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[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION OF PUBLIC LAW 115–97

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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33–137 WASHINGTON : 2018 JCS–1–18

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation in consultation with the staffs of the House Committee on Ways and Means, the Senate Committee on Finance, and the Treasury Department's Office of Tax Policy, provides an explanation of Public Law No. 115–97 (also referred to as the "Act" throughout).[2] The explanation of the provisions follows the order of the Act.

For each provision, the document includes a description of prior law, an explanation of the provision, and the effective date. The prior law section describes the law in effect immediately prior to enactment and does not reflect changes to the law made by the provision or by subsequent legislation. For contemporaneous legislative history related to the Act, please see the relevant House Ways and Means Committee report,[3] the reconciliation recommendations submitted by the Senate Budget Committee,[4] and the Conference Report.[5] This document includes citations to some, but not necessarily all, regulations and other administrative guidance issued as of the time of publication of the document. These citations are included strictly as reference tools for readers.

Section references are to the Internal Revenue Code of 1986, as amended, (the "Code") unless otherwise indicated.

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[1] This document may be cited as follows: Joint Committee on Taxation, *General Explanation of Public Law No. 115–97* (JCS–1–18), December 2018.

[2] Pub. L. No. 115–97, 31 Stat. 2054.

[3] Report of the Committee on Ways and Means on H.R. 1, the "Tax Cuts and Jobs Act," H. Rep. No. 115–409, November 13, 2017.

[4] Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Prt. 115–20, December 2017.

[5] Conference Report to Accompany H.R. 1, the "Tax Cuts and Jobs Act", Rep. No. 115–466, December 15, 2017.

TITLE I

SUBTITLE A—INDIVIDUAL TAX REFORM

PART I—TAX RATE REFORM

A. Modification of Rates (sec. 11001 of the Act and sec. 1 of the Code)

Prior Law

In general

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

Tax rate schedules

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

TABLE 1.—FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2017 [6]

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $9,325	10% of the taxable income
Over $9,325 but not over $37,950	$932.50 plus 15% of the excess over $9,325
Over $37,950 but not over $91,900	$5,226.25 plus 25% of the excess over $37,950
Over $91,900 but not over $191,650	$18,713.75 plus 28% of the excess over $91,900
Over $191,650 but not over $416,700	$46,643.75 plus 33% of the excess over $191,650
Over $416,700 but not over $418,400	$120,910.25 plus 35% of the excess over $416,700
Over $418,400	$121,505.25 plus 39.6% of the excess over $418,400
Heads of Households	
Not over $13,350	10% of the taxable income
Over $13,350 but not over $50,800	$1,335 plus 15% of the excess over $13,350
Over $50,800 but not over $131,200	$6,952.50 plus 25% of the excess over $50,800
Over $131,200 but not over $212,500	$27,052.50 plus 28% of the excess over $131,200
Over $212,500 but not over $416,700	$49,816.50 plus 33% of the excess over $212,500
Over $416,700 but not over $444,550	$117,202.50 plus 35% of the excess over $416,700
Over $444,550	$126,950 plus 39.6% of the excess over $444,550
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $18,650	10% of the taxable income
Over $18,650 but not over $75,900	$1,865 plus 15% of the excess over $18,650
Over $75,900 but not over $153,100	$10,452.50 plus 25% of the excess over $75,900
Over $153,100 but not over $233,350	$29,752.50 plus 28% of the excess over $153,100
Over $233,350 but not over $416,700	$52,222.50 plus 33% of the excess over $233,350
Over $416,700 but not over $470,700	$112,728 plus 35% of the excess over $416,700
Over $470,700	$131,628 plus 39.6% of the excess over $470,700

TABLE 1.—FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2017 [6]—Continued

If taxable income is:	Then income tax equals:
Married Individuals Filing Separate Returns	
Not over $9,325	10% of the taxable income
Over $9,325 but not over $37,950	$932.50 plus 15% of the excess over $9,325
Over $37,950 but not over $76,550	$5,226.25 plus 25% of the excess over $37,950
Over $76,550 but not over $116,675	$14,876.25 plus 28% of the excess over $76,550
Over $116,675 but not over $208,350	$26,111.25 plus 33% of the excess over $116,675
Over $208,350 but not over $235,350	$56,364 plus 35% of the excess over $208,350
Over $235,350	$65,814 plus 39.6% of the excess over $235,350
Estates and Trusts	
Not over $2,550	15% of the taxable income
Over $2,550 but not over $6,000	$382.50 plus 25% of the excess over $2,550
Over $6,000 but not over $9,150	$1,245 plus 28% of the excess over $6,000
Over $9,150 but not over $12,500	$2,127 plus 33% of the excess over $9,150
Over $12,500	$3,232.50 plus 39.6% of the excess over $12,500

Unearned income of children

Special rules (generally referred to as the "kiddie tax") apply to the net unearned income of certain children.[7] Generally, the kiddie tax applies to a child if: (1) the child has not reached the age of 19 by the close of the taxable year, or the child is a full-time student under the age of 24, and either of the child's parents is alive at such time; (2) the child's unearned income exceeds. $2,100 (for 2017); and (3) the child does not file a joint return.[8] The kiddie tax applies regardless of whether the child may be claimed as a dependent by either or both parents. For children above age 17, the kiddie tax applies only to children whose earned income does not exceed one-half of the amount of their support.

Under these rules, the net unearned income of a child (for 2017, unearned income over $2,100) is taxed at the parents' tax rates if the parents' tax rates are higher than the tax rates of the child.[9] The remainder of a child's taxable income (*i.e.*, earned income, plus unearned income up to $2,100 (for 2017), less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child. For these purposes, unearned income is income other than wages, salaries, professional fees, other amounts received as compensation for personal services actually rendered, and distributions from qualified disability trusts.[10] In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.[11]

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($1,050 for 2017 [12]), and (2) the greater of (a) such minimum

[6] Rev. Proc. 2016-55, 2016-45 I.R.B. 707, Sec. 3.01.
[7] Sec. 1(g).
[8] Sec. 1(g)(2).
[9] Special rules apply for determining which parent's rate applies where a joint return is not filed.
[10] Sec. 1(g)(4) and sec. 911(d)(2).
[11] Sec. 1(h).
[12] Sec. 3.02 of Rev. Proc. 2016–55, *supra*.

standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.[13]

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

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

1. The sum of (a) the tax payable by the child on the child's earned income and unearned income up to $2,100 (for 2017), plus (b) the allocable parental tax on the child's unearned income, or
2. The tax on the child's income without regard to the kiddie tax provisions.[16]

If a child's gross income is only from interest and dividends and the amount of the gross income (in 2017) is greater than $1,050, and less than $10,500, the parents may elect to report the child's gross income on the parents' return and the child is treated as having no gross income. A tax at the rate of 10 percent is imposed on up to $1,050 of the child's gross income included on the parents' return.

Capital gains rates

In the case of an individual, estate, or trust, adjusted net capital gain is taxed at rates of 0, 15, and 20 percent. The amount taxed at a zero rate is the amount that would otherwise be taxed at a 0-, 10-, or 15-percent rate if the gain were ordinary income; the amount taxed at a 15-percent rate is the amount that would otherwise be taxed at a 25-, 28-, 33-, or 35-percent rate if the gain were ordinary income; and the amount taxed at a 20-percent rate is the amount that would otherwise be taxed at a 39.6-percent rate if the gain were ordinary income. The same rates applicable to adjusted net capital gain under the regular tax apply to the alternative minimum tax.

The maximum rate on unrecaptured section 1250 gain is 25 percent, and the maximum rate on net collectibles gain and certain gain from the sale of small business stock is 28 percent.

The "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the gain (if any) taxed at maximum rates of 25 and 28 percent. The net capital gain is reduced

[13] Sec. 1(g)(4).
[14] Sec. 1(g)(3).
[15] Sec. 1(g)(6). See Form 8615, Tax for Certain Children Who Have Unearned Income.
[16] Sec. 1(g)(1).

by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation. Net capital gain is increased by the amount of qualified dividend income.

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

Explanation of Provision

The provision temporarily replaces the existing rate structure with a new rate structure.

TABLE 2.—FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2018

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $9,525	10% of the taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $82,500	$4,453.50 plus 22% of the excess over $38,700
Over $82,500 but not over $157,500	$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$32,089.50 plus 32% of the excess over $157,500
Over $200,000 but not over $500,000	$45,689.50 plus 35% of the excess over $200,000
Over $500,000	$150,689.50 plus 37% of the excess over $500,000
Heads of Households	
Not over $13,600	10% of the taxable income
Over $13,600 but not over $51,800	$1,360 plus 12% of the excess over $13,600
Over $51,800 but not over $82,500	$5,944 plus 22% of the excess over $51,800
Over $82,500 but not over $157,500	$12,698 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$30,698 plus 32% of the excess over $157,500
Over $200,000 but not over $500,000	$44,298 plus 35% of the excess over $200,000
Over $500,000	$149,298 plus 37% of the excess over $500,000
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $19,050	10% of the taxable income
Over $19,050 but not over $77,400	$1,905 plus 12% of the excess over $19,050
Over $77,400 but not over $165,000	$8,907 plus 22% of the excess over $77,400
Over $165,000 but not over $315,000	$28,179 plus 24% of the excess over $165,000
Over $315,000 but not over $400,000	$64,179 plus 32% of the excess over $315,000
Over $400,000 but not over $600,000	$91,379 plus 35% of the excess over $400,000
Over $600,000	$161,379 plus 37% of the excess over $600,000
Married Individuals Filing Separate Returns	
Not over $9,525	10% of the taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $82,500	$4,453.50 plus 22% of the excess over $38,700
Over $82,500 but not over $157,500	$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$32,089.50 plus 32% of the excess over $157,500
Over $200,000 but not over $300,000	$45,689.50 plus 35% of the excess over $200,000
Over $300,000	$80,689.50 plus 37% of the excess over $300,000
Estates and Trusts	
Not over $2,550	10% of the taxable income
Over $2,550 but not over $9,150	$255 plus 24% of the excess over $2,550
Over $9,150 but not over $12,500	$1,839 plus 35% of the excess over $9,150
Over $12,500	$3,011.50 plus 37% of the excess over $12,500

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

Under the provision, the brackets applicable to single filers, married taxpayers filing separately, and heads of household are rounded down to the nearest $25, while other brackets are rounded down to the nearest $50.[17]

Simplification of tax on unearned income of children

The provision temporarily simplifies the "kiddie tax" by separating the child's tax from the tax situation of the child's parent or of any sibling. It is intended that the net unearned income (both ordinary income and net capital gain) of a child to whom the provision applies is taxed according to the tax table applicable to a trust, while earned taxable income[18] of a child is taxed according to the tax table applicable to the child (normally the table applicable to unmarried individuals).[19]

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[17] A technical correction may be needed in order to round the bracket breakpoints applicable to heads of household down to the nearest $25. The correction would retain uniformity between those bracket breakpoints and the bracket breakpoints for single filers, which are intended to be identical for the 32-, 35-, and 37-percent brackets.

[18] For this purpose, earned taxable income means taxable income reduced (but not below zero) by net unearned income. Sec. 1(j)(4)(D).

[19] A technical correction may be necessary for the "kiddie tax" to fully reflect this intent. As currently enacted, a child to whom the "kiddie tax" applies uses modified unmarried and estates and trusts brackets to calculate tax on income. The brackets are modified so that the total amount taxed at a given rate does not exceed the amount that would be taxed at that rate in the case of an individual to whom the kiddie tax does not apply.

The following examples illustrate how the tax for a child to whom the "kiddie tax" applies may be calculated, by applying the estates and trusts brackets to net unearned income and applying modified unmarried brackets to earned taxable income.

Example 1.—Assume a child to whom the "kiddie tax" applies is a dependent of another taxpayer and has interest income of $8,000 and no other income for taxable year 2018. The child is allowed a standard deduction of $1,050 (section 63(c)(5)(A) limits the basic standard deduction in the case of certain dependents to the greater of, for 2018, (i) $1,050 or (ii) the sum of $350 and the child's earned income) and thus the child's taxable income is $6,950. The child's net unearned income is $8,000 less $2,100 (section 1(g)(4)(A) provides for a reduction in the amount of net unearned income by twice the basic standard deduction, which for 2018 is $1,050, if the child does not itemize deductions), which is $5,900. The child's earned taxable income is $1,050 ($6,950 less $5,900).

The tax on the net unearned income of $5,900 may be calculated by computing the tax on a trust with that amount of taxable income. The tax is $255 plus 24 percent of the excess over $2,550, which is $1,059 ($255 plus $804). Next, the tax brackets for unmarried taxpayers are reduced by any net unearned income taxed at that same rate. $2,550 of unearned income is taxed at 10 percent, so the top of the 10-percent bracket is reduced to $6,975 ($9,525 less $2,550). $3,350 of unearned income is taxed at 24 percent, so the top of the 24-percent bracket is reduced to $154,150 ($157,500 less $3,350). No changes are made to the top of the 12-, 22-, 32-, and 35-percent brackets.

The tax on $1,050 of earned taxable income is subject to this revised rate schedule. Thus, the tax on this income is $105 ($1,050 at 10 percent). The child's total tax liability is $1,164 ($1,059 plus $105). Note that in this example, a portion of the child's income is subject to tax under a rate schedule other than the estates and trusts rate schedule, notwithstanding that the taxpayer has only unearned income. This is a result of reducing unearned income by two standard deductions to arrive at net unearned income.

Example 2.—Assume a child to whom the "kiddie tax" applies is a dependent of another taxpayer and has interest income of $18,000 and wages of $18,000 for the taxable year 2018. The child is allowed a standard deduction of $12,000 (which is less than the sum of $18,000 plus $350) and thus the child's taxable income is $24,000. The child's net unearned income is $15,900 ($18,000 less $2,100). The child's earned taxable income is $8,100 ($24,000 less $15,900).

The tax on the net unearned income of $15,900 may be calculated by computing the tax on a trust with that amount of taxable income. The tax is $3,011.50 plus 37 percent of the excess over $12,500, which is $4,269.50 ($3,011.50 plus $1,258). Next, the tax brackets for unmarried taxpayers are reduced by any net unearned income taxed at that same rate. $2,550 of net unearned income is taxed at 10 percent, so the top of the 10-percent bracket is reduced to $6,975 ($9,525 less $2,550). $6,600 of net unearned income is taxed at 24 percent, so the top of the 24-percent bracket is reduced to $150,900 ($157,500 less $6,600). $3,400 of net unearned income is taxed at 35 percent, so the top of the 35-percent bracket is reduced to $496,600 ($500,000 less $3,400). No changes are made to the endpoints of the 12-, 22-, or 32-percent brackets.

Continued

The provision's simplification of the "kiddie tax" does not apply to taxable years beginning after December 31, 2025.

