has a worldwide system of taxation. U.S. citizens and resident aliens[584] are taxed on income derived in the United States and on income from outside of the United States. Accordingly, U.S. citizens generally are subject to U.S. taxation even if they reside abroad. Conversely, nonresident aliens[585] are generally taxed only on income from U.S. sources.[586]

An individual may become a U.S. citizen at birth by being born in the United States (or in certain U.S. territories or possessions) or by having a parent who is a U.S. citizen. U.S. citizens may wish to expatriate by relinquishing their U.S. citizenship. Resident aliens who are lawful permanent residents of the United States[587] (green card holders) may wish to become nonresidents for U.S. tax purposes by ceasing to be lawful permanent residents. Section 877A generally requires U.S. citizens and certain lawful permanent residents (*i.e.*, long-term residents[588]) who expatriate to pay a mark-to-market exit tax on a deemed disposition of their worldwide assets as of the day before their expatriation date if they are "covered expatriates."[589]

An individual is a covered expatriate if he or she meets at least one of the following three tests: (A) has an average annual net income tax liability for the five taxable years preceding the year of expatriation that exceeds a specified amount that is adjusted for inflation ($157,000 in 2014) (the "tax liability test"), (B) has a net worth of $2 million or more as of the expatriation date (the "net worth test"), or (C) fails to certify, under penalty of perjury, compliance with all U.S. Federal tax obligations for the five taxable years preceding the taxable year that includes the expatriation date (the "certification test").[590]

The definition of covered expatriate in section 877(a)(2) is modified for an expatriate who became at birth a citizen of both the United States and another country and, as of the expatriation date, continues to be a citizen of, and taxed as a resident of, such other country. For

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[584] See Sec. 7701(b)(1)(A) and Treas. Reg. Sec. 301-7701(b)-1.

[585] See Sec. 7701(b)(1)(B).

[586] See Sec. 872.

[587] See Sec. 7701(b)(6).

[588] See Sec. 877A(g)(5) and 877(e)(2).

[589] Sec. 877A(a).

[590] See Sec. 877A(g)(1)(A) and 877(a)(2).

these dual citizens, the tax liability test and the net worth test are not applicable if the individual has not been a resident of the United States for more than 10 years over the preceding 15 year period.[591] However, this dual citizen remains subject to the certification test.

Under these expatriation rules, dual citizens may subject to a significant U.S. tax liability unless they have satisfied their five preceding years of U.S. tax obligations.

## Description of Proposal

This proposal removes an individual from taxation as a U.S. citizen and as a "covered expatriate" subject to the mark-to-market exit tax under section 877A if six new requirements are met:

1. the individual became at birth a citizen of the United States and a citizen of another country;

2. at all times, up to and including the individual's expatriation date, the individual has been a citizen of a country other than the United States;

3. the individual has not been a resident of the United States (as defined in Section 7701(b)) since attaining age 18½;

4. the individual has never held a U.S. passport or has held a U.S. passport for the sole purpose of departing from the United States in compliance with 22 CFR section 53.1;[592]

5. the individual relinquishes his or her U.S. citizenship within two years after the later of January 1, 2016, or the date on which the individual learns that he or she is a U.S. citizen; and

6. the individual certifies under penalty of perjury his or her compliance with all U.S. Federal tax obligations that would have applied during the five years preceding the year of expatriation if the individual had been a nonresident alien during that period.

Effective date.−The proposal is effective January 1, 2016.

The estimated budget effective of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVIIP, reprinted in the back of this volume.

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[591] Sec. 877A(g)(1)(B).

[592] 22 CFR 53.1 provides passport requirements and definitions. 53.1(a) states that it is unlawful for a citizen of the United States, unless excepted under 22 CFR 53.2, to enter or leave, or attempt to enter or depart, the United States without a valid passport.

## Analysis

The proposal is intended to provide additional relief to a limited class of individuals who became at birth both a citizen of the United States and a citizen of another country, but have had minimal contacts with the United States and may not have learned until recently that they are U.S. citizens. U.S. citizenship often is conferred at birth and in this circumstance is beyond an individual's control, but in a democracy a citizen's decision to remain a citizen, and an immigrant's decision to become a citizen, have been thought of as entirely volitional. By imposing tax on some individuals who choose to, or otherwise would choose to, give up their U.S. citizenship, the present law rules conflict with the concept of voluntary citizenship. The proposal eliminates U.S. tax obligations when an individual who satisfies six criteria intended to identify, in the Administration's words, "accidental citizens" relinquishes U.S. citizenship.

By limiting relief from U.S. citizenship-based tax obligations to a limited class of expatriates (so-called "accidental citizens"), the proposal balances competing policy concerns. One concern is the policy just described, that an individual's decision to remain a U.S. citizen should be entirely voluntary. In tension with that non-tax policy is the concern that an individual should not be motivated to relinquish U.S. citizenship by considerations of taxation. In the absence of the mark-to-market exit tax rules of section 877A, a wealthy or high income U.S. citizen who would like to sell property that has appreciated in value might choose to relinquish U.S. citizenship and become a resident of a low- or zero-tax country and only thereafter sell the property. The proposal leaves the exit tax rules unchanged for the vast majority of U.S. citizens. It prioritizes the non-tax policy of volitional citizenship only in the much less common situation in which a U.S. citizen who, among other requirements, became at birth a citizen of the United States and a citizen of another country and has remained at all times since birth a citizen of another country. The proposal's limited application to dual citizens who also satisfy the proposal's other criteria may reflect a judgment that in contrast with most individuals who become citizens at birth or at a later time, dual citizens who have minimal contacts with the United States may, through no negligence of their own, not be aware of their U.S. tax obligations.

The present law mark-to-market exit tax excludes a somewhat differently defined class of accidental citizens. An individual who otherwise would be subject to the exit tax (because the individual satisfies the tax liability test or net worth test described previously) but who since birth has been a citizen of the United States and another country, is a citizen and is taxed as a resident of the other country at the time of expatriation, and has been a U.S. resident for tax purposes for no more than 10 of the 15 years preceding expatriation is excluded from the exit tax – but only so long as the individual complies with the certification test (that is, certifies compliance with all U.S. Federal tax obligations for the five years preceding expatriation). For a dual citizen who satisfies the proposal's other criteria (referred to below as a "qualifying dual citizen"), the proposal replaces the existing certification test with a requirement that the individual certify under penalty of perjury the individual's compliance with all U.S. Federal tax obligations that would have applied during the five years preceding the year of expatriation if the individual had been a nonresident alien during that period. The broad difference between the certification test and this revised test is that the revised test (referred to below as "the U.S.-source certification test") requires payment of U.S. tax on U.S.-source income rather than on all income, both U.S. and foreign source, for the five years preceding expatriation. Because many dual

citizens who are not U.S. residents may have little or no U.S.-source income, the proposal should reduce significantly or eliminate the U.S. tax burden associated with a qualifying dual citizen's decision to expatriate.

One question is whether the proposal appropriately distinguishes between dual citizens who should be able to avoid the exit tax only by satisfying the certification test and dual citizens who should be able to avoid the exit tax by satisfying the U.S.-source certification test. The proposal extends the less strict U.S.-source certification test only to a dual citizen who has not been a resident of the United States for tax purposes since attaining age 18 ½ and has never held a U.S. passport for any purpose other than departing the United States in compliance with Federal law. An individual who has been a dual citizen since birth and who has neither been tax resident in the United States as an adult nor held a U.S. passport (other than for departing the United States) might be considered blameless for not having complied with U.S. citizenship-based tax obligations. On the other hand, it is likely that there are dual citizens who do not satisfy these requirements but who, based on the totality of their life circumstances, might be viewed as no less blameless than qualifying dual citizens. It is also likely that there are qualifying dual citizens who have known about their U.S. citizenship-based tax obligations but have not complied. Consequently, in relation to any particular dual citizen, the proposal may be either overbroad or underinclusive. It is, however, difficult to imagine any sort of subjective test that could be administered consistently and fairly across all dual citizens seeking to expatriate.

Although the proposal's criteria for qualifying dual citizens are for the most part objective, the proposal is not free of administrative concerns. There could be several factual inquiries including whether the dual citizen has been a citizen of another country since birth; has never been a U.S. tax resident as an adult; has never held a U.S. passport (other than to depart the United States); and has complied with all U.S. Federal tax obligations applicable to nonresidents for the five-year period preceding expatriation. However, there are similar concerns under the existing expatriation rules. Consequently, the proposal may not add to overall compliance and administrative costs for taxpayers and the IRS.

The proposal's requirement that an individual relinquish his or her citizenship within two years after the later of January 1, 2016 or the date on which the individual learns that he or she is a U.S. citizen is intended to exclude from the proposal's favorable treatment individuals who remain U.S. citizens for a significant period of time after they learn that they are U.S. citizens. If an individual learns that he or she is a U.S. citizen and chooses not to expatriate, then at some point – in the Administration's judgment, two years – he or she might no longer be considered to be blameless for not having complied with his or her citizenship-based tax obligations and therefore should no longer be eligible for the relief provided by the proposal. Conversely, as a practical matter it may not be possible for the IRS to know with any degree of certainty for how long an individual has known that he or she is a U.S. citizen. If this two-year limitation is nonetheless appropriate, a question is why it should not apply to all dual citizens seeking to expatriate under the proposal. In the case of individuals who know before the proposal is enacted that they are U.S. citizens, the two-year requirement may be appropriate because these individuals could not have taken advantage of the relief provided by the proposal before it was enacted. On the other hand, why should an otherwise qualifying dual citizen benefit from the proposal if she expatriates within two years after January 1, 2016 even if she has known that she is a U.S. citizen for many years?

## PART XVIII – USER FEES

### A. Reform Inland Waterways Funding

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 717-718. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XVIII.A, reprinted in the back of this volume.

## PART XIX ─ OTHER INITIATIVES

### A. Allow Offset of Federal Income Tax Refunds to Collect Delinquent State Income Taxes for Out-of-State Residents

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 719-720. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XX.A, reprinted in the back of this volume.