Maximum rates on capital gains and qualified dividends

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

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

Unrecaptured section 1250 gain generally is taxed at a maximum rate of 25 percent, and net collectibles gain and certain gain from the sale of small business stock is taxed at a maximum rate of 28 percent.

Paid preparer due diligence requirement for head of household status

The provision directs the Secretary of the Treasury to promulgate due diligence requirements for paid preparers in determining eligibility for a taxpayer to file as head of household. For 2018, a penalty of $520 is imposed for each failure to meet these requirements.[21]

The Treasury Department has provided guidance addressing Federal income tax withholding for 2018.[22]

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

The tax on $8,100 of earned taxable income is subject to this revised rate schedule. Thus the tax on this income is $832.50 ($6,975 at 10 percent and $1,125 at 12 percent). The child's total tax liability is $5,102 ($4,269.50 plus $832.50).

[20] In certain circumstances adjusted net capital gain in this range may be taxed at different rates due to the fact that the 15-percent breakpoints ($38,600, $51,700, and $77,200 for unmarried, head of household, and married filing jointly respectively) are $100 or $200 less than the top of the 12-percent ordinary bracket ($38,700, $51,800, and $77,400 for unmarried, head of household, and married filing jointly respectively).

[21] This amount is indexed for inflation. Sec. 6695(h).

[22] See Internal Revenue Service, *Publication 15, (Circular E), Employer's Tax Guide 2018,* pp. 21–25 and the IRS withholding calculator available at irs.gov/W4App.

B. Inflation Adjustments Based On Chained CPI (sec. 11002 of the Act and sec. 1(f) of the Code)

Prior Law

Many dollar amounts in the Code are adjusted for inflation to protect taxpayers from the effects of rising prices. Under prior law, most of the adjustments are based on annual changes in the level of the Consumer Price Index for All Urban Consumers ("CPI–U"). The CPI–U is an index that measures prices paid by typical urban consumers on a broad range of goods and services, and is developed and published by the Department of Labor. Generally, the Code adjusts applicable calendar year amounts for cost of living by using the percentage by which the price index for the preceding calendar year exceeds the price index for a base calendar year.[23] The IRS annually issues a publication setting forth the inflation-adjusted amounts for taxable years beginning in the next calendar year.

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

Explanation of Provision

The provision requires the use of the Chained Consumer Price Index for All Urban Consumers ("C–CPI–U") to adjust amounts currently indexed by the CPI–U. The C–CPI–U, like the CPI–U, is a measure of the average change over time in prices paid by urban consumers. It is developed and published by the Department of Labor, but differs from the CPI–U in accounting for the ability of individuals to alter their consumption patterns in response to relative price changes.[24] Another notable difference is that, unlike the CPI–U, initially released C–CPI–U index values are subject to a quarterly schedule of revisions until finalized in the following year.[25]

The values of C–CPI–U used for cost-of-living adjustments for any given calendar are the latest values published as of the date on which the initial C–CPI–U index is published for the month of August for the preceding year.[26] Generally, this date is in September of such preceding year.

Under the provision, indexed amounts in the Code use the C–CPI–U and the CPI–U or solely the C–CPI–U in taxable years beginning after December 31, 2017. In the case of applicable dollar

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[23] Sec. 1(f). Under prior law, the indexing base calendar year is the year referenced in section 1(f)(3)(B) as modified.

[24] The C–CPI–U accomplishes this by allowing for consumer substitution between item categories in the collection of consumer goods and services that make up the index, while the CPI–U only allows for modest substitution within item categories.

[25] Bureau of Labor Statistics, *CPI Detailed Report—June 2017*, Table 1C.

[26] Sec. 1(f)(6)(A).

amounts with a base calendar year[27] prior to 2016, the provision indexes these amounts as if the CPI–U applies through 2017 and the C–CPI–U applies for years thereafter; the provision does not index these applicable amounts from their base years using only the C–CPI–U. However, amounts with cost-of-living adjustment base years of 2016 and later are indexed using solely the C–CPI–U. Therefore, amounts that are reset for 2018 (and given indexing base years of 2017)[28] are indexed by the C–CPI–U in taxable years beginning after December 31, 2018.

The Treasury Department has published cost-of-living adjustments for 2018 and 2019.[29]

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

[27] Under the provision, the indexing base calendar year is the year referenced in section 1(f)(3)(A)(ii) as modified.
[28] For example, the basic standard deduction. Sec. 63(c)(7).
[29] Rev. Proc. 2018–18, 2018–10 I.R.B. 392 (March 2, 2018); Rev. Proc. 2018–57, 2018–49 I.R.B. 827 (Nov. 15, 2018).

PART II—DEDUCTION FOR QUALIFIED BUSINESS INCOME OF PASS-THRU ENTITIES

A. Deduction for Qualified Business Income (sec. 11011 of the Act and sec. 199A of the Code)

Prior Law

Individual income tax rates

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

Partnerships

Partnerships generally are treated for Federal income tax purposes as passthrough entities not subject to tax at the entity level.[30] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account by the partners in computing their income tax liability based on the partnership's method of accounting and regardless of whether the income is distributed to the partners.[31] A partner's deduction for partnership losses is limited to the partner's adjusted basis in its partnership interest.[32] Losses not allowed as a result of that limitation generally are carried forward to the next year. A partner's adjusted basis in a partnership interest generally equals (1) the sum of (a) the amount of money and the adjusted basis of property contributed to the partnership, or the amount paid for the partnership interest, (b) the partner's distributive share of partnership income, and (c) the partner's share of partnership liabilities, reduced by (2) the sum of (a) the partner's distributive share of losses allowed as a deduction and certain nondeductible expenditures, and (b) any partnership distributions to the partner.[33] Partners generally may receive distributions of partnership property without recognition of gain or loss, subject to some exceptions.[34]

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[30] Sec. 701.

[31] Sec. 702(a).

[32] Sec. 704(d). In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by a partner's share of partnership deductions (secs. 469 and 465). These limitations do not apply to corporate partners, except certain closely-held corporations.

[33] Sec. 705.

[34] Sec. 731. Gain or loss may nevertheless be recognized, for example, on the distribution of money or marketable securities in excess of basis, distributions with respect to contributed property, or in the case of disproportionate distributions (which can result in ordinary income).

Partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect.[35] In general, an allocation has substantial economic effect to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.[36]

State laws of every State provide for the establishment of limited liability companies[37] ("LLCs"), which are neither partnerships nor corporations under applicable State law, but which are generally treated as partnerships for Federal tax purposes.[38]

A publicly traded partnership generally is treated as a corporation for Federal tax purposes.[39] 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).[40] An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income comprises one or more types of qualifying income.[41]

S corporations

An S corporation[42] generally is not subject to Federal income tax at the corporate level.[43] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation are taken into account by the S corporation shareholders in computing their income tax liabilities (based on the S corporation's method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder's deduction for corporate losses is

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[35] Sec. 704(b)(2).

[36] Treas. Reg. sec. 1.704–1(b)(2).

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

[38] Any domestic nonpublicly traded unincorporated entity with two or more members generally is treated as a partnership for Federal income tax purposes, while any single-member domestic unincorporated entity generally is treated as disregarded for Federal income tax purposes (*i.e.*, treated as not separate from its owner). Instead of the applicable default treatment, however, an LLC may elect to be treated as a corporation for Federal income tax purposes. Treas. Reg. sec. 301.7701–3 (known as the "check-the-box" regulations).

[39] Sec. 7704(a).

[40] Sec. 7704(b).

[41] Sec. 7704(c)(2). Qualifying income is defined to include interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Sec. 7704(d). Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of certain fuel mixtures, alternative fuel, alcohol fuel, or biodiesel fuel. It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) where a principal activity of the partnership is the buying and selling of such commodities, futures, options, or forward contracts. However, the exception for partnerships with qualifying income does not apply to any partnership resembling a mutual fund (*i.e.,* that would be described in section 851(a) if it were a domestic corporation), which includes a corporation registered under the Investment Company Act of 1940 (Pub. L. No. 76-768 (1940)) as a management company or unit investment trust. Sec. 7704(c)(3).

[42] An S corporation is so named because its Federal tax treatment is governed by subchapter S of the Code.

[43] Secs. 1363 and 1366.

limited to the sum of the shareholder's adjusted basis in its S corporation stock and the indebtedness of the S corporation to such shareholder. Losses not allowed as a result of that limitation generally are carried forward to the next year. A shareholder's adjusted basis in the S corporation stock generally equals (1) the sum of (a) the shareholder's capital contributions to the S corporation and (b) the shareholder's pro rata share of S corporation income, reduced by (2) the sum of (a) the shareholder's pro rata share of losses allowed as a deduction and certain nondeductible expenditures, and (b) any S corporation distributions to the shareholder.[44]

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

Electing S corporation status

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.[45] Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders of an S corporation.

Sole proprietorships

Unlike a C corporation, partnership, or S corporation, a business conducted as a sole proprietorship is not treated as an entity distinct from its owner for Federal income tax purposes.[46] Rather, the business owner is taxed directly on business income, and files Schedule C (sole proprietorships generally), Schedule E (rental real estate and royalties), or Schedule F (farms) with his or her individual tax return. Furthermore, transfer of a sole proprietorship is treated as a transfer of each individual asset of the business. Nonetheless, a sole proprietorship is treated as an entity separate from its owner for employment tax purposes,[47] for certain excise taxes,[48] and certain information reporting requirements.[49]

Trade or business

For Federal income tax purposes, a taxpayer conducting activities giving rise to income or loss must evaluate whether its activities rise to the level of constituting a trade or business, and if so, how many trades or businesses the taxpayer has.

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

[45] Sec. 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. Sec. 1361(c)(1).

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

[47] Treas. Reg. sec. 301.7701–2(c)(2)(iv).

[48] Treas. Reg. sec. 301.7701–2(c)(2)(v).

[49] Treas. Reg. sec. 301.7701–2(c)(2)(vi).

Many areas of Federal income tax law require a taxpayer to make a threshold determination of whether its activities rise to the level of constituting a trade or business. For example, expenses are deductible under section 162 if they are incurred "in carrying on any trade or business,"[50] the passive activity loss limitation of section 469 can limit losses from an activity that "involves the conduct of any trade or business,"[51] and research and experimental expenditures are eligible for deduction under section 174 if they are paid or incurred "in connection with [a] trade or business."[52]

Courts have held that for an activity to rise to the level of constituting a trade or business, "the taxpayer must be involved in the activity with continuity and regularity and . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit."[53] In order to meet this standard, the taxpayer must satisfy two requirements: (1) regular and continuous conduct of the activity;[54] and (2) a primary purpose to earn a profit.[55] Whether a taxpayer's activities meet these factors depends on the facts and circumstances of each case.[56] While most activities determined to be trades or businesses are so treated because the taxpayer offers goods or services to the public, a trade or business may also include other activities if such activities are the source of the taxpayer's livelihood.[57]

Once a taxpayer has made the threshold determination that its activities rise to the level of constituting a trade or business, the taxpayer must determine whether it is carrying on a single unified trade or business (involving one or more activities) or multiple separate trades or businesses. The determination of whether the taxpayer is conducting one, or multiple, trades or businesses is relevant to the taxpayer's choices of methods of accounting used to compute taxable income (*e.g.*, the cash method or an accrual method, and various special methods of accounting for certain items).[58] Under section 446, a taxpayer with multiple separate trades or businesses may use different overall methods of accounting (and different special methods of accounting for an item, if applicable)

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[50] Sec. 162(a).

[51] Sec. 469(c)(1)(A). A passive activity generally is one in which the taxpayer does not materially participate, and additional rules apply.

[52] Sec. 174(a). Another example outside the domestic context is that a foreign corporation may be subject to U.S. corporate income tax rules if it is engaged in the "conduct of a trade or business within the United States." These examples are not exhaustive.

[53] *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987).

[54] This first factor depends on the extent of the taxpayer's activities. For example, a taxpayer who devoted 60 to 80 hours per week to gambling on dog races was determined to have engaged in the activity regularly and continuously such that the gambling activity rose to the level of constituting a trade or business. See *Commissioner v. Groetzinger*, 480 U.S. 23 (1987). As another example, a taxpayer who executed a total of 372 securities trades in a year, with at least one trade taking place on 110 days of the year, was determined not to have engaged in securities trading on a regular or continuous basis. See *Holsinger v. Commissioner*, T.C. Memo 2008–191. As a third example, a married couple who owned two homes, one of which they lived in and renovated while monitoring the home market with an eye toward potential sale, and the other of which they rented out but eventually planned to occupy, were held to have neither engaged in the activity with sufficient frequency nor possessed the required profit motive necessary to meet the standard for being engaged in a trade or business. See *Ohana v. Commissioner*, T.C. Memo 2014–83.

[55] This second factor depends on the taxpayer's state of mind. The taxpayer must have a good faith intention to make a profit from the activity, and not be engaged in it "merely for pleasure, exhibition, or social diversion." See *Doggett v. Burnet*, 65 F.2d 191 (D.C. Cir. 1933), rev'g 23 B.T.A. 744 (1931).

[56] See, *e.g., Higgins v. Commissioner*, 61 S. Ct. 475 (1941).

[57] *Commissioner v. Groetzinger*, 480 U.S. 23, at 34–35 (1987).

[58] Sec. 446(c) and Treas. Reg. sec. 1.446–1(c)(1).

to compute taxable income for each trade or business.[59] However, a taxpayer with a single unified trade or business must use the same overall method of accounting for the activities (and the same special method of accounting, if applicable) within that trade or business.[60] A taxpayer filing its first return may adopt any permissible method of accounting in connection with each separate trade or business.[61]

Treasury regulations provide that activities are not considered separate and distinct trades or businesses unless they each keep a complete and separable set of books and records.[62] Courts evaluating whether activities are separate and distinct trades or businesses have looked to factors such as the existence of common management, use of shared office space (or lack thereof), use of shared employees (or the lack thereof), and the nature of each business.[63] The IRS has ruled that an entity that is disregarded for Federal income tax purposes, and thus treated as a separate division of its owner (*e.g.*, a single-member limited liability company or a qualified subchapter S subsidiary); may constitute a separate trade or business under section 446 depending on the taxpayer's facts and circumstances.[64]

Cooperatives and their patrons

Certain corporations are eligible to be treated as cooperatives and taxed under the special rules of subchapter T of the Code.[65] In general, the subchapter T rules apply to any corporation operating on a cooperative basis (except mutual savings banks, insur-

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[59] Sec. 446(d) and Treas. Reg. sec. 1.446–1(d)(1). For example, a taxpayer may account for a personal service trade or business using the cash method and may account for a manufacturing business on an accrual method if such activities constitute separate trades or businesses. For a discussion of trades or businesses eligible to use the cash method and an accrual method, including changes to such rules by the Act, see discussion of section 13102 of the Act (Small Business Accounting Method Reform).

[60] For example, a taxpayer with a single trade or business that includes both manufacturing and service activities generally must account for such trade or business using an accrual method. See, *e.g., Thompson Electric, Inc. v. Commissioner*, T.C. Memo. 1995–292. For a discussion of trades or businesses eligible to use the cash method and an accrual method, including changes to such rules by the Act, see discussion of section 13102 of the Act (Small Business Accounting Method Reform).

[61] Treas. Reg. sec. 1.446–1(e)(1). See also, Rev. Rul. 90–38, 1990–1 C.B. 57 (holding that a taxpayer adopts a method of accounting (1) when it uses a permissible method of accounting on a single tax return, or (2) when it uses the same impermissible method of accounting on two or more consecutive tax returns). Except as otherwise provided, section 446(e) requires taxpayers to secure the consent of the Secretary before changing a method of accounting, including any change in method of accounting attributable to a taxpayer's redetermination of how many separate trades or businesses it has.

[62] Treas. Reg. sec. 1.446–1(d)(2).

[63] Two cases addressing activities involving chicken farming and other related activities illustrate the nature of the analysis. First, in P*eterson Produce, Inc. v. United States*, 313 F.2d 609 (8th Cir. 1963), aff'g 205 F. Supp. 229 (W.D. Ark. 1962), the court upheld a U.S. district court determination that the taxpayer's newly-formed chicken farming division was not separate and distinct from the taxpayer's feed and hatchery trade or business because the existing business primarily sold chicks to the new division and the taxpayer did not keep separate books and records for the two activities. In *Burgess Poultry Mkt., Inc. v. United States*, 64–2 USTC 9515 (E.D. Tex. 1964), however, the court held that the taxpayer's two divisions, one of which raised chicks and the other of which processed broiler chickens, were separate and distinct trades or businesses because they kept separate books and records, had separate employees, and did substantial business with third parties. See also Rev. Rul. 74–270, 1974–1 C.B. 109 (ruling that a bank's commercial banking division and trust division were separate trades or businesses where they had separate books and records, separate employees, separate office space, and separate management).

[64] See, *e.g.*, Sections 9.01 and 15.07(4)(b) of Rev. Proc. 2018–1, 2018–1 I.R.B. 1 (and its predecessors). See also CCA 201430013, July 25, 2014.

[65] Secs. 1381–1388.

ance companies, most tax-exempt organizations, and certain utilities).

For Federal income tax purposes, a cooperative subject to the cooperative tax rules of subchapter T generally computes its income as if it were a taxable corporation, except that, in determining its taxable income, the cooperative does not take into account amounts paid for the taxable year as (1) patronage dividends, to the extent paid in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation) with respect to patronage occurring during such taxable year, and (2) per-unit retain allocations, to the extent paid in money, qualified per-unit retain certificates, or other property (except nonqualified per-unit retain certificates) with respect to marketing occurring during such taxable year.[66]

Patronage dividends are amounts paid to a patron (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation of the cooperative to pay such amount that existed before the cooperative received the amount so paid, and (3) which are determined by reference to the net earnings of the cooperative from business done with or for its patrons.[67] Per-unit retain allocations are allocations to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron.[68]

Because a patron of a cooperative that receives patronage dividends or per-unit retain allocations generally must include such amounts in gross income,[69] excluding patronage dividends and per-unit retain allocations paid by the cooperative from the cooperative's taxable income in effect allows the cooperative to be a conduit with respect to profits derived from transactions with its patrons.

Treatment of taxpayers with domestic production activities income under section 199[70]

In general

Section 199 provides a deduction from taxable income (or, in the case of an individual, adjusted gross income[71]) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income (determined without regard to the section 199 deduction) for the taxable year.[72] The amount of the deduction for a taxable year is limited to 50 percent of the W–2 wages paid by the taxpayer and properly allocable to domestic production gross receipts during the calendar year that ends in such taxable year.[73] W–2 wages are the total wages subject to wage withholding,[74] elec-

[66] Secs. 1382 (determination of taxable income) and 1388 (definitions).
[67] Sec. 1388(a).
[68] Sec. 1388(f).
[69] Sec. 1385(a)(1) and (3).
[70] For a discussion of the repeal of section 199, see the description of section 13305 of the Act (Repeal of Deduction for Income Attributable to Domestic Production Activities).
[71] For this purpose, adjusted gross income is determined after application of sections 86, 135, 137, 219, 221, 222, and 469, and without regard to the section 199 deduction. Sec. 199(d)(2).
[72] Sec. 199(a).
[73] Sec. 199(b).
[74] Defined in sec. 3401(a).

tive deferrals,[75] and deferred compensation[76] paid by the taxpayer with respect to employment of its employees during the calendar year ending during the taxable year of the taxpayer.[77] W–2 wages do not include any amount that is not properly allocable to domestic production gross receipts as a qualified item of deduction.[78] In addition, W–2 wages do not include any amount that was not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.[79]

In the case of oil related qualified production activities income, the deduction is reduced by three percent of the least of the taxpayer's oil related qualified production activities income, qualified production activities income, or taxable income (determined without regard to the section 199 deduction) for the taxable year.[80] For this purpose, oil related qualified production activities income for any taxable year is the portion of qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof[81] during the taxable year.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the cost of goods sold that are allocable to those receipts;[82] and (2) other expenses, losses, or deductions which are properly allocable to those receipts.[83] Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property[84] that was manufactured, produced, grown, or

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[75] Within the meaning of sec. 402(g)(3).

[76] Deferred compensation includes compensation deferred under section 457, as well as the amount of any designated Roth contributions (as defined in section 402A).

[77] Sec. 199(b). In the case of a taxpayer with a short taxable year that does not contain a calendar year ending during such short taxable year, the following amounts are treated as the W–2 wages of the taxpayer for the short taxable year: (1) wages paid during the short taxable year to employees of the qualified trade or business; (2) elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the qualified trade or business; and (3) compensation actually deferred under section 457 during the short taxable year with respect to employees of the qualified trade or business. Amounts that are treated as W–2 wages for a taxable year are not treated as W–2 wages of any other taxable year. See Treas. Reg. sec. 1.199–2(b). In addition, in the case of a taxpayer who is an individual with otherwise qualified production activities income from sources within the commonwealth of Puerto Rico, if all the income for the taxable year is taxable under section 1 (income tax rates for individuals), the determination of W–2 wages with respect to the taxpayer's trade or business conducted in Puerto Rico is made without regard to any exclusion under the wage withholding rules (as provided in section 3401(a)(8)) for remuneration paid for services in Puerto Rico. See sec. 199(d)(8)(B).

[78] Sec. 199(b)(2)(B).

[79] Sec. 199(b)(2)(C).

[80] Sec. 199(d)(9).

[81] Within the meaning of sec. 927(a)(2)(C) as in effect before its repeal.

[82] For this purpose, any item or service brought into the United States is treated as acquired by purchase, and its cost is treated as not less than its value immediately after it entered the United States. A similar rule applies in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts. In addition, for any property exported by the taxpayer for further manufacture, the increase in cost or adjusted basis may not exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture. See sec. 199(c)(3)(A) and (B).

[83] Sec. 199(c)(1). In computing qualified production activities income, the domestic production activities deduction itself is not an allocable deduction. Sec. 199(c)(1)(B)(ii). See also Treas. Reg. secs. 1.199–1 through –9 for rules regarding the proper allocation of items of income, deduction, expense, and loss for purposes of determining qualified production activities income.

[84] Qualifying production property generally includes any tangible personal property, computer software, and sound recordings. Sec. 199(c)(5).

extracted by the taxpayer in whole or in significant part within the United States;[85] (2) any sale, exchange, or other disposition, or any lease, rental, or license, of any qualified film[86] produced by the taxpayer; (3) any sale, exchange, or other disposition, or any lease, rental, or license, of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States by the taxpayer for the construction of real property in the United States.[87]

Domestic production gross receipts do not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.[88] In addition, domestic production gross receipts do not include gross receipts which are derived from: (1) the sale of food and beverages prepared by the taxpayer at a retail establishment; (2) the transmission or distribution of electricity, natural gas, or potable water; or (3) the lease, rental, license, sale, exchange, or other disposition of land.[89]

Special rules

All members of an expanded affiliated group[90] are treated as a single corporation and the deduction is allocated among the members of the expanded affiliated group in proportion to each member's respective amount, if any, of qualified production activities income. In addition, for purposes of determining domestic production gross receipts, if all of the interests in the capital and profits of a partnership are owned by members of a single expanded affiliated group at all times during the taxable year of such partnership, the partnership and all members of such group are treated as a single taxpayer during such period.[91]

For a tax-exempt taxpayer subject to tax on its unrelated business taxable income by section 511, the section 199 deduction is de-

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[85] When used in the Code in a geographical sense, the term "United States" generally includes only the States and the District of Columbia. Sec. 7701(a)(9). A special rule for determining domestic production gross receipts, however, provides that for taxable years beginning after December 31, 2005, and before January 1, 2017, in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term "United States" includes the Commonwealth of Puerto Rico, but only if all of the taxpayer's Puerto Rico-sourced gross receipts are taxable under the Federal income tax for individuals or corporations for such taxable year. See sections 199(d)(8)(A) and (C). Such special rule was extended to taxable years beginning before January 1, 2018, by the Bipartisan Budget Act of 2018, Pub. L. No. 115–123, February 9, 2018. In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico. Sec. 199(d)(8)(B).

[86] Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers. Sec. 199(c)(6).

[87] Sec. 199(c)(4)(A).

[88] Sec. 199(c)(7). For this purpose, a person is treated as related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 are made without regard to section 1563(b).

[89] Sec. 199(c)(4)(B).

[90] For this purpose, an expanded affiliated group is an affiliated group as defined in section 1504(a) determined (i) by substituting "more than 50 percent" for "more than 80 percent" each place it appears, and (ii) without regard to paragraphs (2) and (4) of section 1504(b). See sec. 199(d)(4)(B).

[91] Sec. 199(d)(4)(D).

termined by substituting unrelated business taxable income for taxable income where applicable.[92]

The section 199 deduction is determined by only taking into account items that are attributable to the actual conduct of a trade or business.[93]

Partnerships and S corporations

With regard to the domestic production activities income of a partnership or S corporation, the deduction is determined at the partner or shareholder level. Each partner or shareholder generally takes into account such person's allocable share of the components of the calculation (including domestic production gross receipts; the cost of goods sold allocable to such receipts; and other expenses, losses, or deductions allocable to such receipts) from the partnership or S corporation, as well as any items relating to the partner or shareholder's own qualified production activities income, if any.[94]

In applying the W–2 wage limitation, each partner or shareholder is treated as having been allocated wages from the partnership or S corporation in an amount that is equal to such person's allocable share of W–2 wages.[95]

Specified agricultural and horticultural cooperatives

In general.—With regard to specified agricultural and horticultural cooperatives, section 199 provides the same treatment of qualified production activities income derived from agricultural or horticultural products that are manufactured, produced, grown, or extracted by such cooperatives[96] as it provides for qualified production activities income of other taxpayers, including non-specified cooperatives (*i.e.*, the cooperative may claim a deduction for qualified production activities income). The cooperative is treated as having manufactured, produced, grown, or extracted in whole or significant part any qualifying production property marketed by the cooperative if such items were manufactured, produced, grown, or extracted in whole or significant part by the cooperative's patrons.[97] In addition, the cooperative is treated as having manufactured, produced, grown, or extracted agricultural products with respect to which the cooperative performs storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of such products, provided the products are consumed in connection with or incorporated into the manufacturing, production, growth, or extraction of qualifying production property (whether or not by the cooperative).[98] Finally, for purposes of determining the cooperative's section 199 deduction, qualified production activities income

[92] Sec. 199(d)(7).
[93] Sec. 199(d)(5).
[94] Sec. 199(d)(1)(A).
[95] In the case of a trust or estate, the components of the calculation are apportioned between (and among) the beneficiaries and the fiduciary. See sec. 199(d)(1)(B) and Treas. Reg. sec. 1.199–5(d) and (e).
[96] For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative. See Treas. Reg. sec. 1.199–6(f).
[97] Sec. 199(d)(3)(D) and Treas. Reg. sec. 1.199–6(d).
[98] See Treas. Reg. sec. 1.199–3(e)(1).

and taxable income are determined without regard to any deduction allowable under section 1382(b) and (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions) for the taxable year.[99]

Definition of a specified agricultural or horticultural cooperative.—A specified agricultural or horticultural cooperative is an organization to which part I of subchapter T applies that is engaged in (a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or (b) the marketing of agricultural or horticultural products that the cooperative's patrons have so manufactured, produced, grown, or extracted.[100]

Allocation of the cooperative's deduction to patrons.—Any patron that receives a qualified payment from a specified agricultural or horticultural cooperative is allowed as a deduction for the taxable year in which such payment is received an amount equal to the portion of the cooperative's deduction for qualified production activities income that is (a) allowed with respect to the portion of the qualified production activities income to which such payment is attributable, and (b) identified by the cooperative in a written notice mailed to the patron during the payment period described in section 1382(d).[101] A qualified payment is any amount that (a) is described in paragraph (1) or (3) of section 1385(a) (*i.e.*, patronage dividends and per-unit retain allocations), (b) is received by an eligible patron from a specified agricultural or horticultural cooperative, and (c) is attributable to qualified production activities income with respect to which a deduction is allowed to such cooperative.[102]

The cooperative cannot reduce its income under section 1382 for any deduction allowable to its patrons under this rule (*i.e.*, the cooperative must reduce its deductions allowed for certain payments to its patrons in an amount equal to the section 199 deduction allocated to its patrons).[103]

Explanation of Provision

In general

The provision reflects Congress's belief that a reduction in the corporate income tax rate does not completely address the Federal income tax burden on businesses. While the corporate tax is a tax on capital income, the tax on income from noncorporate businesses may fall on both labor income and capital income. Treating corporate and noncorporate business income more similarly to each other under the Federal income tax requires distinguishing labor income from capital income in a noncorporate business.

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[99] See sec. 199(d)(3)(C) and Treas. Reg. sec. 1.199–6(c).

[100] Sec. 199(d)(3)(F).

[101] Sec. 199(d)(3)(A) and Treas. Reg. sec. 1.199–6(a). The written notice must be mailed by the cooperative to patrons no later than the 15th day of the ninth month following the close of the taxable year. The cooperative must report the amount of the patron's section 199 deduction on Form 1099–PATR, "Taxable Distributions Received From Cooperatives," issued to the patron. Treas. Reg. sec. 1.199–6(g).