### B. Authorize the Limited Sharing of Business Tax Return Information to Improve the Accuracy of Important Measures of the Economy

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 721-726. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XX.B, reprinted in the back of this volume.

### C. Eliminate Certain Reviews Conducted by the U.S. Treasury Inspector General for Tax Administration

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 727-729. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XX.C, reprinted in the back of this volume.

### D. Modify Indexing to Prevent Deflationary Adjustments

This proposal is substantially similar to a proposal found in the President's fiscal year 2013 budget proposal. For a description of that proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 730-31. The estimated budget effect of the current proposal can be found at Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCX-50-15), March 6, 2015, Item XX.D, reprinted in the back of this volume.

# ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S BUDGET PROPOSAL

**JOINT COMMITTEE ON TAXATION**
**March 6, 2015**
**JCX-50-15**

## ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2016 BUDGET PROPOSAL [1]

**Fiscal Years 2015 - 2025**

*[Millions of Dollars]*

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **I. Make Permanent Certain Tax Cuts Enacted in 2009** | | | | | | | | | | | | | | |
| A. Reduce the Earnings Threshold for the Refundable Portion of the Child Tax Credit to $3,000 [2] | tyba 12/31/17 | --- | --- | --- | --- | -12,373 | -12,455 | -12,452 | -12,534 | -12,597 | -12,694 | -12,733 | -24,827 | -87,839 |
| B. Earned Income Tax Credit ("EITC") Modification and Simplification - Increase in Joint Returns Beginning and Ending Income Level for Phaseout by $5,000, Indexed After 2008 [2] | tyba 12/31/17 | --- | --- | --- | -16 | -1,602 | -1,596 | -1,592 | -1,593 | -1,596 | -1,605 | -1,604 | -3,214 | -11,204 |
| C. Extend the EITC for Larger Families [2] | tyba 12/31/17 | --- | --- | --- | -25 | -2,541 | -2,601 | -2,672 | -2,733 | -2,804 | -2,897 | -2,973 | -5,167 | -19,245 |
| D. Extension of American Opportunity Tax Credit [2] | tyba 12/31/17 | --- | --- | --- | -2,361 | -11,791 | -11,651 | -11,327 | -11,116 | -10,739 | -10,565 | -10,316 | -25,803 | -79,866 |
| **Total of Make Permanent Certain Tax Cuts Enacted in 2009** | | **---** | **---** | **---** | **-2,402** | **-28,307** | **-28,303** | **-28,043** | **-27,976** | **-27,736** | **-27,761** | **-27,626** | **-59,011** | **-198,154** |
| **II. Reform U.S. International Tax System** | | | | | | | | | | | | | | |
| A. Restrict Deductions for Excessive Interest of Members of Financial Reporting Groups | tyba 12/31/15 | --- | 2,812 | 5,340 | 5,683 | 5,977 | 6,348 | 6,780 | 7,180 | 7,561 | 8,029 | 8,525 | 26,161 | 64,236 |
| B. Provide Tax Incentives for Locating Jobs and Business Activity in the United States and Remove Tax Deductions for Shipping Jobs Overseas | epoia DOE | -2 | -11 | -20 | -23 | -24 | -25 | -26 | -27 | -28 | -30 | -31 | -105 | -247 |
| C. Repeal Delay in the Implementation of Worldwide Interest Allocation | tyba 12/31/15 | --- | -882 | -1,787 | -1,825 | -1,782 | -1,765 | -963 | 106 | 53 | 13 | -- | -8,041 | -8,832 |
| D. Permanently Extend the Exception under Subpart F for Active Financing Income | [3] | -3,101 | -6,535 | -6,671 | -6,553 | -6,710 | -6,634 | -6,785 | -7,412 | -7,664 | -7,598 | -7,679 | -36,204 | -73,342 |
| E. Permanently Extend the Look-Through Treatment of Payments between Related Controlled Foreign Corporations ("CFCs") | [3] | -454 | -694 | -763 | -833 | -896 | -967 | -1,063 | -1,164 | -1,245 | -1,346 | -1,467 | -4,607 | -10,893 |
| F. Impose a 19-percent Minimum Tax on Foreign Income | tyba 12/31/15 | --- | 15,298 | 29,993 | 28,339 | 28,194 | 28,887 | 29,731 | 28,204 | 26,101 | 24,788 | 22,724 | 130,710 | 262,259 |
| G. Impose a 14-Percent One-Time Tax on Previously Untaxed Foreign Income | [4] | 7,509 | 53,935 | 48,129 | 49,024 | 50,149 | 43,147 | -8,068 | -6,486 | -6,693 | -6,877 | -6,586 | 251,895 | 217,185 |
| H. Limit Shifting of Income through Intangible Property Transfers | tyba 12/31/15 | --- | 87 | 185 | 205 | 227 | 251 | 276 | 304 | 333 | 365 | 399 | 955 | 2,631 |
| I. Disallow the Deduction for Excess Non-Taxed Reinsurance Premiums Paid to Affiliates | pii tyba 12/31/15 | --- | 297 | 718 | 766 | 816 | 869 | 923 | 981 | 1,043 | 1,108 | 1,178 | 3,466 | 8,700 |

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| J. Modify Tax Rules for Dual Capacity Taxpayers | generally tyba 12/31/15 | --- | 717 | 1,359 | 1,337 | 1,296 | 1,215 | 1,117 | 1,008 | 1,083 | 1,161 | 1,273 | 5,923 | 11,566 |
| K. Tax Gain from the Sale of a Partnership Interest on Look-Through Basis | soea 12/31/15 | --- | 159 | 234 | 245 | 255 | 266 | 277 | 289 | 301 | 314 | 327 | 1,159 | 2,666 |
| L. Modify Sections 338(h)(16) and 902 To Limit Credits When Non-Double Taxation Exists | toa 12/31/15 | --- | 52 | 92 | 95 | 97 | 100 | 103 | 106 | 110 | 114 | 118 | 437 | 988 |
| M. Close Loopholes Under Subpart F | tyba 12/31/15 | --- | 1,204 | 2,643 | 2,841 | 2,971 | 3,118 | 3,333 | 3,610 | 3,907 | 4,230 | 4,566 | 12,777 | 32,423 |
| N. Restrict the Use of Hybrid Arrangements that Create Stateless Income | tyba 12/31/15 | --- | 125 | 227 | 252 | 267 | 283 | 304 | 325 | 341 | 362 | 387 | 1,154 | 2,873 |
| O. Limit the Ability of Domestic Entities to Expatriate | Tca 12/31/15 & 1/1/16 | --- | 135 | 463 | 738 | 1,031 | 1,337 | 1,646 | 2,040 | 2,452 | 2,884 | 3,615 | 3,703 | 16,340 |
| **Total of Reform U.S. International Tax System** | | **3,952** | **66,699** | **80,142** | **80,291** | **81,868** | **76,430** | **27,585** | **29,064** | **27,655** | **27,517** | **27,349** | **389,383** | **528,553** |
| **III. Simplification and Tax Relief for Small Business** | | | | | | | | | | | | | | |
| A. Expand and Permanently Extend Increased Expensing for Small Business | qppisi tyba 12/31/14 | -7,843 | -17,169 | -16,349 | -12,510 | -9,726 | -7,633 | -6,372 | -5,210 | -5,077 | -5,787 | -5,966 | -71,230 | -99,643 |
| B. Expand Simplified Accounting for Small Business and Establish a Uniform Definition of Small Business for Accounting Methods | tyba 12/31/15 & tyba 12/31/16 | --- | -3,448 | -3,715 | -2,932 | -2,456 | -2,269 | -2,210 | -2,121 | -2,023 | -1,927 | -1,833 | -14,819 | -24,934 |
| C. Eliminate Capital Gains Taxation on Investments in Small Business Stock | qsbsaa 12/31/14 | 2 | 15 | 15 | 16 | 16 | -215 | -1,546 | -1,645 | -1,727 | -1,804 | -1,654 | -151 | -8,526 |
| D. Increase the Limitations for Deductible New Business Expenditures and Consolidate Provisions for Start-Up and Organizational Expenditures | tyba 12/31/15 | --- | -39 | -98 | -138 | -179 | -222 | -267 | -314 | -362 | -413 | -499 | -675 | -2,530 |
| E. Expand and Simplify the Tax Credit Provided to Qualified Small Employers for Non-Elective Contributions to Employee Health Insurance [2] | tyba 12/31/14 | -95 | -157 | -147 | -187 | -127 | -135 | -229 | -246 | -256 | -268 | -282 | -849 | -2,129 |
| **Total of Simplification and Tax Relief for Small Business** | | **-7,936** | **-20,798** | **-20,294** | **-15,751** | **-12,472** | **-10,474** | **-10,624** | **-9,536** | **-9,445** | **-10,199** | **-10,234** | **-87,724** | **-137,762** |
| **IV. Incentives for Manufacturing, Research, and Clean Energy** | | | | | | | | | | | | | | |
| A. Enhance and Make Permanent Research Incentives | Epoia 12/31/15 | -2,737 | -7,223 | -10,288 | -12,437 | -14,479 | -16,427 | -18,280 | -20,103 | -21,854 | -22,970 | -23,938 | -63,592 | -170,737 |
| B. Extend and Modify Certain Employment Tax Credits, Including Incentives for Hiring Veterans | | | | | | | | | | | | | | |
| 1. Permanently extend and modify the work opportunity tax credit ("WOTC") | wptqiwbwftea 12/31/14 & 12/31/15 | -390 | -1,009 | -1,313 | -1,488 | -1,628 | -1,734 | -1,814 | -1,925 | -2,042 | -2,167 | -2,364 | -7,562 | -17,875 |
| 2. Permanently extend and modify the Indian employment credit | wptqei tyba 12/31/14 & tyba 12/31/15 | -22 | -33 | -15 | -6 | -2 | -2 | -2 | -2 | -2 | -2 | -2 | -80 | -91 |
| C. Modify and Permanently Extend Renewable Electricity Production Tax Credit and Investment Tax Credit [2] | poweba 12/31/14 | -13 | -45 | -825 | -1,695 | -2,553 | -3,354 | -4,118 | -4,756 | -5,401 | -6,145 | -6,875 | -8,485 | -35,780 |
| D. Modify and Permanently Extend the Deduction for Energy-Efficient Commercial Building Property | ppisa 12/31/15 | -168 | -363 | -527 | -693 | -708 | -726 | -719 | -694 | -697 | -687 | -667 | -3,185 | -6,648 |