[102] Sec. 199(d)(3)(E). For this purpose, patronage dividends and per-unit retain allocations include any advances on patronage and per-unit retains paid in money during the taxable year. Treas. Reg. sec. 1.199–6(e).

[103] Sec. 199(d)(3)(B) and Treas. Reg. sec. 1.199–6(b).

Taxpayers with qualified business income

For taxable years beginning after December 31, 2017, and before January 1, 2026, an individual taxpayer generally may deduct 20 percent of qualified business income with respect to a partnership, S corporation, or sole proprietorship, as well as 20 percent of aggregate qualified REIT dividends, qualified cooperative dividends,[104] and qualified publicly traded partnership income.[105] Eligible taxpayers also generally include fiduciaries and beneficiaries of trusts and estates with qualified business income. Special rules apply to specified agricultural or horticultural cooperatives. A limitation based on W–2 wages, or W–2 wages and capital investment (as applicable), phases in above a threshold amount of taxable income.[106] A disallowance of the deduction on income of specified service trades or businesses also phases in above the same threshold amount of taxable income.

Qualified business income

Qualified business income is separately determined for each qualified trade or business of the taxpayer. For any taxable year, qualified business income (or qualified business loss[107]) means the net amount of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business of the taxpayer. Qualified items of income or deduction[108] are taken into account to determine qualified business income only to the extent they are included in taxable income for the year under the methods of accounting of the qualified trade or business.[109] For example, in a taxable year, if a qualified trade or business has $100,000 of ordinary income from inventory sales and makes an expenditure of $25,000 that is required to be capitalized and amortized over five years under applicable Federal income tax rules, the qualified business income is $100,000 minus $5,000 (current-year ordinary amortization deduction), or $95,000. The qualified business income is not reduced by the entire amount of the capital expenditure, but rather only by the amount allowed as a deduction in determining taxable income for the year under the qualified trade or business's method of accounting.

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[104] The treatment of income relating to specified agricultural and horticultural cooperatives (both the cooperative itself and payments received by patrons from the cooperative) under section 199A (as originally enacted December 22, 2017) was modified by the Consolidated Appropriations Act, 2018, Pub. L. No. 115–141, enacted March 23, 2018, effective as if included in section 11011 of Pub. L. No. 115–97. The description of the modification was originally published as Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the House Amendment to the Senate Amendment to H.R. 1625 (Rules Committee Print 115–66)* (JCX–6–18), March 22, 2018, pp. 5–27, which is reproduced in the Appendix.

[105] Sec. 199A.

[106] For purposes of the provision, taxable income is computed without regard to the 20-percent deduction. Sec. 199A(e)(1).

[107] A qualified business loss from a qualified trade or business may not be combined with or netted against qualified business income from other qualified trades or businesses prior to applying the W–2 wage limit or W–2 wage and capital limit, described below. Specifically, section 199A(b)(2) applies the W–2 wage limit or W–2 wage and capital limit to each respective qualified trade or business prior to the combination of the deductible amounts from each qualified trade or business in section 199A(b)(1)(A). See secs. 199A(b)(1)(A) and (b)(2). Examples below illustrate these rules.

[108] Business expenses deductible from gross income of a business generally only include the ordinary and necessary expenditures directly connected with or pertaining to such business. See Treas. Reg. sec. 1.162–1(a).

[109] See, *e.g.*, secs. 162, 166, 167, 168, 197, 263, 263A, and subchapter E of Chapter 1 (secs. 441–483).

Qualified items of gain or loss are taken into account to determine qualified business income or qualified business loss only to the extent included or allowed in the determination of taxable income for the year.[110] For example, assume a qualified trade or business has a passive loss that is not allowable by reason of section 469 for taxable year 2017 in the amount of $50,000, and that the loss is attributable to a qualified trade or business. Assume further that $20,000 of the loss is allowed for the taxable year 2018. The $20,000 loss allowed in 2018 is taken into account in determining the taxpayer's qualified business income from the qualified trade or business in 2018.

Domestic business

Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States.[111] In the case of an individual with qualified business income from sources within the Commonwealth of Puerto Rico, if all such income for the taxable year is taxable under section 1 (income tax rates for individuals), then the term "United States" is considered to include the Commonwealth of Puerto Rico for purposes of determining the individual's qualified business income.[112]

Reasonable compensation and guaranteed payments

Qualified business income of the taxpayer does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer.[113] Similarly, qualified business income does not include any guaranteed payment for services rendered with respect to the trade or business,[114] and, to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner, acting other than in his or her capacity as a partner, for services.[115]

Treatment of certain investment items

Certain items are not taken into account as qualified items of income, gain, deduction, or loss.[116] Specifically, qualified items of income, gain, deduction, or loss do not include (1) any item taken into account in determining net capital gain or net capital loss, (2) dividends, income equivalent to a dividend, or payments in lieu of dividends, (3) interest income other than that which is properly allo-

[110] Generally, net operating loss carryovers and carrybacks determined under section 172 are not qualified items of deduction or loss with respect to a trade or business. However, a carryover may be treated as such a qualified item to the extent that any portion of a net operating loss carryover or carryback is attributable to a loss that was not allowed in the prior year in which it was incurred (*e.g.*, an excess business loss that was not allowed under section 461(l), as enacted by the Act). Consistent with this, the loss that was not allowed in the prior year is included in qualified business income in the taxable year in which the net operating loss carryover or carryback of which it is a part is deducted. For a discussion of the excess business loss rules enacted by the Act, see the description of section 11012 of the Act (Limitation on Losses for Taxpayers Other Than Corporations).

[111] For this purpose, section 864(c) is applied by substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or for "foreign corporation," each place they appear. Sec. 199A(c)(3)(A). A clerical correction may be needed to correct statutory references with respect to this substitution.

[112] Sec. 199A(f)(1)(C).

[113] Sec. 199A(c)(4).

[114] Described in sec. 707(c).

[115] Described in sec. 707(a).

[116] See sec. 199A(c)(3)(B).

cable to a trade or business, (4) the excess of gain over loss from commodities transactions other than those entered into (i) in the normal course of the trade or business or (ii) with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business, (5) the excess of foreign currency gains over foreign currency losses from section 988 transactions other than transactions directly related to the business needs of the business activity, (6) net income from notional principal contracts other than clearly identified hedging transactions that are treated as ordinary (*i.e.*, not treated as capital assets), and (7) any amount received from an annuity that is not received in connection with the trade or business. Qualified items also do not include any item of deduction or loss properly allocable to any of the preceding items.

Qualified business loss carryover

If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, the qualified business loss is carried over for purposes of calculating the deduction under section 199A and in the next taxable year is treated as a loss from a qualified trade or business.[117] The qualified business loss carryover continues to carry forward, reduced by any qualified business income in subsequent years, until the taxpayer has a taxable year with net qualified business income. In the first succeeding taxable year in which the taxpayer has net qualified business income from all qualified trades or businesses, the taxpayer takes the qualified business loss carryover under section 199A(c)(2) into account in calculating the sum of the deductible amounts for its trades or businesses under section 199A(b)(1)(A). Specifically, the sum of the deductible amounts for its qualified trades or businesses for the taxable year is reduced, but not below zero,[118] by 20 percent of any qualified business loss carryover under section 199A(c)(2) when determining the combined qualified business income amount for that subsequent year.

For example, in year one, Taxpayer has qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B. In year two, Taxpayer has qualified business income of $20,000 from qualified business A and qualified business income of $50,000 from qualified business B. (Neither business is subject to the W–2 wage, or W–2 wage and capital, limitations described below.) Under section 199A(c)(2), Taxpayer's $30,000 net qualified business loss from year one carries forward and is treated as a $30,000 loss from a qualified trade or business in year 2. To determine the deduction for year two, Taxpayer combines 20 percent of the qualified business income of busi-

[117] Sec. 199A(c)(2). Like a current year qualified business loss, a qualified business loss carryover is not associated with a particular qualified trade or business of the taxpayer. Like a qualified business loss, a qualified business loss carryover may not be aggregated with or netted against qualified business income in a subsequent year prior to applying the W–2 wage limit or W–2 wage and capital limit, described below, to each qualified trade or business. See below for examples illustrating the application of the W–2 wage limit or W–2 wage and capital limit in taxable years in which there is a qualified business loss carryover.

[118] A technical correction may be needed to carry out this intent.

nesses A and B in year 2 with 20 percent of the $30,000 loss carryover from year 1 for a total deduction of $8,000.[119]

Qualified trade or business [120]

A qualified trade or business means any trade or business other than a specified service trade or business and other than the trade or business of performing services as an employee.[121]

An activity that is treated as a trade or business for all relevant Federal income tax purposes (and that keeps a complete and separable set of books and records) may be treated as a qualified trade or business. For example, assume that an individual owns a rental building in which the ground floor space is rented to three unrelated commercial establishments (a coffee shop, a drycleaner, and a newsstand) and the upper floors hold apartments rented to residential tenants. For Federal tax purposes, the individual accounts for the rental activities with respect to the entire building using a single set of books and records. Assume further that the individual materially participates in the rental activity, cost recovery deductions under section 168 are allowable with respect to the building, and deductions for expenses with respect to operating and maintaining the building are allowable under section 162. Because a complete and separable set of books and records is kept with respect to the entire building (including the both the commercial and residential rentals), and because deductions under section 162 are allowable, the real estate rental trade or business is a qualified trade or business for purposes of section 199A.

Whether one or more trade or business activities or rental activities may be treated as a single activity for purposes of section 469 [122] is not determinative of a separate and distinct trade or business for purposes of section 199A.

Specified service trade or business

The provision identifies some service businesses that generally give rise to income from labor services, that is, labor income, and excludes those businesses from the provision (subject to a phase-in). A specified service trade or business means any trade or business involving the performance of services in the fields of health,[123] law, accounting, actuarial science, performing arts,[124] con-

[119] ($70,000 * 20 percent) − ($30,000 * 20 percent) = $14,000 − $6,000 = $8,000. This simple example is intended to illustrate the operation of this rule alone. For more comprehensive examples showing interaction among various rules of the provision, see the additional examples below, in particular, example 3.

[120] The provision does not alter the meaning of the term trade or business, which retains its ordinary meaning for Federal income tax purposes. See prior law, above, for a description of how to determine under prior and present law whether an activity rises to the level of a trade or business, and whether trades or businesses are treated as separate and distinct from each other for Federal income tax purposes.

[121] Sec. 199A(d)(1).

[122] Sec. 469(c) and Treas. Reg. sec. 1.469–4.

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

[124] For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of the performing arts means the provision of services

sulting,[125] athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.[126] For example, a trade or business in which the taxpayer works as an independent contractor for various unrelated businesses, where the business generally holds minimal tangible and intangible property, is a specified service trade or business if the principal asset of such trade or business is the reputation or skill of its owner.

A specified service trade or business involving the performance of services that consist of investing and investment management, trading, or dealing is intended to include any trade or business primarily engaged in providing financial markets services (*i.e.*, investing, investment management, trading, or dealing services with respect to financial instruments) to customers, as well as any trade or business that primarily involves investing and managing its own invested capital. For example, a trade or business engaged in providing portfolio management services to institutional and individual customers is a specified service trade or business. However, a trade or business primarily engaged in the purchase and sale of a physical commodity (so that it might be viewed as engaged in trading or dealing in commodities), and that regularly takes physical possession of the commodity in the ordinary course of its trade or business at a location or facility operated by the business, is not a specified service trade or business because its trade or business does not involve the performance of financial markets services.

Phase-in of specified service trade or business limitation above threshold amount

The exclusion from the definition of a qualified trade or business for specified service trades or businesses phases in for a taxpayer with taxable income[127] in excess of a threshold amount. The threshold amount is $157,500 ($315,000 in the case of a joint return) (together, the "threshold amount"), adjusted for inflation in

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by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performance of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers). See Treas. Reg. sec. 1.448–1T(e)(4)(iii).

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

[126] Sec. 199A(d)(2). For this purpose a security and a commodity have the meanings provided in the rules for the mark to market accounting method for dealers in securities. See secs. 475(c)(2) and (e)(2).

[127] For this purpose, taxable income is determined without regard to the section 199A deduction.

taxable years beginning after 2018.[128] The exclusion from the definition of a qualified trade or business for specified service trades or businesses is fully phased in for a taxpayer with taxable income in excess of the threshold amount plus $50,000 ($100,000 in the case of a joint return).[129] Thus, the range over which the phase-in of the specified service trade or business limitation[130] applies is taxable income of $157,500 to $207,500 ($315,000 to $415,000 in the case of a joint return). A taxpayer whose taxable income exceeds the top of that range is not entitled to any deduction under section 199A with respect to a specified service trade or business.

For a taxpayer with taxable income within the phase-in range, the computation of qualified business income with respect to a specified service trade or business takes into account only the applicable percentage of qualified items of income, gain, deduction, or loss, and of allocable W–2 wages, or of W–2 wages and capital. The applicable percentage with respect to any taxable year is 100 percent reduced (but not below zero) by the percentage equal to the ratio that the excess of the taxable income of the taxpayer for the taxable year over the threshold amount bears to $50,000 ($100,000 in the case of a joint return).

Tentative deductible amount for a qualified trade or business

Taxpayers with taxable income below threshold amount

For a taxpayer with taxable income at or below the threshold amount, the deductible amount for each qualified trade or business is equal to 20 percent of the qualified business income with respect to the trade or business.[131]

Limitation based on W–2 wages, or W–2 wages and capital

For a taxpayer with taxable income above the threshold amount, the taxpayer is allowed a deductible amount for each qualified trade or business[132] equal to the lesser of (1) 20 percent of the qualified business income with respect to such trade or business, or (2) the greater of (a) 50 percent of the W–2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the W–2 wages paid with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property of the qualified trade or business.[133] The threshold amount is $157,500 ($315,000 in the case of a joint return), adjusted for inflation in taxable years beginning after 2018.[134]

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[128] Sec. 199A(e)(2).

[129] See sec. 199A(d)(3).

[130] The limitation based on W–2 wages, or W–2 wages and capital, described below, is also phased in above the threshold amount.

[131] Sec. 199A(b)(3).

[132] A qualified trade or business does not include a specified service trade or business (with a phase-in above the threshold amount) and does not include the trade or business of performing services as an employee, as described above.

[133] Sec. 199A(b)(2). The W–2 wage, or W–2 wage and capital, limitation applies to a qualified trade or business regardless of whether the business has qualified business income or qualified business loss for the current taxable year. For examples illustrating the interaction among various rules of the provision, see the additional examples below.

[134] Sec. 199A(e)(2). A phase-in for a taxpayer with taxable income above the threshold amount also applies with respect to the exclusion from the definition of a qualified trade or business in the case of a specified service trade or business (as described above).

Phase-in of limitation based on W–2 wages, or W–2 wages and capital

The W–2 wage, or W–2 wage and capital, limitation phases in for a taxpayer with taxable income in excess of the threshold amount.[135] The limitation applies fully for a taxpayer with taxable income in excess of the threshold amount plus $50,000 ($100,000 in the case of a joint return).

Meaning of W–2 wages and qualified property

W–2 wages are the total wages subject to wage withholding,[136] elective deferrals,[137] and deferred compensation[138] paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the taxable year of the taxpayer.[139] In the case of a taxpayer who is an individual with otherwise qualified business income from sources within the Commonwealth of Puerto Rico, if all the income for the taxable year is taxable under section 1 (income tax rates for individuals), the determination of W–2 wages with respect to the taxpayer's qualified trade or business conducted in Puerto Rico is made without regard to any exclusion under the wage withholding rules[140] for remuneration paid for services in Puerto Rico. W–2 wages do not include any amount that is not properly allocable to qualified business income as a qualified item of deduction.[141] In addition, W–2 wages do not include any amount that was not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for the return.[142]

Qualified property means, with respect to a qualified trade or business for a taxable year, tangible property of a character subject to depreciation under section 167 that is held by, and available for use in, the qualified trade or business at the close of the taxable year, that is used at any point during the taxable year in the production of qualified business income, and for which the depreciable period has not ended before the close of the taxable year.[143] The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of (a) the date that is 10 years after that date, or (b) the last day of the last full year in the applicable recovery period that would apply to the

[135] Sec. 199A(b)(3)(B). For this purpose, taxable income is determined without regard to the section 199A deduction.

[136] Defined in sec. 3401(a).

[137] Within the meaning of sec. 402(g)(3).

[138] Deferred compensation includes compensation deferred under section 457, as well as the amount of any designated Roth contributions (as defined in section 402A).

[139] Sec. 199A(b)(4). In the case of a taxpayer with a short taxable year that does not contain a calendar year ending during such short taxable year, the following amounts are treated as the W–2 wages of the taxpayer for the short taxable year: (1) wages paid during the short taxable year to employees of the qualified trade or business; (2) elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the qualified trade or business; and (3) compensation actually deferred under section 457 during the short taxable year with respect to employees of the qualified trade or business. Amounts that are treated as W–2 wages for a taxable year are not treated as W–2 wages of any other taxable year.

[140] As provided in sec. 3401(a)(8).

[141] Sec. 199A(b)(4)(B).

[142] Sec. 199A(b)(4)(C).

[143] Sec. 199A(b)(6).

property under section 168 (determined without regard to the alternative depreciation system under section 168(g)).[144]

Examples

For example,[145] a taxpayer (a single individual) has taxable income of $187,500, of which $100,000 is attributable to an accounting sole proprietorship after paying wages of $80,000 to employees. The accounting sole proprietorship pays W–2 wages of $80,000, and has no qualifying property. The taxpayer has an applicable percentage of 40 percent.[146] In determining qualified business income, the taxpayer takes into account 40 percent of $100,000, or $40,000. In determining W–2 wages, the taxpayer takes into account 40 percent of $80,000, or $32,000. The taxpayer calculates the deduction by taking the lesser of 20 percent of $40,000 ($8,000) or 50 percent of $32,000 ($16,000), which in this case is $8,000. In this example, the W–2 wage limitation is not binding.

As another example,[147] a taxpayer (who is subject to the W–2 wage, or W–2 wage and capital, limitation) has a sole proprietorship that manufactures widgets. The business buys a widget-making machine for $100,000 and places it in service in 2020. The business has no employees in 2020. The limitation in 2020 is the greater of (a) 50 percent of W–2 wages, or $0, or (b) the sum of 25 percent of W–2 wages ($0) plus 2.5 percent of the unadjusted basis of the machine immediately after its acquisition ($2,500). The taxpayer's section 199A deduction for 2020 for the widget sole proprietorship may not exceed $2,500.

Regulatory authority with respect to W–2 wage, or W–2 wage and capital, limitation

Property that is no longer available for use in the qualified trade or business, for example because it was sold, is not taken into account in determining the W–2 wage and capital limitation. The Secretary is required to provide rules for applying the limitation in cases of a short taxable year and when the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the year. The Secretary is required to provide guidance applying rules similar to the rules of section 179(d)(2) to address acquisitions of property from a related party, as well as in a sale-leaseback or other transaction as needed to carry out the purposes of the provision.

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[144] The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. Exercising authority granted by Congress, the Secretary issued Rev. Proc. 87–56, 1987–2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Rev. Proc. 88–22, 1988–1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Rev. Proc. 87–56, as modified, remains in effect except to the extent that Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property. For a discussion of the changes to applicable recovery periods made by the Act, see the discussion of sections 13203 (Modifications of Treatment of Certain Farm Property) and 13204 (Applicable Recovery Period for Real Property).

[145] This example illustrates the operation of the exclusion of a specified service trade or business when the W–2 wage, or W–2 wage and capital, limitation does not bind. For more comprehensive examples showing the interaction among various rules of the provision, see below.

[146] 1 − ($187,500 − $157,500)/$50,000 = 1 − $30,000/$50,000 = 1 − 0.6 = 40 percent.

[147] This example illustrates the operation of the W–2 wage, or W–2 wage and capital, limitation. For more comprehensive examples showing the interaction among various rules of the provision, see below.

Similarly, the Secretary is required to provide guidance prescribing rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions as needed to carry out the purposes of the provision and to provide anti-abuse rules, including under the limitation based on W–2 wages and capital.

Partnerships and S corporations

In the case of a partnership or S corporation, the section 199A deduction is determined at the partner or shareholder level. Each partner in a partnership takes into account the partner's allocable share of each qualified item of income, gain, deduction, and loss, and is treated as having W–2 wages and unadjusted basis of qualified property for the taxable year equal to the partner's allocable share of W–2 wages and unadjusted basis of qualified property of the partnership. The partner's allocable share of W–2 wages and unadjusted basis of qualified property are required to be determined in the same manner as the partner's allocable share of wage expenses and depreciation, respectively.[148] Similarly, each shareholder of an S corporation takes into account the shareholder's pro rata share of each qualified item of income, gain, deduction, and loss of the S corporation, and is treated as having W–2 wages and unadjusted basis of qualified property for the taxable year equal to the shareholder's pro rata share of W–2 wages and unadjusted basis of qualified property of the S corporation.

Qualified REIT dividends, qualified cooperative dividends,[149] and qualified publicly traded partnership income

A deduction is allowed for 20 percent of the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income for the taxable year.[150] If the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income is a loss for the taxable year, the combined qualified business income amount for that taxable year is reduced by 20 percent of the aggregate amount of such items.

Qualified REIT dividends do not include any portion of a dividend received from a REIT that is a capital gain dividend[151] or qualified dividend income.[152] It is intended that holding period rules (similar to section 1(h)(11)(B)(iii)) apply to stock giving rise to qualified REIT dividends under section 199A, to prevent an individual from buying REIT stock immediately before the stock goes ex-dividend and selling it immediately after it goes ex-dividend and

[148] The partner's allocable share of unadjusted basis of qualified property is determined in the same manner as the partner's allocable share of depreciation, regardless of whether certain items of qualified property are fully depreciated as of the close of the taxable year. The Treasury Department will provide guidance regarding the determination of a partner's allocable share of unadjusted basis of qualified property in taxable years in which the partnership does not have a depreciation deduction.

[149] The discussion of qualified cooperative dividends in this section reflects the provision as originally enacted. Modifications enacted March 23, 2018, are described in the Appendix.

[150] See sec. 199A(a) and (b).

[151] Defined in sec. 857(b)(3).

[152] Defined in sec. 1(h)(11). See sec. 199A(e)(3).

claiming the qualified business income deduction on the dividend.[153]

A qualified cooperative dividend[154] means any patronage dividend,[155] per-unit retain allocation,[156] qualified written notice of allocation,[157] or any other similar amount, provided such amount is includible in gross income and is received from either (1) a tax-exempt organization described in section 501(c)(12)[158] or a taxable or tax-exempt cooperative that is described in section 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the Code in 1962.[159]

Qualified publicly traded partnership income means (with respect to any qualified trade or business of the taxpayer) the sum of (a) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss of the partnership from a publicly traded partnership not treated as a corporation,[160] and (b) gain recognized by the taxpayer on disposition of its interest in such partnership that is treated as ordinary income (for example, by reason of section 751).[161]

Many individuals invest in REIT stock or interests in publicly traded partnerships indirectly through a regulated investment company (a "RIC" or mutual fund). The RIC may receive amounts that would be treated as qualified REIT dividends or qualified publicly traded partnership income[162] eligible for the section 199A deduction in the hands of an individual RIC shareholder had that individual directly held the REIT stock or the interest in the publicly traded partnership. It is intended that in the case of an individual shareholder of a RIC that itself owns stock in a REIT or interests in a publicly traded partnership, the individual is treated as receiving qualified REIT dividends or qualified publicly traded partnership income to the extent any dividends received by the individual from the RIC are attributable to qualified REIT dividends or qualified publicly traded partnership income received by the RIC.

Determination of the taxpayer's deduction

The taxpayer's deduction for qualified business income for the taxable year is equal to the sum of (1) the lesser of (a) the combined qualified business income amount for the taxable year, or (b) an amount equal to 20 percent of taxable income[163] (reduced by

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[153] A technical correction may be needed to carry out this intent.

[154] As originally enacted. Modifications enacted March 23, 2018, are described in the Appendix.

[155] Defined in sec. 1388(a).

[156] Defined in sec. 1388(f).

[157] Defined in sec. 1388(c).

[158] Organizations described in section 501(c)(12) are benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations, but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses. Sec. 501(c)(12)(A).

[159] Sec. 199A(e)(4).

[160] Such items must be effectively connected with a U.S. trade or business, be included or allowed in determining taxable income for the taxable year, and not constitute excepted enumerated investment-type income. Such items do not include the taxpayer's reasonable compensation, guaranteed payments for services, or (to the extent provided in regulations) section 707(a) payments for services.

[161] Sec. 199A(e)(5).

[162] Sec. 199A(b)(1)(B).

[163] Section 63(a) defines taxable income as "gross income minus the deductions allowed by" chapter 1 of the Code. For these purposes, taxable income is also computed without regard to the deduction allowable under section 199A. See sec. 199A(e)(1).

any net capital gain[164] and qualified cooperative dividends), plus (2) the lesser of (a) 20 percent of qualified cooperative dividends, or (b) taxable income (reduced by net capital gain). This sum may not exceed the taxpayer's taxable income for the taxable year (reduced by net capital gain).[165] The combined qualified business income amount for the taxable year is the sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer[166] and 20 percent of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income.[167]

Specified agricultural or horticultural cooperatives with qualified business income[168]

For taxable years beginning after December 31, 2017, and before January 1, 2026, a deduction is allowed to any specified agricultural or horticultural cooperative equal to the lesser of (a) 20 percent of the excess (if any) of the cooperative's gross income over the qualified cooperative dividends paid during the taxable year for the taxable year, or (b) the greater of 50 percent of the W–2 wages paid by the cooperative with respect to its trade or business or the sum of 25 percent of the W–2 wages of the cooperative with respect to its trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of qualified property of the cooperative. The cooperative's section 199A(g) deduction may not exceed its taxable income for the taxable year.[169]

A specified agricultural or horticultural cooperative is an organization to which part I of subchapter T applies that is engaged in (a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, (b) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted, or (c) the provision of supplies, equipment, or services to farmers or organizations described in the foregoing.

Additional rules and regulatory authority

The taxpayer's deduction for qualified business income is not allowed in computing adjusted gross income; instead, the deduction is allowed in computing taxable income.[170] The deduction is available to both individuals who itemize their deductions and individuals who do not itemize their deductions.[171]

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

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

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[164] Defined in sec. 1(h).
[165] Sec. 199A(a).
[166] This amount cannot be less than zero. A technical correction may be necessary to reflect this intent.
[167] Sec. 199A(b)(1).
[168] The discussion in this section reflects the provision as originally enacted. Modifications enacted March 23, 2018, are described in the Appendix.
[169] For this purpose, taxable income is computed without regard to the cooperative's deduction under section 199A(g).
[170] Sec. 62(a).
[171] Sec. 63(b) and (d).

Trusts and estates are eligible for the 20-percent deduction under the provision. Rules similar to the rules under former section 199 (as in effect on December 1, 2017) apply for apportioning between fiduciaries and beneficiaries any W–2 wages and unadjusted basis of qualified property under the limitation based on W–2 wages and capital. An electing small business trust ("ESBT")[172] is a trust eligible for the 20-percent deduction under the provision.

The deduction under the provision is allowed only for Federal income tax purposes. Thus, the deduction is not allowed in determining net earnings from self-employment or self-employment tax, for example.

For purposes of determining a substantial underpayment of income tax under the accuracy related penalty,[173] a substantial underpayment exists if the amount of the understatement exceeds the greater of five percent (not 10 percent) of the tax required to be shown on the return or $5,000.

Authority is provided to promulgate regulations needed to carry out the purposes of the provision, including regulations requiring, or restricting, the allocation of items of income, gain, loss, or deduction, or of W–2 wages, and unadjusted basis of qualified property, under the provision. In addition, regulatory authority is provided to address reporting requirements appropriate under the provision, and the application of the provision in the case of tiered entities.

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

Additional examples

The following additional examples further illustrate the application of the provision.

Example 1

H and W file a joint return for 2018 on which they report taxable income of $340,000 (determined without regard to this provision). This amount exceeds the threshold amount for joint filers by $25,000. H is a partner in a trade or business that is not a specified service trade or business ("qualified business A"). W has a sole proprietorship that is a specified service trade or business ("qualified business B"). H and W also received $10,000 in qualified REIT dividends during the tax year.