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| E. Provide a Carbon Dioxide Investment and Sequestration Tax Credit [2] | DOE | --- | --- | --- | -176 | -404 | -637 | -914 | -1,147 | -995 | -826 | -817 | -1,217 | -5,915 |
| F. Provide Additional Tax Credits for Investment in Qualified Property Used in a Qualified Advanced Energy Manufacturing Project | DOE | --- | -406 | -718 | -393 | -144 | -103 | -23 | 56 | 65 | 33 | 7 | -1,764 | -1,625 |
| G. Provide New Manufacturing Communities Tax Credit | qiai 2016-2018 | --- | --- | -4 | -20 | -68 | -139 | -209 | -257 | -287 | -306 | -299 | -230 | -1,587 |
| H. Extend the Tax Credit for Second Generation Biofuel Production (sunset 12/31/24) | fsoua 12/31/14 | -12 | -35 | -62 | -91 | -112 | -132 | -137 | -122 | -98 | -66 | -24 | -444 | -889 |
| **Total of Incentives for Manufacturing, Research, and Clean Energy** | | **-3,342** | **-9,114** | **-13,752** | **-16,999** | **-20,098** | **-23,254** | **-26,216** | **-28,950** | **-31,311** | **-33,136** | **-34,979** | **-86,559** | **-241,147** |
| **V. Incentives To Promote Regional Growth** | | | | | | | | | | | | | | |
| A. Modify and Permanently Extend the New Markets Tax Credit | DOE | -28 | -107 | -325 | -436 | -589 | -763 | -958 | -1,178 | -1,389 | -1,542 | -1,531 | -2,247 | -8,844 |
| B. Reform and Expand the Low-Income Housing Tax Credit ("LIHTC") | | | | | | | | | | | | | | |
| 1. Allow states to convert private activity bond ("PAB") volume cap into LIHTCs that the State can allocate; and alternative qualification by building owners for PAB-related LIHTCs | [5] | --- | -6 | -45 | -159 | -348 | -596 | -887 | -1,199 | -1,517 | -1,839 | -2,145 | -1,154 | -8,741 |
| 2. Encourage mixed income occupancy by allowing LIHTC-supported projects to elect a criterion employing a restriction on average income | [6] | --- | -3 | -4 | -5 | -6 | -7 | -10 | -11 | -12 | -13 | -14 | -25 | -85 |
| 3. Change formulas for 70 percent PV and 30 percent PV LIHTCs | amo/a DOE | --- | -6 | -8 | -11 | -14 | -16 | -20 | -22 | -25 | -27 | -30 | -55 | -179 |
| 4. Add preservation of Federally assisted affordable housing to allocation criteria | ami cyba DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| 5. Remove the qualified Census tract population cap | DOE | --- | -5 | -7 | -8 | -10 | -12 | -16 | -18 | -20 | -22 | -24 | -42 | -142 |
| 6. Implement requirement that LIHTC-supported housing protect victims of domestic abuse | [7] | *Negligible Revenue Effect* | | | | | | | | | | | | |
| **Total of Incentives To Promote Regional Growth** | | **-28** | **-127** | **-389** | **-619** | **-967** | **-1,394** | **-1,891** | **-2,428** | **-2,963** | **-3,443** | **-3,744** | **-3,523** | **-17,991** |
| **VI. Incentives for Investment in Infrastructure** | | | | | | | | | | | | | | |
| A. Provide America Fast Forward Bonds and Expand Eligible Uses [2] | bio/a 1/1/16 | --- | -7 | -55 | -143 | -239 | -340 | -448 | -563 | -681 | -802 | -927 | -785 | -4,206 |
| B. Allow Current Refundings of State and Local Governmental Bonds | DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| C. Repeal the $150 Million Nonhospital Bond Limitation on all Qualified 501(c)(3) Bonds | bia DOE | [8] | -1 | -2 | -4 | -6 | -8 | -11 | -13 | -15 | -18 | -20 | -22 | -99 |
| D. Increase National Limitation Amount for Qualified Highway or Surface Freight Transfer Facility Bonds | DOE | [8] | [8] | -1 | -7 | -15 | -24 | -33 | -41 | -43 | -43 | -42 | -48 | -250 |

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| E. Provide a New Category of Qualified Private Activity Bonds for Infrastructure Projects Referred to as "Qualified Public Infrastructure Bonds" | bis 1/1/16 | --- | -16 | -81 | -182 | -291 | -406 | -527 | -649 | -772 | -897 | -1,024 | -976 | -4,845 |
| F. Modify Qualified Private Activity Bonds for Public Educational Facilities | bia DOE | -4 | -25 | -58 | -68 | -80 | -90 | -100 | -110 | -120 | -131 | -142 | -325 | -928 |
| G. Modify Treatment of Banks Investing in Tax-Exempt Bonds | bii cybo/a 1/1/16 | --- | -57 | -138 | -233 | -325 | -409 | -476 | -528 | -573 | -612 | -647 | -1,162 | -3,998 |
| H. Repeal Tax-Exempt Bond Financing of Professional Sports Facilities | bia 12/31/15 | --- | 1 | 7 | 15 | 24 | 34 | 45 | 56 | 68 | 80 | 93 | 81 | 423 |
| I. Allow More Flexible Research Arrangements for Purposes of Private Business Use Limits | raeia DOE | [8] | [8] | -1 | -3 | -5 | -7 | -9 | -11 | -14 | -16 | -18 | -16 | -84 |
| J. Modify Tax-Exempt Bonds for Indian Tribal Governments | DOE | -1 | -3 | -7 | -11 | -15 | -20 | -26 | -31 | -37 | -43 | -49 | -55 | -241 |
| K. Exempt Certain Foreign Pension Funds from the Application of the Foreign Investment in Real Property Tax Act ("FIRPTA") | doUSrpioa 12/31/15 | --- | -91 | -146 | -165 | -178 | -192 | -206 | -222 | -239 | -255 | -272 | -771 | -1,965 |
| **Total of Incentives for Investment in Infrastructure** | | **-5** | **-199** | **-482** | **-801** | **-1,130** | **-1,462** | **-1,791** | **-2,112** | **-2,426** | **-2,737** | **-3,048** | **-4,079** | **-16,193** |
| **VII. Eliminate Fossil Fuel Preferences** | | | | | | | | | | | | | | |
| A. Eliminate Oil And Natural Gas Preferences | | | | | | | | | | | | | | |
| 1. Repeal enhanced oil recovery ("EOR") credit | pocia 12/31/15 | --- | *No Revenue Effect* | | | | | | | | | | | |
| 2. Repeal credit for oil and gas produced from marginal wells | pocia 12/31/15 | --- | *No Revenue Effect* | | | | | | | | | | | |
| 3. Repeal expensing of intangible drilling costs | pocia 12/31/15 | --- | 1,529 | 2,244 | 2,070 | 1,888 | 1,713 | 1,382 | 804 | 582 | 433 | 808 | 9,444 | 13,454 |
| 4. Repeal deduction for tertiary injectants | pocia 12/31/15 | --- | 5 | 7 | 7 | 8 | 8 | 6 | 6 | 5 | 4 | 4 | 35 | 60 |
| 5. Repeal exception to passive loss limitations for working interests in oil and natural gas properties | pocia 12/31/15 | --- | 11 | 22 | 23 | 23 | 24 | 24 | 25 | 25 | 26 | 26 | 103 | 229 |
| 6. Repeal percentage depletion for oil and natural gas wells | pocia 12/31/15 | --- | 1,054 | 1,616 | 1,650 | 1,715 | 1,774 | 1,820 | 1,852 | 1,877 | 1,900 | 1,919 | 7,807 | 17,177 |
| 7. Repeal domestic manufacturing deduction for oil and natural gas production | pocia 12/31/15 | --- | 387 | 1,022 | 1,163 | 1,258 | 1,279 | 1,300 | 1,330 | 1,368 | 1,411 | 1,462 | 5,109 | 11,980 |
| 8. Increase geological and geophysical amortization period for independent producers to seven years | pocia 12/31/15 | --- | 44 | 156 | 232 | 217 | 170 | 123 | 75 | 42 | 32 | 29 | 819 | 1,120 |
| 9. Repeal exemption from the corporate income tax for publicly traded partnerships with qualifying income and gains from activities relating to fossil fuels | tyba 12/31/20 | --- | --- | --- | --- | --- | --- | 131 | 239 | 250 | 263 | 276 | 0 | 1,159 |
| B. Eliminate Coal Preferences | | | | | | | | | | | | | | |
| 1. Repeal expensing of exploration and development costs | pocia 12/31/15 | --- | 54 | 82 | 80 | 78 | 77 | 79 | 85 | 93 | 100 | 108 | 371 | 836 |
| 2. Repeal percentage depletion for hard mineral fossil fuels | pocia 12/31/15 | --- | 39 | 62 | 66 | 69 | 72 | 74 | 77 | 79 | 82 | 84 | 308 | 704 |
| 3. Repeal capital gains treatment for royalties | Ara tyba 12/31/15 | 4 | 24 | 15 | 42 | 43 | 44 | 46 | 47 | 49 | 51 | 53 | 173 | 420 |