H's allocable share of qualified business income from qualified business A is $200,000, such that 20 percent of the qualified business income with respect to the business is $40,000.[174] H's allocable share of W–2 wages paid by qualified business A is $50,000, such that 50 percent of the W–2 wages with respect to the business is $25,000.[175] Business A has placed in service depreciable property that is qualified property, and H's share of the unadjusted basis of the property immediately after acquisition is $60,000. H's limitation under the wage and capital limitation is the sum of 25 percent of the W–2 wages ($12,500[176]) plus 2.5 percent of the unadjusted

[172] Secs. 1361(e) and 641(c).
[173] Sec. 6662(d)(1)(A).
[174] $200,000 * 20 percent = $40,000.
[175] $50,000 * 50 percent = $25,000.
[176] $50,000 * 25 percent = $12,500.

basis, of qualified property ($1,500[177]), or $14,000. Thus, H's limitation under the W–2 wage, or W–2 wage and capital, limitation is the greater of $25,000 or $14,000 (*i.e.*, $25,000), subject to the applicable phase-in. As H and W's taxable income is above the threshold amount for a joint return, the application of the W–2 wage limit for qualified business A is phased in. Accordingly, the $40,000 amount (*i.e.*, 20 percent of H's qualified business income) is reduced by 25 percent[178] of the difference between $40,000 (*i.e.*, H's deductible amount without limitation) and $25,000 (*i.e.*, H's deductible amount with limitation), or $3,750.[179] H's deductible amount for qualified business A is $36,250.[180]

W's qualified business income and W–2 wages from qualified business B, which is a specified service trade or business, are $200,000 and $140,000, respectively. H and W's taxable income is above the threshold amount for a joint return. Thus, the exclusion of qualified business income and W–2 wages from the specified service trade or business are phased in. Assume that qualified business B has no qualified property, so the W–2 wage and capital limitation is less than the W–2 wage limitation and therefore not binding. W has an applicable percentage of 75 percent.[181] In determining includible qualified business income, W takes into account 75 percent of $200,000, or $150,000. In determining includible W–2 wages, W takes into account 75 percent of $140,000, or $105,000. W calculates the deductible amount for qualified business B by taking the lesser of 20 percent of $150,000 ($30,000) or 50 percent of includible W–2 wages of $105,000 ($52,500).[182] W's deductible amount for qualified business B is $30,000.

H and W's combined qualified business income amount of $68,250 consists of the deductible amount for qualified business A of $36,250, the deductible amount for qualified business B of $30,000, and the deductible amount equal to 20 percent of the $10,000 in qualified REIT dividends ($2,000). H and W's deduction is limited to 20 percent of their taxable income for the year ($340,000), or $68,000. The taxable income limit binds, and accordingly, H and W's total section 199A deduction for the taxable year is $68,000.

Example 2

Assume the same facts as Example 1, except that W's W–2 wages from qualified business B are $60,000. Consistent with Example 1, W has an applicable percentage of 75 percent. Consistent with Example 1, in determining includible qualified business income, W takes into account 75 percent of $200,000, or $150,000, so 20 percent of the qualified business income with respect to qualified business B is $30,000. In determining includible W–2 wages, W takes into account 75 percent of $60,000, or $45,000. Fifty percent of the W–2 wages with respect to the business is $22,500. Because H and

[177] $60,000 * 2.5 percent = $1,500.
[178] ($340,000 - $315,000)/$100,000 = 25 percent.
[179] ($40,000 - $25,000) * 25 percent = $3,750.
[180] $40,000 - $3,750 = $36,250.
[181] 1 – ($340,000-$315,000)/$100,000 = 1 – $25,000/$100,000 = 1 – .25 = 75 percent.
[182] Although H and W's taxable income is above the threshold amount for a joint return, the W–2 wage limit is not binding as the 20 percent of includible qualified business income of qualified business B ($30,000) is less than 50 percent of includible W–2 wages of qualified business B ($52,500).

W's taxable income is above the threshold amount for a joint return, the application of the W–2 wage limit for qualified business B is phased in. Accordingly, the $30,000 amount (*i.e.,* 20 percent of W's qualified business income) is reduced by 25 percent[183] of the difference between $30,000 (*i.e.,* W's deductible amount without limitation) and $22,500 (*i.e.,* W's deductible amount with limitation), or $1,875.[184] W's deductible amount for qualified business B is $28,125.[185]

H and W's combined qualified business income amount of $66,375 consists of the deductible amount for qualified business A of $36,250, the deductible amount for qualified business B of $28,125, and the deductible amount equal to 20 percent of the $10,000 in qualified REIT dividends ($2,000). H and W's deduction is limited to 20 percent of their taxable income for the year ($340,000), or $68,000. The taxable income limit does not bind, and accordingly H and W's total section 199A deduction for the taxable year is $66,375.

Example 3

Assume the same facts as Example 1, except that H's qualified business A has placed in service depreciable property that is qualified property and H's share of the unadjusted basis of the property immediately after acquisition is $1,300,000. Consistent with Example 1, 20 percent of the qualified business income with respect to qualified business A is $40,000. Consistent with Example 1, H's allocable share of W–2 wages paid by qualified business A is $50,000, such that 50 percent of the W–2 wages with respect to qualified business A is $25,000. H's limitation under the wage and capital limitation is the sum of 25 percent of the W–2 wages ($12,500) plus 2.5 percent of the unadjusted basis of qualified property ($32,500[186]), or $45,000. Thus, H's limitation under the W–2 wage, or W–2 wage and capital, limitation is the greater of $25,000 or $45,000 (*i.e.,* $45,000), subject to the applicable phase-in. As H's W–2 wage and capital limitation of $45,000 is in excess of 20 percent of H's qualified business income of $40,000, the W–2 wage and capital limitation is not binding and no phase-in of the limitation is required. H's deductible amount for qualified business A is $40,000.

H and W's combined qualified business income amount of $70,000 consists of the deductible amount for qualified business A of $40,000, the deductible amount for qualified business B of $30,000, and the deductible amount equal to 20 percent of the $10,000 in qualified REIT dividends ($2,000). H and W's deduction is limited to 20 percent of their taxable income for the year ($340,000), or $68,000. The taxable income limit does bind, and accordingly H and W's total section 199A deduction for the taxable year is $68,000.

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[183] ($340,000 − $315,000)/$100,000 = 25 percent.
[184] ($30,000 − $22,500) * 25 percent = $1,875.
[185] $30,000 − $1,875 = $28,125.
[186] $1,300,000 * 2.5 percent = $32,500.

Example 4

H and W file a joint return on which they report taxable income of $100,000 (determined without regard to this provision). H has a sole proprietorship qualified trade or business that is not a specified service trade or business ("qualified business A"). W is a partner in a qualified trade or business that is not a specified service trade or business ("qualified business B"). H and W have a carryover qualified business loss under section 199A(c)(2) of $5,000.

H's qualified business income from qualified business A is $60,000; 20 percent is $12,000. H and W's taxable income is below the threshold amount applicable to a joint return, so the W–2 wage, or W–2 wage and capital, limitation does not apply to qualified business A. H's deductible amount for qualified business A is $12,000. W's allocable share of qualified business income from qualified business B is a loss of $40,000, such that 20 percent of the qualified business loss with respect to the business is $8,000. Additionally, the carryover qualified business loss $5,000 is treated as a loss from a qualified trade or business in the current year, 20 percent of which is $1,000.

H and W's combined qualified business income amount of $3,000 consists of the deductible amount for qualified business A of $12,000, the reduction to the deduction for qualified business B of $8,000, and the reduction to the deduction of $1,000 attributable to the carryover qualified business loss. H and W's deduction is limited to 20 percent of their taxable income for the year ($100,000), or $20,000. H and W's deduction for the taxable year is $3,000.

Example 5

Taxpayer files a return as a single taxpayer on which he reports taxable income of less than $157,500. Taxpayer has a sole proprietorship qualified trade or business that is not a specified service trade or business ("qualified business A"). Taxpayer is a partner in a qualified trade or business that is not a specified service trade or business ("qualified business B").

In year one, Taxpayer has qualified business income of $10,000 from qualified business A, a qualified business loss of $30,000 from qualified business B, and $5,000 of qualified REIT dividends. Taxpayer is permitted a deduction of $1,000 (*i.e.,* 20 percent of the $5,000 of REIT dividends) in year one and carries forward a qualified business loss of $20,000.

In year two, Taxpayer has qualified business income of $15,000 from qualified business A, qualified business income of $25,000 from qualified business B, and $5,000 of qualified REIT dividends. Neither business is subject to the W–2 wage, or W–2 wage and capital, limitation. To determine the deduction for year two, Taxpayer combines 20 percent of the $40,000 qualified business income of businesses A and B in year 2 ($8,000) with 20 percent of the $20,000 qualified business loss carryover from year one (−$4,000) and 20 percent of the qualified REIT dividends ($1,000[187]). Tax-

[187] Qualified REIT dividends of $5,000 * 20 percent = $1,000.

payer's deductible amount for Year 2 is $4,000[188] plus $1,000, or $5,000.

Example 6

H and W file a joint return on which they report taxable income of $500,000 (determined without regard to this provision). H has a sole proprietorship qualified trade or business that is not a specified service trade or business ("qualified business A"). W is a partner in a qualified trade or business that is not a specified service trade or business ("qualified business B").

H's qualified business income from qualified business A is $800,000, such that 20 percent of the qualified business income with respect to the business is $160,000.[189] H's allocable share of wages paid by qualified business A is $200,000, such that 50 percent of the W–2 wages with respect to the business is $100,000.[190] Qualified business A does not have qualified property. H's limitation under the W–2 wage, or W–2 wage and capital, limitation is the sum of 25 of percent of the W–2 wages ($50,000[191]) plus 2.5 percent of the unadjusted basis of qualified property (zero), or $50,000. Thus, H's limitation under the W–2 wage, or W–2 wage and capital, limitation is the greater of $100,000 or $50,000 (*i.e.,* $100,000). As H and W's taxable income is in excess of $415,000, the W–2 wage and W–2 wage and capital limitation is fully phased-in. H's deductible amount for qualified business A is $100,000.

W's qualified business loss from qualified business B is $100,000, such that 20 percent of the qualified business loss with respect to the business is a reduction to the deduction of $20,000.[192] W's allocable share of wages paid by qualified business B is $100,000, such that 50 percent of the W–2 wages with respect to the business is $50,000.[193] Qualified business B does not have placed in service depreciable property that is qualified property. W's limitation under the W–2 wage and capital limitation is the sum of 25 of percent of the W–2 wages ($25,000[194]) plus 2.5 percent of the unadjusted basis of qualified property (zero), or $25,000. Thus, H's limitation under the W–2 wage, or W–2 wage and capital, limitation is the greater of a reduction of $50,000 or $25,000 (*i.e.,* $50,000). As H and W's taxable income is in excess of $415,000, the W–2 wage and W–2 wage and capital limitation is fully phased-in. W's deductible amount for qualified business B is a reduction to the deduction of $20,000.[195]

H and W's combined qualified business income amount of $80,000 consists of the deductible amount for qualified business A

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[188] ($40,000 * 20 percent) − ($20,000 * 20 percent) = $8,000 − $4,000 = $4,000.
[189] $800,000 * 20 percent = $160,000.
[190] $200,000 * 50 percent = $100,000.
[191] $200,000 * 25 percent = $50,000.
[192] ($100,000) * 20 percent = ($20,000).
[193] $100,000 * 50 percent = $50,000.
[194] $100,000 * 25 percent = $25,000.
[195] In situations where a qualified trade or business has a qualified business loss, and the taxpayer does not have an overall qualified business loss carryover arising in the taxable year, the amount determined under section 199A(b)(2) is equal to 20 percent of the qualified business loss. The application of the W–2 wage, or W–2 wage and capital, limitation is not binding on the qualified trade or business as the limitation (a positive amount) is greater than 20 percent of the qualified business loss (a negative amount). The application of the W–2 wage, or W–2 wage and capital, limitation to each separate qualified trade or business under section 199A(b)(2)(B) occurs prior to combining the deductible amount from each respective qualified trade or business (*i.e.,* the deductible amount determined under section 199A(b)(2)) under section 199A(b)(1)(A).

of $100,000 and the reduction to the deduction for qualified business B of $20,000. H and W's deduction is limited to 20 percent of their taxable income for the year ($500,000), or $100,000. Accordingly, H and W's deduction for the taxable year is $80,000.

Example 7

Assume the same facts as Example 6, except that H and W have a qualified business loss carryover from the prior year of $25,000. There is no qualified business loss carryover for the current year as H and W's net amount of qualified business income from all qualified trades or businesses during the taxable year is $675,000.

Consistent with Example 6, H's deductible amount for qualified business A is $100,000 and W's deductible amount for qualified business B is a reduction to the deduction of $20,000.

H and W's combined qualified business income amount of $75,000 consists of the deductible amount for qualified business A of $100,000, the reduction to the deduction for qualified business B of $20,000, and the reduction to the deduction for the qualified business loss carryover of $5,000.[196] H and W's deduction is limited to 20 percent of their taxable income for the year ($500,000), or $100,000. Accordingly, H and W's deduction for the taxable year is $75,000.

Example 8

Assume the same facts as Example 6, except that H and W have a qualified business loss carryover from the prior year of $450,000. There is no qualified business loss carryover for the current year as H and W's net amount of qualified business income from all qualified trades or businesses during the taxable year is $250,000.

Consistent with Example 6, H's deductible amount for qualified business A is $100,000 and W's deductible amount for qualified business B is a reduction to the deduction of $20,000.

H and W's combined qualified business income amount of zero consists of the deductible amount for qualified business A of $100,000, the reduction to the deduction for qualified business B of $20,000, and the reduction to the deduction, but not below zero,[197] for the qualified business loss carryover of $90,000.[198] Accordingly, H and W's deduction for the taxable year is zero.

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[196] ($25,000) * 20 percent = ($5,000). Similar to a qualified trade or business with a qualified business loss, in situations where the taxpayer has a qualified business loss carryover, but does not have an overall qualified business loss carryover arising in the taxable year, the amount determined under section 199A(b)(2) for the qualified business loss carryover is equal to 20 percent of the loss carryover. The application of the W–2 wage, or W–2 wage and capital, limitation is not binding on the qualified business loss carryover as the limitation (a positive amount) is greater than 20 percent of the qualified business loss carryover (a negative amount).

[197] A technical correction may be necessary to reflect this intent.

[198] ($450,000) * 20 percent = ($90,000). Similar to a qualified trade or business with a qualified business loss, in situations where the taxpayer has a qualified business loss carryover, but does not have an overall qualified business loss carryover arising in the taxable year, the amount determined under section 199A(b)(2) for the qualified business loss carryover is equal to 20 percent of the loss carryover. The application of the W–2 wage, or W–2 wage and capital, limitation is not binding on the qualified business loss carryover as the limitation (a positive amount) is greater than 20 percent of the qualified business loss carryover (a negative amount).

The Treasury Department has issued proposed regulations and published guidance addressing this provision.[199]

Effective Date

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

As the repeal of former section 199 is also effective for taxable years beginning after December 31, 2017,[200] any item taken into account in determining the qualified production activities income of the taxpayer under former section 199 cannot be taken into account in determining the combined qualified business income amount of the taxpayer under section 199A. For example, assume that an individual holds an interest in a fiscal-year partnership or S corporation, the taxable year of which began before January 1, 2018, and ends within or with the individual's first taxable year beginning after December 31, 2017 (*e.g.,* the individual's 2018 calendar taxable year). The individual's share of any item from the partnership or S corporation that constitutes qualified business income, qualified REIT dividends, qualified cooperative dividends,[201] and qualified publicly traded partnership income and that is taken into account in determining taxable income for the individual's 2018 taxable year is eligible for the section 199A deduction. However, the individual's share of any item from the partnership or S corporation that would otherwise be taken into account in determining qualified production activities income for the individual's 2018 taxable year is not eligible for the former section 199 deduction, as former section 199 is repealed for taxable years beginning after December 31, 2017.

B. Limitation on Losses for Taxpayers Other Than Corporations (sec. 11012 of the Act and sec. 461(l) of the Code)

Prior Law

Loss limitation rules applicable to individuals

Passive loss rules

The passive loss rules limit deductions and credits from passive trade or business activities.[202] The passive loss rules apply to individuals, estates and trusts, and closely held corporations. A passive activity for this purpose is a trade or business activity in which the taxpayer owns an interest, but in which the taxpayer does not materially participate. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial.[203] Deductions attributable to passive activities, to the ex-

[199] REG–107892–18, 83 Fed. Reg. 40884, August 16, 2018; and Notice 2018–64, 2018–35 I.R.B. 347, August 27, 2018.

[200] For a discussion of the effective date of the repeal of former section 199, see the description of section 13305 of the Act (Repeal of Deduction for Income Attributable to Domestic Production Activities).

[201] As originally enacted. Modifications enacted March 23, 2018, are described in the Appendix.

[202] Sec. 469.

[203] Regulations provide more detailed standards for material participation. See Treas. Reg. sec. 1.469–5 and –5T.

tent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer makes a taxable disposition of his entire interest in the passive activity to an unrelated person.

Excess farm loss rules

A limitation on excess farm losses applies to taxpayers other than C corporations.[204] If a taxpayer other than a C corporation receives an applicable subsidy[205] for the taxable year, the amount of the excess farm loss is not allowed for the taxable year, and is carried forward and treated as a deduction attributable to farming businesses in the next taxable year. An excess farm loss for a taxable year means the excess of aggregate deductions that are attributable to farming businesses over the sum of aggregate gross income or gain attributable to farming businesses plus the threshold amount. The threshold amount is the greater of (1) $300,000 ($150,000 for married individuals filing separately), or (2) for the five-consecutive-year period preceding the taxable year, the excess of the aggregate gross income or gain attributable to the taxpayer's farming businesses over the aggregate deductions attributable to the taxpayer's farming businesses.

Explanation of Provision

For taxable years beginning after December 31, 2017, and before January 1, 2026, an excess business loss of a taxpayer other than a corporation is not allowed for the taxable year. The disallowed excess business loss is treated as a net operating loss ("NOL") for the taxable year for purposes of determining any NOL carryover to subsequent taxable years.[206]

An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation

[204] Sec. 461(j).

[205] For this purpose, an applicable subsidy means (A) any direct or counter-cyclical payment under title I of the Food, Conservation, and Energy Act of 2008, or any payment elected to be received in lieu of such payment, or (B) any Commodity Credit Corporation loan. Sec. 461(j)(3).

[206] See sec. 172. For a discussion of the changes made by the Act to section 172, see the description of section 13302 of the Act (Modification of Net Operating Loss Deduction). A technical correction may be necessary to reflect the intent that excess business losses that are not allowed are treated as a net operating loss arising in the taxable year. Thus, such excess business losses are carried over to a subsequent taxable year under the applicable NOL rules. For example, assume that for 2018, H and W file a joint return on which they report a $1,150,000 loss from their farming business on Schedule F (Form 1040). H and W do not have any other income or loss for 2018. After application of the $500,000 threshold amount for joint filers (sec. 461(l)(3)(A)(ii)(II)), the remaining $650,000 business loss is an excess business loss and is not allowed for H and W's taxable year 2018 by reason of section 461(l)(1)(B). Under the provision, H and W have a $500,000 NOL for 2018 that is eligible for a two-year carryback under section 172(b)(1)(B), and a $650,000 NOL (increased by any portion of the $500,000 NOL for 2018 remaining after application of the two-year carryback) eligible for carryover to 2019. Because the $500,000 NOL for 2018 arises in a taxable year beginning after December 31, 2017, it is subject to the 80-percent limitation under section 172(a)(2). Accordingly, in this example, the amount of the taxpayer's $500,000 NOL carried back to 2016 and 2017 is limited to 80 percent of the taxable income (determined without regard to the NOL deduction) for the 2016 and 2017 taxable years, respectively.

of the provision),[207] over the sum of aggregate gross income or gain attributable to trades or businesses of the taxpayer plus a threshold amount. The threshold amount for a taxable year beginning in 2018 is $250,000 (or twice the otherwise applicable threshold amount in the case of a joint return, *i.e.*, $500,000). The threshold amount is indexed for inflation in taxable years beginning after 2018.

The aggregate deductions taken into account to determine the excess business loss of the taxpayer for the taxable year that are attributable to trades or businesses of the taxpayer are determined without regard to the deduction under section 172 or 199A.[208] For example, assume that a taxpayer has an NOL carryover from a prior taxable year to the current taxable year. Such NOL carryover is not part of the taxpayer's aggregate deductions attributable to the trade or business for the current taxable year under section 461(l).

An excess business loss (the deduction for which is limited by section 461(l)) does not take into account gross income or gains or deductions attributable to the trade or business of performance of services as an employee.[209] For example, assume married taxpayers filing jointly for the taxable year have a loss from a trade or business conducted by one spouse as a sole proprietorship as well as wage income of the other spouse from employment. The wage income is not taken into account in determining the amount of the deduction limited under section 461(l).

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

The provision applies after the application of the passive loss rules.[210]

For taxable years beginning after December 31, 2017, and before January 1, 2026, the prior-law limitation relating to excess farm losses does not apply.[211]

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[207] It is intended that aggregate deductions (for purposes of section 461(l)) not include the amount of any NOL carryback or carryover under section 172 that is attributable to such trades or businesses from a different taxable year. For example, continuing the example in the preceding footnote, none of the $650,000 excess business loss in taxable year 2018 is subject to section 461(l) in a subsequent taxable year. Thus, any deduction with respect to any portion of the $650,000 that is carried over to a subsequent taxable year under the rules of section 172 is governed by the rules of section 172 (not section 461(l)). Similarly, any deduction with respect to any portion of the $500,000 remaining after carrybacks to 2016 and 2017 that is carried over to a subsequent year is governed by the rules of section 172 (not section 461(l)).

[208] A technical correction may be necessary to carry out this intent.

[209] A technical correction may be necessary to carry out this intent. For this purpose, the trade or business of performance of services by the taxpayer as an employee has the same meaning as it does under section 62(a)(1).

[210] Sec. 469.

[211] The excess farm loss rules will apply again for taxable years beginning after December 31, 2025.

Effective Date

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

PART III—TAX BENEFITS FOR FAMILIES AND INDIVIDUALS

A. Increase in Standard Deduction (sec. 11021 of the Act and sec. 63 of the Code)

Prior Law

An individual who does not elect to itemize deductions reduces his or her adjusted gross income ("AGI") by the amount of the applicable standard deduction in arriving at his or her taxable income. The standard deduction is the sum of the basic standard deduction and, if applicable, the additional standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2017, the amount of the basic standard deduction is $6,350 for a single individual and a married individual filing a separate return,[212] $9,350 for a head of household, and $12,700 for a joint return and a surviving spouse. An additional standard deduction is allowed to an individual who is elderly (has attained age 65 before the close of the taxable year) or blind.[213]

In the case of a dependent for whom a deduction for a personal exemption is allowable to another taxpayer, the standard deduction may not exceed the greater of (i) $1,050 (in 2017) or (ii) the sum of $350 (in 2017) plus the dependent's earned income. The standard deduction for an estate or trust is zero.

The amount of the standard deduction is indexed annually for inflation.

Explanation of Provision

The provision temporarily increases the basic standard deduction for individuals. Under the provision, the amount of the basic standard deduction is temporarily increased to $24,000 for a joint return and a surviving spouse, $18,000 for a head of household, and $12,000 for other individuals. The amount of the standard deduction is indexed for inflation using the C–CPI–U for taxable years beginning after December 31, 2018.

The additional standard deduction for the elderly and the blind and the basic standard deduction for dependents are not changed by the Act (other than the change to the inflation adjustment).

The increase of the amount of the basic standard deduction does not apply to taxable years beginning after December 31, 2025.[214]

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[212] In the case of a married individual filing a separate return where either spouse itemizes deductions, the standard deduction is zero.

[213] For 2017, the additional amount is $1,250 for a married taxpayer (for each spouse meeting the applicable criteria in the case of a joint return) and surviving spouses. The additional amount for single individuals and heads of households is $1,550. An individual who qualifies as both blind and elderly is entitled to two additional standard deductions, for a total additional amount (for 2017) of $2,500 or $3,100, as applicable.

[214] The standard deduction continues to be indexed with the C-CPI-U after this sunset.

Effective Date

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

B. Increase in and Modification of Child Tax Credit (sec. 11022 of the Act and sec. 24 of the Code)

Prior Law

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

The credit is allowable against both the regular tax and the alternative minimum tax ("AMT").

In some circumstances, all or a portion of the otherwise allowable credit is treated as a refundable credit (the "additional child tax credit"). The amount treated as a refundable credit reduces the amount of the nonrefundable credit. A refundable credit creates an overpayment of income tax to the extent the credit (together with other refundable credits) exceeds the taxpayer's income tax liability (reduced by nonrefundable credits).

The credit is treated as refundable in an amount equal to 15 percent of earned income in excess of $3,000 (the "earned income" formula). Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Only items taken into account in computing taxable income are treated as earned income.[215] However, at the taxpayer's election, combat pay may be treated as earned income for these purposes.

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

The name and taxpayer identification number ("TIN")[216] of the qualifying child must appear on the return and the TIN must be issued on or before the due date for filing the return. The TIN of the taxpayer must also be issued on or before the due date for filing the return.

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[215] Some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income for income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

[216] A Social Security number or an Individual Taxpayer Identification Number ("ITIN").

Qualifying child

Generally, for purposes of the child tax credit, a qualifying child is any individual under the age of 17[217] who is the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual. The child must share the same principal place of abode as the taxpayer for more than one-half of the taxable year, may not have provided over one-half of their own support for the taxable year, and may not file a joint return with a spouse.[218] In order to qualify for the child tax credit, the child must be a U.S. citizen, national, or resident.

Other dependents

An individual may be claimed as a taxpayer's dependent, for purposes of the deduction for personal exemptions, if the individual is a qualifying child[219] or a qualifying relative of the taxpayer and meets certain other requirements.[220] An individual is a taxpayer's qualifying relative if such individual (1) bears the appropriate relationship to the taxpayer; (2) has a gross income that does not exceed the personal exemption amount; (3) receives one-half of his or her support from the taxpayer; and (4) is not a qualifying child of the taxpayer. Generally, an individual bears the appropriate relationship to the taxpayer if the individual is the taxpayer's lineal descendent or ancestor, brother, sister, aunt, uncle, niece, or nephew. Some relations by marriage also qualify, including stepmothers, stepfathers, stepbrothers, stepsisters, sons-in-law, daughters-in-law, fathers-in-law, mothers-in-law, brothers-in-law, and sisters-in-law. In addition, an individual bears the appropriate relationship if the individual has the same principal place of abode as the taxpayer and is a member of the taxpayer's household. In order to claim the personal exemption deduction with respect to any individual, the taxpayer must include the individual's TIN on the tax return.

Children who are U.S. citizens or nationals living abroad or non-U.S. citizens or nationals living in Canada or Mexico may qualify as dependents. In addition, a legally adopted child who does not satisfy the residency or citizenship requirement may nevertheless qualify as a dependent if (1) the child's principal place of abode is the taxpayer's home and (2) the taxpayer is a citizen or national of the United States.

Explanation of Provision

The provision temporarily increases the child tax credit to $2,000 per qualifying child, and provides a $500[221] nonrefundable credit

[217] Sec. 24(c)(1).

[218] Sec. 152(c).

[219] In the context of the dependency rules under section 152, the age requirements differ from the rules for the child tax credit. Under these rules, an individual meets the age requirement either a) if they are under age 19 or b) they are a student who is under age 24. Thus, for example, a student who is age 20 and meets the otherwise applicable requirements would not be eligible for the child tax credit, but would still be considered a qualifying child for purposes of the dependency rules. See sec. 152(c)(3).

[220] Sec. 152(d).

[221] Neither the $2,000 nor the $500 credit amounts are indexed for inflation.

for each dependent other than a qualifying child.[222] The provision generally retains the prior-law definition of a dependent.[223]

The AGI threshold amount at which the credit begins to phase out is $400,000 in the case of a joint return and $200,000 for all other taxpayers. These phase-out thresholds are not indexed for inflation.

To receive the credit (both the refundable and nonrefundable portions) for a qualifying child, a taxpayer must include the Social Security number of the child on the tax return claiming the credit.[224] For these purposes, the Social Security number must be issued before the due date for the filing of the return for the taxable year. The Social Security number also must be issued to a citizen of the United States or pursuant to a provision of the Social Security Act relating to the lawful admission for employment in the United States.[225]

The Social Security number requirement does not apply with respect to a qualifying dependent for whom a $500 nonrefundable credit is claimed. In order to claim the $500 nonrefundable credit with respect to any individual, however, the taxpayer must include such individual's TIN on the tax return.[226]

The provision lowers the earned income threshold for the refundable child tax credit from $3,000 to $2,500. The maximum amount of the refundable child credit may not exceed $1,400 per qualifying child. This $1,400 amount is indexed for inflation, although the amount may not exceed $2,000.

The modifications described above do not apply to taxable years beginning after December 31, 2025.

The Treasury Department has issued published guidance addressing this provision.[227]

Effective Date

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

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[222] Qualifying child for these purposes retains the same definition as under the prior law child tax credit. An individual who, under prior law, would have been a qualifying child for purposes of the dependency exemption under section 151, but not a qualifying child for purposes of the child tax credit (*e.g.*, a child who is age 17 or 18, or a student under the age of 24) is eligible to be a qualifying dependent for purposes of the $500 nonrefundable credit.

[223] A technical correction may be necessary to achieve this result. Additionally, under the provision the $500 nonrefundable credit may be claimed only with respect to any dependent who is a citizen, national or resident of the United States. Thus, non-U.S. citizens living in Canada and Mexico may not qualify for the $500 nonrefundable credit.

[224] A qualifying child with respect to whom the child tax credit is not allowed because the child does not have a proper Social Security number as the child's taxpayer identification number may nonetheless qualify as a dependent for purposes of the non-refundable $500 credit.

[225] Sec. 205(c)(2)(B)(i)(I) (or that portion of subclause (III) that relates to subclause (I)) of the Social Security Act.

[226] A technical correction may be necessary to reflect this intent.

[227] Notice 2018–70, 2018–38 I.R.B. 441, September 17, 2018.