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 4. Repeal domestic manufacturing deduction for the production of coal and other hard mineral fossil fuels... | pocia 12/31/15 | --- | 13 | 35 | 40 | 45 | 49 | 50 | 51 | 53 | 55 | 57 | 182 | 448 |
| **Total of Eliminate Fossil Fuel Preferences** | | **4** | **3,160** | **5,261** | **5,373** | **5,344** | **5,210** | **5,035** | **4,591** | **4,423** | **4,357** | **4,826** | **24,351** | **47,587** |
| **VIII. Reform the Treatment of Financial and Insurance Industry Products** | | | | | | | | | | | | | | |
| A. Require that Derivative Contracts be Marked to Market with Resulting Gain or Loss Treated as Ordinary | dceia 12/31/15 | --- | 533 | 3,405 | 2,498 | 2,091 | 1,839 | 1,486 | 1,332 | 1,218 | 1,096 | 997 | 10,366 | 16,496 |
| B. Modify Rules that Apply to Sales of Life Insurance Contracts | [9] | --- | 40 | 52 | 64 | 76 | 90 | 107 | 120 | 137 | 158 | 177 | 322 | 1,021 |
| C. Modify Proration Rules for Life Insurance Company General and Separate Accounts | tyba 12/31/15 | --- | 186 | 509 | 555 | 609 | 670 | 683 | 697 | 711 | 726 | 740 | 2,529 | 6,086 |
| D. Extend Pro Rata Interest Expense Disallowance for Corporate-Owned Life Insurance | [10] | --- | 45 | 191 | 385 | 479 | 629 | 765 | 953 | 1,100 | 1,290 | 1,350 | 1,729 | 7,187 |
| E. Conform Net Operating Loss Rules of Life Insurance Companies to Those of Other Corporations | tyba 12/31/15 | --- | 40 | 65 | 30 | 31 | 32 | 33 | 34 | 36 | 37 | 38 | 198 | 376 |
| **Total of Reform Treatment of Financial and Insurance Industry Products** | | **---** | **844** | **4,222** | **3,532** | **3,286** | **3,260** | **3,074** | **3,136** | **3,202** | **3,307** | **3,302** | **15,144** | **31,166** |
| **IX. Other Revenue Changes and Loophole Closers** | | | | | | | | | | | | | | |
| A. Repeal Last-In, First-Out ("LIFO") Method of Accounting for Inventories | ftyba 12/31/15 | --- | 5,426 | 10,869 | 10,906 | 10,943 | 10,981 | 11,020 | 11,059 | 11,100 | 11,141 | 11,183 | 49,125 | 104,628 |
| B. Repeal Lower-Of- Cost-or-Market ("LCM") Inventory Accounting Method | tyba 12/31/15 | --- | 513 | 1,026 | 1,027 | 1,029 | 556 | 83 | 85 | 86 | 88 | 90 | 4,151 | 4,583 |
| C. Modify Like-Kind Exchange Rules for Real Property and Collectibles | lkeca 12/31/15 | --- | 38 | 86 | 148 | 252 | 423 | 699 | 1,086 | 1,641 | 2,460 | 3,671 | 947 | 10,504 |
| D. Modify Depreciation Rules for Purchases of General Aviation Passenger Aircraft | ppisa 12/31/15 | --- | 92 | 318 | 504 | 567 | 635 | 659 | 487 | 269 | 170 | 146 | 2,116 | 3,847 |
| E. Expand the Definition of Built-In Loss for Purposes of Partnership Loss Transfers | soea DOE | 7 | 47 | 62 | 64 | 67 | 69 | 73 | 76 | 80 | 83 | 87 | 316 | 715 |
| F. Extend Partnership Basis Limitation Rules to Nondeductible Expenditures | ptybo/a DOE | 15 | 95 | 123 | 129 | 133 | 140 | 146 | 152 | 160 | 167 | 175 | 635 | 1,435 |
| G. Limit the Importation of Losses Under Related Party Loss Limitation Rules | tma DOE | 28 | 92 | 115 | 119 | 124 | 129 | 136 | 141 | 148 | 155 | 162 | 607 | 1,349 |
| H. Deny Deduction for Punitive Damages | dpoia 12/31/15 | --- | 27 | 37 | 38 | 39 | 40 | 42 | 43 | 44 | 45 | 47 | 181 | 402 |
| I. Conform Corporate Ownership Standards | toa 12/31/15 | --- | 14 | 20 | 20 | 20 | 21 | 22 | 23 | 24 | 25 | 26 | 95 | 215 |
| J. Tax Corporate Distributions as Dividends | DOE & toa 12/31/15 | --- | 28 | 80 | 82 | 84 | 87 | 89 | 91 | 94 | 95 | 96 | 361 | 826 |
| K. Repeal Federal Insurance Contributions Act ("FICA") Tip Credit [11] | tyba 12/31/15 | --- | 552 | 983 | 1,084 | 1,172 | 1,239 | 1,300 | 1,365 | 1,434 | 1,505 | 1,540 | 5,031 | 12,176 |

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| L. Repeal the Excise Tax Credit for Distilled Spirits with Flavor and Wine Additives | aspioiiUSa 12/31/15 | --- | 89 | 119 | 120 | 120 | 121 | 121 | 122 | 122 | 123 | 123 | 568 | 1,179 |
| **Total of Other Revenue Changes and Loophole Closers** | | **50** | **7,013** | **13,838** | **14,241** | **14,550** | **14,441** | **14,390** | **14,731** | **15,202** | **16,057** | **17,345** | **64,133** | **141,859** |
| **X. Tax Reform for Families and Individuals** | | | | | | | | | | | | | | |
| A. Reform Child Care Tax Incentives [2] | tyba 12/31/15 | --- | -42 | -4,180 | -4,337 | -4,506 | -4,719 | -4,909 | -5,146 | -5,383 | -5,623 | -5,873 | -17,783 | -44,717 |
| B. Simplify and Better Target Tax Benefits for Education | | | | | | | | | | | | | | |
| 1. Expand and modify the AOTC and repeal Lifetime Learning Credits [2] | tyba 12/31/15 | --- | -548 | -2,732 | -2,637 | -2,543 | -3,310 | -3,902 | -4,726 | -4,816 | -5,652 | -6,591 | -11,770 | -37,457 |
| 2. Make Pell grants excludable from income [2] | tyba 12/31/15 | --- | -30 | -335 | -615 | -592 | -575 | -570 | -561 | -561 | -558 | -548 | -2,146 | -4,944 |
| 3. Modify reporting of tuition expenses and scholarships on Form 1098-T [2] | tyba 12/31/15 | --- | 5 | 45 | 48 | 51 | 54 | 57 | 60 | 64 | 67 | 69 | 203 | 520 |
| 4. Repeal the student loan interest deduction and provide exclusion for certain debt relief and scholarships [2] | tyba 12/31/15 & dola 12/31/15 | --- | -4 | -14 | -14 | -15 | 9 | 132 | 263 | 397 | 535 | 685 | -37 | 1,976 |
| 5. Repeal Coverdells and reduce the Federal tax benefits of qualified tuition programs | tyba 12/31/15 | *Proposal Withdrawn by the Administration* | | | | | | | | | | | | |
| C. Provide for Automatic Enrollment in IRAs, Including a Small Employer Tax Credit, Increase the Tax Credit for Small Employer Plan Start-Up Costs, and Provide an Additional Tax Credit for Small Employer Plans Newly Offering Auto-enrollment [2] | tyba 12/31/16 | --- | --- | -561 | -1,415 | -1,460 | -1,480 | -1,470 | -1,534 | -1,610 | -1,684 | -1,754 | -4,917 | -12,968 |
| D. Expand Penalty-Free Withdrawals for Long-Term Unemployed | edoa 12/31/15 | --- | -105 | -144 | -150 | -160 | -170 | -178 | -187 | -195 | -205 | -214 | -729 | -1,708 |
| E. Require Retirement Plans to Allow Long-Term Part-Time Workers to Participate [2] | pyba 12/31/15 | --- | -35 | -55 | -64 | -72 | -83 | -94 | -106 | -118 | -130 | -144 | -309 | -901 |
| F. Facilitate Annuity Portability | pyba 12/31/15 | *Negligible Revenue Effect* | | | | | | | | | | | | |
| G. Simplify Minimum Required Distribution ("MRD") Rules | [12] | --- | -7 | -31 | -40 | -30 | -5 | 22 | 59 | 105 | 161 | 227 | -114 | 460 |
| H. Allow All Inherited Plan and IRA Balances to be Rolled Over Within 60 Days | dma 12/31/15 | *Negligible Revenue Effect* | | | | | | | | | | | | |
| I. Expand the EITC for Workers without Qualifying Children [2] | tyba 12/31/15 | --- | -68 | -6,830 | -6,984 | -7,036 | -7,114 | -7,167 | -7,271 | -7,365 | -7,498 | -7,636 | -28,031 | -64,969 |
| J. Simplify the Rules for Claiming the EITC for Workers Without Qualifying Children [2] | tyba 12/31/15 | --- | -1 | -82 | -86 | -87 | -90 | -93 | -96 | -99 | -101 | -104 | -346 | -838 |
| K. Provide a Second-Earner Tax Credit [2] | tyba 12/31/15 | --- | -2,517 | -8,401 | -8,449 | -8,525 | -8,590 | -8,646 | -8,697 | -8,766 | -8,811 | -8,854 | -36,483 | -80,257 |
| L. Extend Exclusion from Income for Cancellation of Certain Home Mortgage Debt (sunset 12/31/17) | doioa 12/31/14 | -454 | -2,887 | -1,991 | -1,187 | --- | --- | --- | --- | --- | --- | --- | -6,519 | -6,519 |
| **Total of Tax Reform for Families and Individuals** | | **-454** | **-6,239** | **-25,311** | **-25,930** | **-24,975** | **-26,073** | **-26,818** | **-27,942** | **-28,347** | **-29,499** | **-30,737** | **-108,981** | **-252,322** |
| **XI. Reforms to Capital Gains Taxation, Upper-Income Tax Benefits, and the Taxation of Financial Institutions** | | | | | | | | | | | | | | |
| A. Reduce the Value of Certain Tax Expenditures | tyba 12/31/15 | -576 | 14,405 | 48,017 | 46,764 | 49,755 | 52,924 | 56,238 | 59,476 | 62,603 | 65,922 | 69,545 | 211,290 | 525,075 |

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| B. Reform the Taxation of Capital Income | [13] | 3,198 | 21,591 | 5,273 | 19,245 | 20,749 | 22,384 | 24,173 | 26,106 | 27,997 | 30,012 | 32,121 | 92,440 | 232,847 |
| C. Implement the Buffett Rule by Imposing a New "Fair Share Tax" | tyba 12/31/15 | 1,120 | 5,136 | -5,546 | 4,503 | 4,785 | 5,092 | 5,409 | 5,785 | 6,045 | 6,275 | 6,546 | 15,090 | 45,151 |
| D. Impose a Financial Fee | 1/1/16 | --- | 5,640 | 10,807 | 10,750 | 10,994 | 11,230 | 11,489 | 11,753 | 12,023 | 12,300 | 12,583 | 49,421 | 109,569 |
| **Total of Reforms to Capital Gains Taxation, Upper-Income Tax Benefits, and the Taxation of Financial Institutions** | | **3,742** | **46,772** | **58,551** | **81,262** | **86,283** | **91,630** | **97,309** | **103,120** | **108,668** | **114,509** | **120,795** | **368,241** | **912,642** |
| **XII. Loophole Closers** | | | | | | | | | | | | | | |
| A. Require Current Inclusion in Income of Accrued Market Discount and Limit the Accrual Amount for Distressed Debt | dsaa 12/31/15 | --- | 11 | 40 | 75 | 107 | 126 | 128 | 118 | 99 | 77 | 57 | 359 | 839 |
| B. Require that the Cost Basis of Stock that is a Covered Security Must Be Determined Using an Average Cost Basis Method | psaa 12/31/15 | -2 | -10 | -8 | 11 | 69 | 142 | 195 | 256 | 320 | 362 | 406 | 202 | 1,741 |
| C. Tax Carried (Profits) Interests as Ordinary Income | tyea 12/31/15 | 60 | 1,322 | 2,056 | 2,091 | 1,853 | 1,736 | 1,564 | 1,432 | 1,296 | 1,175 | 1,059 | 9,118 | 15,644 |
| D. Require Non-Spouse Beneficiaries of Deceased IRA Owners and Retirement Plan Participants to Take Inherited Distributions Over No More Than Five Years | [14] | --- | [15] | 40 | 150 | 278 | 462 | 869 | 943 | 906 | 867 | 824 | 929 | 5,339 |
| E. Limit the Total Accrual of Tax-Favored Retirement Benefits [16] | caaf tyba 12/31/15 | --- | 296 | 401 | 412 | 423 | 433 | 445 | 459 | 472 | 486 | 500 | 1,965 | 4,327 |
| F. Conform Self-Employment Contributions Act ("SECA") Taxes For Professional Service Businesses [17] | tyba 12/31/15 | --- | 1,511 | 2,805 | 3,073 | 3,260 | 3,387 | 3,538 | 3,697 | 3,858 | 4,034 | 4,219 | 14,036 | 33,382 |
| G. Limit Roth Conversions to Pre-Tax Dollars | doa 12/31/15 | --- | [15] | 3 | 7 | 12 | 18 | 24 | 30 | 36 | 43 | 50 | 41 | 224 |
| H. Eliminate Deduction for Dividends on Stock of Publicly-Traded Corporations Held in Employee Stock Ownership Plans | dadpa DOE | 173 | 649 | 969 | 1,003 | 1,038 | 1,075 | 1,112 | 1,151 | 1,191 | 1,233 | 1,276 | 4,907 | 10,870 |
| I. Repeal Exclusion of Net Unrealized Appreciation in Employer Securities | dma 12/31/15 | --- | -16 | -22 | -16 | -10 | -4 | 2 | 11 | 20 | 29 | 42 | -68 | 36 |
| J. Disallow the Deduction for Charitable Contributions that are a Prerequisite for Purchasing Tickets to College Sporting Events | cmi tyba 12/31/15 | --- | 43 | 218 | 227 | 236 | 245 | 255 | 265 | 276 | 287 | 299 | 970 | 2,352 |
| **Total of Loophole Closers** | | **232** | **3,807** | **6,502** | **7,033** | **7,265** | **7,620** | **8,133** | **8,362** | **8,474** | **8,594** | **8,731** | **32,459** | **74,754** |
| **XIII. Incentives for Job Creation, Clean Energy, and Manufacturing** | | | | | | | | | | | | | | |
| A. Designate Promise Zones | | | | | | | | | | | | | | |
| 1. Employment credit provided to businesses that employ zone residents | tyba 12/31/15 | --- | -54 | -211 | -370 | -524 | -620 | -621 | -622 | -624 | -625 | -627 | -1,779 | -4,898 |
| 2. Allow qualified property placed in service within the zone to be eligible for additional first-year depreciation of 100% of the adjusted basis of the property | tyba 12/31/15 | --- | -199 | -507 | -354 | -255 | -186 | -132 | -100 | -83 | -79 | -84 | -1,501 | -1,979 |

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| B. Provide a Tax Credit for the Production of Advanced Technology Vehicles [18] | vpisa 12/31/15 & before 1/1/23 | --- | -272 | -394 | -368 | -415 | -400 | -342 | -332 | -189 | -67 | -31 | -1,849 | -2,810 |
| C. Provide a Tax Credit for Medium- and Heavy-Duty Alternative-Fuel Commercial Vehicles [19] | vpisa 12/31/15 & before 1/1/22 | --- | -69 | -112 | -132 | -159 | -188 | -209 | -116 | -63 | -56 | -51 | -661 | -1,157 |
| D. Modify and Extend the Tax Credit for the Construction of Energy-Efficient New Homes | haa 12/31/15 & before 1/1/26 | -62 | -119 | -150 | -178 | -200 | -218 | -232 | -238 | -237 | -233 | -231 | -926 | -2,098 |
| E. Reduce Excise Taxes on Liquefied Natural Gas to Bring Into Parity with Diesel [20] | fsoua 12/31/15 | --- | -2 | -3 | -3 | -3 | -3 | -3 | -3 | -4 | -4 | -4 | -15 | -34 |
| F. Enhance and Modify the Conservation Easement Deduction | | | | | | | | | | | | | | |
| 1. Enhance and make permanent incentives for the donation of conservation easements [21] | cma DOE | -13 | -38 | -45 | -48 | -50 | -55 | -66 | -75 | -84 | -92 | -100 | -249 | -666 |
| 2. Pilot an allocable credit for conservation contributions and report to Congress | cma DOE | -5 | -19 | -25 | -25 | -25 | -25 | -25 | -25 | -25 | -25 | -25 | -124 | -249 |
| 3. Eliminate the deduction for contributions of conservation easements on golf courses | cma DOE | 10 | 24 | 24 | 25 | 25 | 26 | 26 | 27 | 28 | 28 | 29 | 134 | 272 |
| 4. Restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation | cma DOE | 4 | 19 | 20 | 20 | 21 | 22 | 22 | 23 | 24 | 24 | 30 | 106 | 229 |
| **Total of Incentives for Job Creation, Clean Energy, and Manufacturing** | | **-67** | **-728** | **-1,403** | **-1,432** | **-1,584** | **-1,648** | **-1,581** | **-1,461** | **-1,258** | **-1,129** | **-1,095** | **-6,863** | **-13,390** |
| **XIV. Modify Estate and Gift Tax Provisions** | | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
| A. Restore the Estate, Gift and Generation-Skipping Transfer ("GST") Tax Parameters in Effect in 2009 with Portability of Exemption Amount Between Spouses | dda & tma 12/31/15 | --- | 1,576 | 7,028 | 8,978 | 12,085 | 15,506 | 16,769 | 17,723 | 18,639 | 19,566 | 20,549 | 45,174 | 138,421 |
| B. Require Consistency in Value for Transfer and Income Tax Purposes | ta tyoe | --- | 25 | 172 | 190 | 203 | 215 | 225 | 234 | 243 | 250 | 258 | 806 | 2,015 |
| C. Modify Transfer Tax Rules for Grantor Retained Annuity Trusts ("GRATs") and Other Grantor Trusts | tca DOE | --- | 87 | 217 | 300 | 421 | 589 | 821 | 1,131 | 1,546 | 2,094 | 2,815 | 1,614 | 10,021 |
| D. Limit Duration of GST Tax Exemption | tca DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| E. Extend the Lien on Estate Tax Deferrals where Estate Consists Largely of Interest in Closely Held Business | [22] | --- | 3 | 4 | 6 | 8 | 8 | 8 | 9 | 10 | 11 | 13 | 29 | 80 |
| F. Modify GST Tax Treatment of Health and Education Exclusion Trusts | [23] | --- | -10 | -20 | -20 | -18 | -16 | -14 | -12 | -10 | -8 | -7 | -83 | -134 |
| G. Simplify Gift Tax Exclusion for Annual Gifts | gma tyoe | --- | --- | 36 | 101 | 167 | 233 | 302 | 385 | 448 | 538 | | 538 | 2,211 |
| H. Expand Applicability of Definition of Executor | DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| **Total of Modify Estate and Gift Tax Provisions** | | **---** | **1,681** | **7,437** | **9,555** | **12,866** | **16,535** | **18,111** | **19,470** | **20,876** | **22,451** | **23,628** | **48,078** | **152,614** |

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **XV. Other Revenue Raisers** | | | | | | | | | | | | | | |
| A. Increase Oil Spill Liability Trust Fund Financing Rate (to 9 Cents Per Barrel Effective 2016 and 10 Cents Per Barrel Effective 2017) and Update the Law to Include Other Sources of Crudes [24] | [25] | --- | 69 | 113 | 119 | 123 | 127 | 132 | 137 | 142 | 147 | 153 | 551 | 1,262 |
| B. Reinstate Superfund Taxes | | | | | | | | | | | | | | |
| 1. Reinstate and Extend Superfund Excise Taxes | pa 12/31/15 & before 1/1/26 | --- | 421 | 563 | 564 | 564 | 563 | 561 | 561 | 561 | 561 | 562 | 2,675 | 5,479 |
| 2. Reinstate Superfund Environmental Income Tax | tyba 12/31/15 & before 1/1/26 | --- | 1,002 | 1,591 | 1,625 | 1,634 | 1,661 | 1,699 | 1,743 | 1,789 | 1,805 | 1,805 | 7,515 | 16,355 |
| C. Increase Tobacco Taxes and Index for Inflation [2] [26] | ara 12/31/15 | --- | 6,395 | 8,241 | 8,005 | 8,222 | 8,485 | 8,726 | 8,998 | 9,225 | 9,422 | 9,605 | 39,349 | 85,325 |
| D. Make the 0.2 Percent Unemployment Insurance ("UI") Surtax Permanent [27] | wpo/a 1/1/16 | --- | 1,070 | 1,438 | 1,452 | 1,464 | 1,477 | 1,490 | 1,504 | 1,517 | 1,530 | 1,544 | 6,901 | 14,486 |
| E. Expand Federal Unemployment Tax Act ("FUTA") Base [27] | DOE | --- | --- | 13,506 | 9,176 | 2,910 | -3,610 | -3,030 | -2,740 | -2,962 | -3,324 | -2,678 | 21,982 | 7,248 |
| F. Reform the UI extended benefits program [27] | 10/1/15 | --- | --- | --- | 1 | 6 | 15 | 25 | 20 | -3 | -31 | -48 | 22 | -15 |
| G. Modernize the UI program [27] | 10/1/15 | --- | --- | --- | --- | -49 | -155 | -156 | -121 | -106 | -202 | -165 | -204 | -954 |
| H. Levy a Fee on the Production of Hardrock Minerals to Restore Abandoned Mines [27] | rma 12/31/16 | --- | --- | 111 | 148 | 148 | 148 | 148 | 148 | 148 | 148 | 148 | 555 | 1,295 |
| I. Return Fees on the Production of Coal to Pre-2006 Levels to Restore Abandoned Mines (sunset 9/30/21) [27] | Cma 9/30/15 | --- | --- | 36 | 37 | 38 | 39 | 38 | 38 | --- | --- | --- | 150 | 226 |
| **Total of Other Revenue Raisers** | | **---** | **8,957** | **25,599** | **21,127** | **15,060** | **8,750** | **9,633** | **10,288** | **10,311** | **10,056** | **10,926** | **79,496** | **130,707** |
| **XVI. Reduce the Tax Gap and Make Reforms** | | | | | | | | | | | | | | |
| A. Expand Information Reporting | | | | | | | | | | | | | | |
| 1. Improve information reporting for certain businesses and contractors: | | | | | | | | | | | | | | |
| a. Require a certified taxpayer identification number ("TIN") from contractors and allow certain withholding | pmtca 12/31/15 | --- | 7 | 53 | 37 | 39 | 41 | 43 | 46 | 48 | 51 | 53 | 178 | 419 |
| b. Require information reporting for private separate accounts of life insurance companies | tyba 12/31/15 | --- | | | | | | *Negligible Revenue Effect* | | | | | | |
| 2. Provide an exception to the limitation on disclosing tax return information to expand TIN matching beyond forms where payments are subject to backup withholding | DOE | | | | | | | *Negligible Revenue Effect* | | | | | | |
| 3. Provide for reciprocal reporting of information in connection with the implementation of the Foreign Account Tax Compliance Act ("FATCA") | rrtbfa 12/31/16 | --- | --- | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | 1 |
| 4. Improve mortgage interest deduction reporting | irdf cyba 12/31/15 | 19 | 131 | 154 | 160 | 172 | 180 | 200 | 215 | 236 | 260 | 283 | 816 | 2,010 |

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 5. Require Form W-2 reporting for employer contributions to defined contribution plans | irdf cyba 12/31/15 | *Negligible Revenue Effect* | | | | | | | | | | | | |
| B. Improve Compliance By Businesses | | | | | | | | | | | | | | |
| 1. Increase certainty with respect to worker classification [2] [28] | generally DOE | --- | 158 | 551 | 993 | 1,183 | 1,254 | 1,277 | 1,306 | 1,335 | 1,359 | 1,378 | 4,140 | 10,796 |
| 2. Increase information sharing to administer excise taxes | DOE | --- | 3 | 5 | 7 | 9 | 11 | 14 | 17 | 19 | 21 | 22 | 35 | 126 |
| 3. Provide authority to readily share beneficial ownership of U.S. companies with law enforcement | DOE | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | 1 |
| C. Strengthen Tax Administration | | | | | | | | | | | | | | |
| 1. Impose liability on shareholders to collect unpaid income taxes of applicable corporations | [29] | 59 | 222 | 217 | 141 | 147 | 153 | 160 | 166 | 173 | 180 | 187 | 938 | 1,804 |
| 2. Increase levy authority for payments to Medicare providers with delinquent tax debt | pma DOE | --- | 40 | 55 | 56 | 57 | 58 | 60 | 61 | 62 | 63 | 64 | 267 | 577 |
| 3. Implement a program integrity statutory cap adjustment for tax administration [27] [30] | DOE | --- | 432 | 1,454 | 2,939 | 4,440 | 5,913 | 7,099 | 7,867 | 8,230 | 8,410 | 8,471 | 15,178 | 55,255 |
| 4. Streamline audit and adjustment procedures for large partnerships | [31] | --- | --- | 87 | 634 | 790 | 824 | 886 | 966 | 1,050 | 1,092 | 1,118 | 2,335 | 7,447 |
| 5. Revise offer-in-compromise application rules | oicsa DOE | -5 | -5 | [32] | [32] | [32] | [32] | [32] | [32] | [32] | [32] | [32] | -10 | -10 |
| 6. Expand Internal Revenue Service ("IRS") access to information in the National Directory of New Hires for tax administration purposes | DOE | *No Revenue Effect* | | | | | | | | | | | | |
| 7. Make repeated willful failure to file a tax return a felony | rrtbfa 12/31/15 | *Negligible Revenue Effect* | | | | | | | | | | | | |
| 8. Facilitate tax compliance with local jurisdictions | Dma DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| 9. Extend statute of limitations for assessment of overstated basis and State adjustments | rrtbfa 12/31/15 | --- | 26 | 70 | 87 | 98 | 110 | 126 | 146 | 168 | 177 | 182 | 391 | 1,190 |
| 10. Improve investigative disclosure statute | Dma DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| 11. Allow the IRS to absorb credit and debit card processing fees for certain tax payments | pma DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| 12. Provide the IRS with Greater Flexibility to Address Correctable Errors [2] | DOE | [15] | [15] | 13 | 14 | 14 | 14 | 15 | 15 | 16 | 16 | 17 | 55 | 133 |
| 13. Enhance electronic filing of returns | tyba DOE & rrtbfa 12/31/15 | *Negligible Revenue Effect* | | | | | | | | | | | | |
| 14. Improve the whistleblower program | DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| 15. Index all civil penalties for inflation | DOE | --- | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] | [15] |
| 16. Extend IRS authority to require truncated Social Security Numbers on Form W–2 | DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| 17. Combat tax-related identity theft | DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| 18. Allow States to send notices of intent to offset Federal tax refunds to collect State tax obligations by regular first-class mail instead of certified mail | DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| 19. Rationalize tax return filing due dates so they are staggered [2] | rrtbfa 12/31/15 | --- | -878 | 10 | 7 | 66 | 81 | 80 | 84 | 85 | 88 | 95 | -715 | -284 |

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 20. Increase oversight and due diligence of paid tax return preparers: | | | | | | | | | | | | | | |
| a. Extend paid preparer EITC due diligence requirements to the child tax credit ("CTC") [2] | rrtba 12/31/15 | --- | --- | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 19 | 43 |
| b. Explicitly provide that the Department of the Treasury and the IRS have authority to regulate all paid return preparers [2] | DOE | [15] | 5 | 11 | 12 | 13 | 14 | 15 | 15 | 16 | 17 | 18 | 54 | 135 |
| c. Increase the penalty applicable to paid tax preparers who engage in willful or reckless conduct | rrtbfa 12/31/15 | --- | [15] | [15] | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 3 | 9 |
| 21. Enhance administrability of the appraiser penalty | rrtbfa 12/31/15 | --- | *Negligible Revenue Effect* | | | | | | | | | | | |
| 22. Enhance UI program integrity [2] [27] [30] | 10/1/15 | --- | 31 | 61 | 60 | 56 | 52 | 50 | 50 | 50 | 52 | 54 | 260 | 516 |
| **Total of Reduce the Tax Gap and Make Reforms** | | **73** | **172** | **2,746** | **5,153** | **7,090** | **8,711** | **10,031** | **10,960** | **11,494** | **11,792** | **11,948** | **23,944** | **80,168** |
| **XVII. Simplify the Tax System** | | | | | | | | | | | | | | |
| A. Modify Adoption Credit to Allow Tribal Determination of Special Needs | tyba 12/31/15 | --- | [8] | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -3 | -7 |
| B. Repeal Non-Qualified Preferred Stock ("NQPS") Designation | sia 12/31/15 | --- | 5 | 11 | 12 | 12 | 13 | 13 | 14 | 15 | 16 | 17 | 53 | 128 |
| C. Repeal Preferential Dividend Rule for Publicly Traded and Publicly Offered REITs | dmi tyba DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| D. Reform Excise Tax Based on Investment Income of Private Foundations | tyba DOE | --- | -9 | -13 | -13 | -14 | -15 | -15 | -16 | -16 | -17 | -18 | -63 | -146 |
| E. Remove Bonding Requirements for Certain Taxpayers Subject to Federal Excise Taxes on Distilled Spirits, Wine, and Beer | 90da DOE | --- | *Negligible Revenue Effect* | | | | | | | | | | | |
| F. Simplify Arbitrage Investment Restrictions | bia DOE | [8] | -3 | -12 | -24 | -35 | -46 | -58 | -71 | -83 | -96 | -108 | -120 | -536 |
| G. Simplify Single-Family Housing Mortgage Bond Targeting Requirements | bia DOE | [8] | -1 | -5 | -11 | -19 | -28 | -37 | -48 | -60 | -74 | -90 | -64 | -373 |
| H. Streamline Private Business Limits on Governmental Bonds | bia DOE | [8] | [8] | -1 | -3 | -5 | -7 | -9 | -11 | -13 | -15 | -17 | -16 | -81 |
| I. Repeal Technical Terminations of Partnerships | ta 12/31/15 | --- | 4 | 12 | 19 | 22 | 23 | 24 | 25 | 26 | 27 | 23 | 80 | 205 |
| J. Repeal Anti-Churning Rules of Code Section 197 | aa 12/31/15 | --- | -22 | -76 | -152 | -250 | -370 | -435 | -435 | -435 | -435 | -435 | -871 | -3,047 |
| K. Repeal Special Estimated Tax Payment Provision for Certain Insurance Companies | tyba 12/31/15 | --- | *Negligible Revenue Effect* | | | | | | | | | | | |
| L. Repeal the Telephone Excise Tax | [33] | --- | -368 | -417 | -378 | -342 | -309 | -279 | -253 | -229 | -207 | -187 | -1,814 | -2,969 |
| M. Increase the Standard Mileage Rate for Automobile Use by Volunteers | tyba 12/31/15 | --- | -13 | -52 | -54 | -56 | -57 | -59 | -61 | -63 | -66 | -68 | -231 | -549 |
| N. Consolidate Contribution Limitations for Charitable Deductions and Extend the Carryforward Period for Excess Charitable Contribution Deduction Amounts | tyba 12/31/15 | --- | -15 | -239 | -260 | -278 | -289 | -498 | -683 | -838 | -987 | -1,124 | -1,082 | -5,212 |
| O. Exclude from Gross Income Subsidies from Public Utilities for Purchase of Water Runoff Management | spfwcaswma 12/31/15 | --- | *Negligible Revenue Effect* | | | | | | | | | | | |

| Provision | Effective | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| P. Provide Relief for Certain Accidental Dual Citizens | 1/1/16 | -4 | -28 | -32 | -33 | -32 | -18 | -20 | -23 | -27 | -30 | -32 | -147 | -279 |
| **Total of Simplify the Tax System** | | **-4** | **-449** | **-825** | **-898** | **-998** | **-1,104** | **-1,375** | **-1,564** | **-1,725** | **-1,885** | **-2,040** | **-4,279** | **-12,866** |
| **XVIII. User Fees** | | | | | | | | | | | | | | |
| A. Reform Inland Waterways Funding [27] | vuicwtba 9/30/15 | --- | 63 | 84 | 84 | 84 | 84 | 84 | 84 | 84 | 83 | 83 | 399 | 817 |
| B. Reauthorize Special Assessment On Domestic Nuclear Utilities [27] | 10/1/15 | --- | 152 | 154 | 158 | 162 | 165 | 169 | 173 | 177 | 181 | 185 | 791 | 1,676 |
| **Total of User Fees** | | **---** | **215** | **238** | **242** | **246** | **249** | **253** | **257** | **261** | **264** | **268** | **1,190** | **2,493** |
| **XIX. Trade Initiatives** | | | | | | | | | | | | | | |
| A. Extend the Generalized System of Preferences (sunset 12/31/16) [27] | 10/1/15 | --- | -1,149 | -104 | --- | --- | --- | --- | --- | --- | --- | --- | -1,253 | -1,253 |
| B. Extend African Growth and Opportunity Act (sunset 9/30/30) [27] | 10/1/15 | --- | -88 | -120 | -133 | -147 | -162 | -178 | -195 | -215 | -235 | -256 | -650 | -1,729 |
| **Total of Trade Initiatives** | | **---** | **-1,237** | **-224** | **-133** | **-147** | **-162** | **-178** | **-195** | **-215** | **-235** | **-256** | **-1,903** | **-2,982** |
| **XX. Other Initiatives** | | | | | | | | | | | | | | |
| A. Allow Offset of Federal Income Tax Refunds to Collect Delinquent State Income Taxes for Out-of-State Residents | DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| B. Authorize the Limited Sharing of Business Tax Return Information to Improve the Accuracy of Important Measures of the Economy | DOE | *No Revenue Effect* | | | | | | | | | | | | |
| C. Eliminate Certain Reviews Conducted by the U.S. Treasury Inspector General for Tax Administration ("TIGTA") | tyba 12/31/15 | --- *No Revenue Effect* | | | | | | | | | | | | |
| D. Modify Indexing to Prevent Deflationary Adjustments | DOE | *No Revenue Effect* | | | | | | | | | | | | |
| E. Enact Comprehensive Immigration Reform | DOE | *JCT's Estimate of the Revenue Effects of Immigration Reform is Included in the CBO Immigration Cost Estimate* | | | | | | | | | | | | |
| **Total of Other Initiatives** | | ***Negligible Revenue Effect*** | | | | | | | | | | | | |
| **NET TOTAL** | | **-3,783** | **100,428** | **141,857** | **162,842** | **143,180** | **138,964** | **95,037** | **101,815** | **105,140** | **108,879** | **115,359** | **683,497** | **1,209,737** |

Joint Committee on Taxation

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NOTE: Details may not add to totals due to rounding. The date of enactment is generally assumed to be July 1, 2015.

*[Legend and Footnotes for JCX-50-15 appear on the following pages]*

**Legend for JCX-50-15:**

Legend for "Effective" column:

aa = acquisitions after
amo/a = allocations made on or after
ami = allocations made in
ara = articles removed after
Ara = amounts realized after
aspioiiUSa = all spirits produced in or imported into the United States after
bia = bonds issued after
bii = bonds issued in
bio/a = bonds issued on or after
bis = bonds issued starting
caaf = contributions and accruals for
cma = contributions made after
Cma = coal mined after
cyba = calendar years beginning after
cybo/a = calendar years beginning on or after
dadpa = dividends and distributions paid after
dceia = derivative contracts entered into after
dda = decedents dying after
dma = distributions made after
Dma = disclosures made after
dmi = distributions made in
doa = distributions occurring after
DOE = date of enactment
doioa = discharge of indebtedness occurring after
dola = discharges of loans after
doUSrpioa = dispositions of U.S. real property interests occurring after
dpoia = damages paid or incurred after
dsaa = debt securities acquired after
edoa = eligible distributions occurring after
epoia = expenses paid or incurred after
Epoia = expenditures paid or incurred after
fsoua = fuel sold or used after
ftyba = first taxable year beginning after
gma = gifts made after
irdf = information returns due for
lkeca = like-kind exchanges completed after
oicsa = offers-in-compromise submitted after
pa = periods after
pii = policies issued in
pma = payments made after
pmtca = payments made to contractors after
pocia = production of costs incurred after
powcba = property on which construction begins after
ppisa = property placed in service after
psaa = portfolio stock acquired after
ptybo/a = partnership's taxable year beginning on or after
pyba = plan years beginning after
qiai = qualified investments approved in
qppisi = qualifying property placed in service in
qsbsaa = qualified small business stock acquired after
qwpdt12mpbo = qualified wages paid during the 12-month period beginning on
raeia = research agreements entered into after
rma = rock mined after
rrtbfa = returns required to be filed after
sia = stock issued after
soea = sales or exchanges after
spfwcaswma = subsidies provided for water conservation and storm water management after
ta = transfers after
tca = trusts created after
Tca = transactions completed after
tma = transfers made after
toa = transactions occurring after
tyba = taxable years beginning after
tyea = taxable years ending after
tyoe = the year of enactment
vpisa = vehicles placed in service after
vuicwtba = vessels used in commercial waterway transportation beginning after
wpo/a = wages paid on or after
wptqei = wages paid to qualified employees in
wptqiwbwftea = wages paid to qualified individuals who begin work for the employer after
90da = 90 days after



*[Footnotes for JCX-50-15 appear on the following pages]*

**Footnotes for JCX-50-15:**

[1] To the extent the proposals are not fully specified, estimates will be updated as new information becomes available and policy intent is clarified.

| [2] Estimate includes the following outlay effects [34]: | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Reduce the earnings threshold for the refundable portion of the child tax credit to $3,000 | --- | --- | --- | --- | 12,373 | 12,455 | 12,452 | 12,534 | 12,597 | 12,694 | 12,733 | 24,827 | 87,839 |
| EITC modification and simplification ($5,000) | --- | --- | --- | --- | 1,342 | 1,334 | 1,325 | 1,318 | 1,313 | 1,317 | 1,316 | 2,676 | 9,265 |
| Extend EITC for larger families | --- | --- | --- | --- | 2,433 | 2,491 | 2,557 | 2,610 | 2,673 | 2,757 | 2,827 | 4,924 | 18,348 |
| American opportunity tax credit | --- | --- | --- | --- | 6,279 | 6,275 | 6,252 | 6,278 | 6,255 | 6,262 | 6,280 | 12,554 | 43,881 |
| Expand and simplify the tax credit provided to qualified small employers for non-elective contributions to employee health insurance | 8 | 13 | 13 | 16 | 11 | 11 | 19 | 21 | 22 | 23 | 24 | 72 | 181 |
| Modify and permanently extend renewable electricity production tax credit and investment tax credit | --- | --- | 25 | 269 | 502 | 586 | 620 | 584 | 594 | 592 | 631 | 1,384 | 4,405 |
| Provide a carbon dioxide investment and sequestration tax credit | --- | --- | --- | 176 | 404 | 637 | 914 | 1,147 | 995 | 826 | 817 | 1,217 | 5,915 |
| Provide America Fast Forward Bonds and expand eligible uses | --- | 91 | 760 | 1,978 | 3,300 | 4,695 | 6,185 | 7,765 | 9,391 | 11,065 | 12,787 | 10,824 | 58,017 |
| Reform child care tax incentives | --- | --- | 828 | 876 | 887 | 899 | 908 | 928 | 964 | 980 | 983 | 3,490 | 8,253 |
| Expand and modify the AOTC and repeal Lifetime Learning Credits | --- | --- | 3,742 | 3,504 | 3,186 | 3,376 | 3,498 | 3,868 | 3,518 | 3,614 | 3,768 | 13,808 | 32,074 |
| Make Pell grants excludable from income | --- | --- | 186 | 476 | 461 | 450 | 456 | 454 | 457 | 458 | 451 | 1,573 | 3,849 |
| Modify reporting of tuition expenses and scholarships on Form 1098-T | --- | --- | -14 | -14 | -15 | -16 | -17 | -18 | -19 | -20 | -21 | -61 | -156 |
| Repeal the student loan interest deduction and provide exclusion for certain debt relief and scholarships | --- | --- | --- | --- | --- | --- | -15 | -30 | -46 | -64 | -82 | --- | -237 |
| Provide for automatic enrollment in IRAs, including a small employer tax credit, and double the tax credit for small employer plan start-up costs and provide an additional tax credit for small employer plans newly offering auto-enrollment | --- | --- | --- | 393 | 371 | 387 | 401 | 414 | 429 | 448 | 462 | 1,151 | 3,305 |
| Require retirement plans to allow long-term part-time workers to participate | --- | --- | -8 | -11 | -11 | -12 | -14 | -15 | -15 | -17 | -18 | -41 | -120 |
| Expand the EITC for workers without qualifying children | --- | --- | 5,384 | 5,511 | 5,514 | 5,544 | 5,569 | 5,627 | 5,687 | 5,758 | 5,847 | 21,953 | 50,441 |
| Simplify the rules for claiming the EITC for workers without qualifying children | --- | --- | 58 | 61 | 62 | 64 | 66 | 68 | 70 | 72 | 74 | 246 | 596 |
| Provide a second-earner tax credit | --- | --- | 728 | 744 | 744 | 725 | 717 | 702 | 694 | 685 | 672 | 2,941 | 6,411 |
| Increase tobacco taxes and index for inflation [27] | --- | -16 | -76 | -122 | -166 | -213 | -255 | -299 | -326 | -335 | -335 | -592 | -2,143 |
| Increase certainty with respect to worker classification | --- | 34 | 59 | 88 | 70 | 83 | 83 | 83 | 83 | 82 | 82 | 334 | 746 |
| Provide the IRS with greater flexibility to address correctable errors | [35] | [35] | -3 | -3 | -3 | -4 | -4 | -4 | -4 | -4 | -4 | -14 | -33 |
| Rationalize tax return filing due dates so they are staggered | --- | -1 | -4 | -7 | -10 | -12 | -15 | -17 | -19 | -20 | -22 | -34 | -126 |
| Extend paid preparer EITC due diligence requirements to the CTC | --- | --- | -4 | -4 | -4 | -4 | -4 | -4 | -4 | -5 | -4 | -18 | -40 |
| Explicitly provide that the Department of Treasury and IRS have authority to regulate all paid return preparers | [35] | -2 | -4 | -4 | -4 | -5 | -5 | -5 | -5 | -6 | -6 | -18 | -45 |
| Enhance UI program integrity [27] | --- | -31 | -63 | -70 | -80 | -90 | -100 | -111 | -121 | -131 | -141 | -334 | -938 |
| Total Outlay Effects | 8 | 88 | 11,607 | 13,857 | 37,646 | 39,656 | 41,594 | 43,898 | 45,183 | 47,031 | 49,121 | 102,862 | 329,687 |

[3] Effective for taxable years of foreign corporations beginning after December 31, 2014, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

[4] Effective on the date of enactment and would apply to earnings accumulated for taxable years beginning before January 1, 2016.

[5] Effective with respect to PAB volume cap to be received in, and additional LIHTC allocation authority received for, calendar years beginning after the date of enactment; and effective for projects that are allocated volume cap after the date of enactment.

*[Footnotes for JCX-50-15 continue on the following pages]*

**Footnotes for JCX-50-15 continued:**

[6] Effective for elections under section 42(g)(1) that are made after the date of enactment.

[7] The proposed requirements for Long-Term Use Agreements would be effective for Agreements that are either first executed, or subsequently modified, 30 days or more after enactment. The proposed clarification of the general public use requirement would be effective for taxable years ending after the date of enactment.

[8] Loss of less than $500,000.

[9] Effective for sales or assignment of interests in life insurance policies and payments of death benefits in taxable years beginning after December 31, 2015.

[10] Effective for contracts issued after December 31, 2015, in taxable years ending after that date.

[11] Estimate includes the following effects:

| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Revenue Effects | --- | 552 | 983 | 1,084 | 1,172 | 1,240 | 1,300 | 1,365 | 1,434 | 1,505 | 1,540 | 5,031 | 12,176 |
| On-budget effects | --- | 582 | 1,058 | 1,183 | 1,281 | 1,356 | 1,423 | 1,494 | 1,569 | 1,647 | 1,687 | 5,459 | 13,280 |
| Off-budget effects | --- | -30 | -75 | -99 | -109 | -116 | -123 | -129 | -135 | -142 | -147 | -428 | -1,104 |

[12] Generally effective for taxpayers attaining age 70½ after December 31, 2015, and for taxpayers who die on or after December 31, 2015, before attaining age 70½.

[13] Effective for capital gains realized and qualified dividends received in taxable years beginning after December 31, 2015, and for gains on gifts made and of decedents dying after December 31, 2015.

[14] Generally effective for distributions with respect to plan participants or IRA owners who die after December 31, 2015.

[15] Gain of less than $500,000.

[16] Estimate includes the following effects:

| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Revenue Effects | --- | 296 | 401 | 412 | 423 | 433 | 445 | 459 | 472 | 486 | 500 | 1,965 | 4,327 |
| On-budget effects | --- | 290 | 393 | 403 | 414 | 424 | 436 | 449 | 462 | 476 | 490 | 1,924 | 4,237 |
| Off-budget effects | --- | 6 | 8 | 9 | 9 | 9 | 9 | 10 | 10 | 10 | 10 | 41 | 90 |

[17] Estimate includes the following effects:

| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Revenue Effects | --- | 1,511 | 2,804 | 3,073 | 3,261 | 3,387 | 3,538 | 3,697 | 3,859 | 4,034 | 4,219 | 14,036 | 33,382 |
| On-budget effects | --- | 758 | 1,485 | 1,632 | 1,732 | 1,798 | 1,878 | 1,969 | 2,070 | 2,175 | 2,284 | 7,405 | 17,781 |
| Off-budget effects | --- | 753 | 1,319 | 1,441 | 1,529 | 1,589 | 1,660 | 1,728 | 1,789 | 1,859 | 1,935 | 6,631 | 15,601 |

[18] The credit would be 75 percent of the otherwise allowable amount for vehicles placed in service in 2020, 50 percent of such amount for vehicles placed in service in 2021, and 25 percent of such amount for vehicles placed in service in 2022.

[19] For vehicles placed in service in calendar year 2021, the credit would be limited to 50 percent of the otherwise allowable amount.

[20] The proposal would lower the 24.3 cents per gallon excise tax on LNG to 14.1 cents per gallon beginning after December 31, 2015.

[21] Estimate includes interaction with the proposal to create an allocable credit for conservation contributions.

[22] The proposal would be effective for the estates of all decedents dying on or after the effective date, as well as for all estates of decedents dying before the date of enactment as to which the section 6324(a)(1) lien has not expired on the effective date.

[23] Effective for trusts created after the introduction of the bill proposing this change, and to transfers after that date made to pre-existing trusts.

[24] The revenue estimate assumes a permanent extension of the financing rate at the rate of 10 cents per barrel effective for production after December 31, 2017.

[25] Effective at the applicable rate on such crudes received at a U.S. refinery, entered into the United States, or used or exported as described above after December 31, 2015.

[26] Estimate provided in consultation with the Congressional Budget Office and includes both outlay effects (see footnote 2 above) and indirect effects (following) resulting from the health benefits of a reduction in tobacco consumption:

| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| On-budget effects | --- | 10 | 28 | 37 | 46 | 57 | 71 | 86 | 104 | 123 | 146 | 178 | 707 |
| Off-budget effects | --- | 4 | 10 | 14 | 17 | 22 | 27 | 32 | 39 | 46 | 54 | 68 | 266 |

[27] Estimate provided by the Congressional Budget Office.

[28] Estimate includes the following effects:

| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2015-20 | 2015-25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Revenue Effects | --- | 158 | 551 | 993 | 1,183 | 1,254 | 1,277 | 1,306 | 1,335 | 1,359 | 1,378 | 4,140 | 10,796 |
| On-budget effects | --- | -8 | -13 | -14 | -35 | -64 | -70 | -76 | -81 | -88 | -96 | -133 | -545 |
| Off-budget effects | --- | 166 | 564 | 1,007 | 1,218 | 1,318 | 1,348 | 1,382 | 1,417 | 1,447 | 1,474 | 4,273 | 11,341 |

[29] Effective for sales of controlling interests in the stock of applicable C corporations occurring on or after April 10, 2013.

*[Footnotes for JCX-50-15 continue on the following page]*

**Footnotes for JCX-50-15 continued:**

[30] The budgetary savings would not be counted for Congressional scorekeeping purposes.
[31] Effective for a partnership's taxable year ending on or after the date that is two years from the date of enactment.
[32] Negligible revenue effect.
[33] Effective for amounts paid pursuant to bills first rendered more than 90 days after enactment of legislation repealing the tax.
[34] The outlay effects are preliminary and subject to change.
[35] Decrease in outlays of less than $500,000.