C. Modifications to the Deduction for Charitable Contributions (secs. 11023, 13704, and 13705 of the Act and sec. 170 of the Code)

Prior Law

In general

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

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.,* an organization or entity described in section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.,* not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.[228] Fourth, the transfer must be of money or property—contributions of services are not deductible.[229] Finally, the transfer must be substantiated and in the proper form.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration.[230] This rule of nondeductibility, often referred to as the partial interest rule, generally prohibits a charitable deduction for contributions of income interests, remainder interests, or rights to use property.

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

Percentage limits on charitable contributions

Individual taxpayers

Charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's adjusted gross income ("AGI") for a taxable year, disregarding any net operating loss carryback to the year under section 172.[231]

The deduction for charitable contributions by an individual taxpayer of cash and property that is not appreciated to a charitable

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

[229] 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.

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

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

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

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).[232] An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to nonoperating private foundations are deductible up to the lesser of 20 percent of the taxpayer's contribution base or the excess of (i) 30 percent of the contribution base over (ii) the amount of contributions subject to the 30 percent limitation.

Finally, contributions that are for the use of (not to) the donee charity get less favorable percentage limits. Contributions of capital gain property for the use of public charities and other organizations described in section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's contribution base. Property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization.[233] Charitable contributions of income interests (where deductible) also generally are treated as contributions for the use of the donee organization.

TABLE 3.—CHARITABLE CONTRIBUTION PERCENTAGE LIMITS FOR INDIVIDUAL TAXPAYERS [234]

	Ordinary Income Property and Cash	Capital Gain Property to the Recipient [235]	Capital Gain Property for the use of the Recipient
Public Charities, Private Operating Foundations, and Private Distributing Foundations	50%	[236] 30%	20%
Nonoperating Private Foundations	30%	20%	20%

Corporate taxpayers

A corporation generally may deduct charitable contributions up to 10 percent of the corporation's taxable income for the taxable

[232] Special percentage limits and carryforward rules apply to qualified conservation contributions. Secs. 170(b)(1)(E) and 170(b)(2)(B).

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

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

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

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

year.[237] For this purpose, taxable income is determined without regard to: (1) the charitable contributions deduction; (2) any net operating loss carryback to the taxable year; (3) deductions for dividends received; and (4) any capital loss carryback to the taxable year.[238]

Carryforwards of excess contributions

Charitable contributions that exceed the applicable percentage limit generally may be carried forward for up to five years.[239] In general, contributions carried over from a prior year are taken into account after contributions for the current year that are subject to the same percentage limit. Excess contributions made for the use of (rather than to) an organization generally may not be carried forward.

Valuation of charitable contributions

In general

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

Charitable contributions of cash are deductible in the amount contributed, subject to the percentage limits discussed above. In addition, a taxpayer generally may deduct the full fair market value of long-term capital gain property contributed to charity.[240] Contributions of tangible personal property also generally are deductible at fair market value if the use by the recipient charitable organization is related to its tax-exempt purpose.

In certain other cases, however, section 170(e) limits the deductible value of the contribution of appreciated property to the donor's tax basis in the property. This limitation of the property's deductible value to basis generally applies, for example, for: (1) contributions of inventory or other ordinary income or short-term capital gain property;[241] (2) contributions of tangible personal property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose;[242] and (3) contributions to or for the use of a private foundation (other than certain private operating foundations).[243]

Although most charitable contributions of property are valued at fair market value or the donor's tax basis in the property, certain

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

[238] Sec. 170(b)(2)(D).

[239] Sec. 170(d).

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

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

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

[243] Sec. 170(e)(1)(B)(ii). For contributions of qualified appreciated stock, the above-described rule that limits the value of property contributed to or for the use of a private nonoperating foundation to the taxpayer's basis in the property does not apply; therefore, subject to certain limits, contributions of qualified appreciated stock to a nonoperating private foundation may be deducted at fair market value. Sec. 170(e)(5). Certain contributions of patents or other intellectual property also generally are limited to the donor's basis in the property. Sec. 170(e)(1)(B)(iii). However, a special rule permits additional charitable deductions beyond the donor's tax basis in certain situations.

statutorily described contributions of appreciated inventory and other property qualify for an "enhanced deduction" valuation that exceeds the donor's tax basis in the property, but which is less than the fair market value of the property.[244]

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

College athletic seating rights

In general, where a taxpayer receives or expects to receive a substantial return benefit for a payment to charity, the payment is not deductible as a charitable contribution. However, special rules apply to certain payments to institutions of higher education in exchange for which the payor receives the right to purchase tickets for seating at an athletic event. Specifically, the payor may treat 80 percent of a payment as a charitable contribution where: (1) the amount is paid to or for the benefit of an institution of higher education (as defined in section 3304(f)) described in section (b)(1)(A)(ii) (generally, a school with a regular faculty and curriculum and meeting certain other requirements), and (2) such amount would be allowable as a charitable deduction but for the fact that the taxpayer receives (directly or indirectly) as a result of the payment the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution.[245]

Substantiation and other formal requirements

In general

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution.[246] In the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. In such cases, the recordkeeping requirements may not be satisfied by maintaining other written records.

No charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[247]

In addition, any charity receiving a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is re-

[244] Sec. 170(e)(3).
[245] Sec. 170(l).
[246] Sec. 170(f)(17).
[247] Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services. Sec. 170(f)(8).

quired to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[248]

If the total charitable deduction claimed for noncash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[249] In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.

Exception for certain contributions reported by the donee organization

Subsection 170(f)(8)(D) provides an exception to the contemporaneous written acknowledgment requirement described above. Under the exception, a contemporaneous written acknowledgment is not required if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, that includes the same content. "[T]he section 170(f)(8)(D) exception is not available unless and until the Treasury Department and the IRS issue final regulations prescribing the method by which donee reporting may be accomplished."[250] No such final regulations have been issued.[251]

Explanation of Provision

The provision makes the following modifications to the charitable deduction rules. The first modification (relating to percentage limits) is temporary. The other modifications are permanent.

Temporary increase in percentage limit for contributions of cash to public charities

In general

The provision adds new subparagraph 170(b)(1)(G), which increases the income-based percentage limit from 50 percent to 60 percent for certain charitable contributions by an individual taxpayer of cash to organizations described in section 170(b)(1)(A) (generally, public charities and certain private foundations that are not nonoperating private foundations).[252] To the extent such contributions exceed the 60-percent limit for any taxable year, the excess is carried forward and treated as a charitable contribution

[248] Sec. 6115.

[249] Sec. 170(f)(11).

[250] See IRS, Notice of Proposed Rulemaking, Substantiation Requirement for Certain Contributions, REG–138344–13 (October 13, 2015), I.R.B. 2015–41 (preamble).

[251] In October 2015, the IRS issued proposed regulations that, if finalized, would have implemented the section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement. The proposed regulations provided that a return filed by a donee organization under section 170(f)(8)(D) must include, in addition to the information generally required on a contemporaneous written acknowledgment: (1) the name and address of the donee organization; (2) the name and address of the donor; and (3) the taxpayer identification number of the donor. In addition, the return must be filed with the IRS (with a copy provided to the donor) on or before February 28 of the year following the calendar year in which the contribution was made. Under the proposed regulations, donee reporting would have been optional and would have been available solely at the discretion of the donee organization. The proposed regulations were withdrawn in January 2016. See Prop. Treas. Reg. sec 1.170A–13(f)(18).

[252] New sec. 170(b)(1)(G).

that is subject to the 60-percent limit in each of the five succeeding taxable years in order of time.

The provision applies to the amount of charitable contributions taken into account for taxable years beginning after December 31, 2017, and before January 1, 2026.

Coordination with certain other percentage limits applicable to individuals

It is intended that any contribution of cash by an individual to an organization described in section 170(b)(1)(A) (generally, public charities and certain private foundations that are not nonoperating private foundations) shall be allowed to the extent that the aggregate of such contributions for the taxable year does not exceed 60 percent of the taxpayer's contribution base, reduced by the aggregate amount of the contributions allowed under section 170(b)(1)(A) for the year. In other words, the 60-percent limit for cash contributions is intended to be applied after (and reduced by) the amount of noncash contributions to organizations described in section 170(b)(1)(A).[253]

For example, assume an individual with a contribution base of $100,000 for taxable year 2018 makes two contributions to public charities: unappreciated property with a fair market value of $50,000 and $10,000 in cash. The individual makes no other charitable contributions in 2018 and has no charitable contribution carryforwards from a prior year. The cash contribution limit under new section 170(b)(1)(G) is determined after accounting for noncash contributions. Thus, the $50,000 contribution of unappreciated property is accounted for first, using up the individual's entire 50-percent contribution limit under section 170(b)(1)(A) (50 percent of the individual's $100,000 contribution base), and leaving $10,000 in allowable cash contributions under the 60-percent limit ($60,000 (60 percent of $100,000) reduced by the $50,000 in noncash contributions allowed under section 170(b)(1)(A)).

Denial of charitable deduction for college athletic event seating rights

The provision amends section 170(l) to provide that no charitable deduction shall be allowed for any amount described in paragraph 170(l)(2), generally, a payment to an institution of higher education in exchange for which the payor receives the right to purchase tickets for seating at an athletic event.

Repeal of substantiation exception for certain contributions reported by the donee organization

The provision repeals the section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement.

Effective Date

The provisions that increase the charitable contribution percentage limit and deny a deduction for stadium seating payments are

[253] A technical correction may be needed to reflect this intent. In the absence of a technical correction, there is concern that some might interpret the provision as requiring that the 50-percent limit for noncash contributions under section 170(b)(1)(A) be applied after (and reduced by) the amount of cash contributions allowed under the 60-percent limit of section 170(b)(1)(G).

effective for contributions made in taxable years beginning after December 31, 2017. The provision that repeals the substantiation exception for certain contributions reported by the donee organization is effective for contributions made in taxable years beginning after December 31, 2016.

D. Increased Contributions to ABLE Accounts (sec. 11024 of the Act and secs. 25B and 529A of the Code)

Prior Law

Qualified ABLE programs

The Code provides for a tax-favored savings program intended to benefit disabled individuals, known as qualified ABLE programs.[254] A qualified ABLE program is a program established and maintained by a State or agency or instrumentality thereof. A qualified ABLE program must meet the following conditions: (1) under the provisions of the program, contributions may be made to an account (an "ABLE account"), established for the purpose of meeting the qualified disability expenses of the designated beneficiary of the account; (2) the program must limit a designated beneficiary to one ABLE account; and (3) the program must meet certain other requirements discussed below. A qualified ABLE program is generally exempt from income tax, but is otherwise subject to the taxes imposed on the unrelated business income of tax-exempt organizations.

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

Contributions to an ABLE account must be made in cash and are not deductible for Federal income tax purposes. Except in the case of a rollover contribution from another ABLE account, an ABLE account must provide that it may not receive aggregate contributions during a taxable year in excess of the amount under section 2503(b) of the Code (the annual gift tax exclusion). For 2017, this is $14,000.[255] Additionally, a qualified ABLE program must provide adequate safeguards to ensure that ABLE account contributions do not exceed the limit imposed on accounts under the qualified tuition program of the State maintaining the qualified ABLE program. Amounts in the account accumulate on a tax-deferred basis (*i.e.,* income on accounts under the program is not subject to current income tax).

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[254] Sec. 529A.

[255] The amount under sec. 2503(b) is indexed for inflation. In the case that contributions to an ABLE account exceed the annual limit, an excise tax in the amount of six percent of the excess contribution to such account is imposed on the designated beneficiary. Such tax does not apply in the event that the trustee of such account makes a corrective distribution of such excess amounts by the due date (including extensions) of the individual's tax return for the year in which the excess contribution was made.

Saver's credit

Certain taxpayers may claim a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.[256] The tax credit is such savings contributions as do not exceed $2,000 multiplied by the credit rate. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. For this purpose, AGI is determined without regard to certain excludable foreign-source earned income and certain U.S. possession income.

For taxable years beginning in 2017, married taxpayers filing joint returns with AGI of $62,000 or less, taxpayers filing head of household returns with AGI of $46,500 or less, and all other taxpayers filing returns with AGI of $31,000 or less are eligible for the credit. As the taxpayer's AGI increases, the credit rate available to the taxpayer is reduced, until, at certain AGI levels, the credit is unavailable. The credit rates based on AGI for taxable years beginning in 2017 are provided in the table below. The AGI levels used for the determination of the available credit rate are indexed for inflation.

TABLE 4.—CREDIT RATES FOR SAVER'S CREDIT

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

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

Qualified retirement savings contributions consist of (1) elective deferrals to a section 401(k) plan, a section 403(b) plan, a governmental section 457 plan, a SIMPLE plan, or a SARSEP; (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a qualified retirement plan or section 403(b) plan. Under the rules governing these arrangements, an individual's contribution to the arrangement generally cannot exceed the lesser of an annual dollar amount (for example, in 2017, $5,500 in the case of an IRA of an individual under age 50) or the individual's compensation that is includible in income. In the case of IRA contributions of a married couple, the combined includible compensation of both spouses may be taken into account.

The amount of any contribution eligible for the credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer files a joint return with the spouse) from any retirement plan to which eligible contributions can be made during the taxable year for which the credit is claimed, during the two taxable years prior to the year for which the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date (including exten-

[256] Sec. 25B.

sions) for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.

Explanation of Provision

The provision temporarily increases the contribution limitation to ABLE accounts under certain circumstances. While the annual limitation on contributions (the per-donee annual gift tax exclusion ($15,000 for 2018)) and the overall limitation remain the same, the limitation is increased with respect to contributions made by the designated beneficiary of the ABLE account. Under the provision, an ABLE account's designated beneficiary may contribute an additional amount each year, without regard to the annual limitation, up to the lesser of (a) the Federal poverty line for a one-person household; or (b) the individual's compensation for the taxable year.

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

The modifications described above do not apply to taxable years beginning after December 31, 2025.

Effective Date

The provision is effective for taxable years beginning after the date of enactment (December 22, 2017).

E. Rollovers to ABLE Programs from 529 Programs (sec. 11025 of the Act and secs. 529 and 529A of the Code)

Prior Law

Qualified ABLE programs

The Code provides for a tax-favored savings program intended to benefit disabled individuals, known as qualified ABLE programs.[257] A qualified ABLE program is a program established and maintained by a State or agency or instrumentality thereof. A qualified ABLE program must meet the following conditions: (1) under the provisions of the program, contributions may be made to an account (an "ABLE account"), established for the purpose of meeting the qualified disability expenses of the designated beneficiary of the account; (2) the program must limit a designated beneficiary to one ABLE account; and (3) the program must meet certain other requirements discussed below. A qualified ABLE program is generally exempt from income tax, but is otherwise subject to the taxes imposed on the unrelated business income of tax-exempt organizations.

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

[257] Sec. 529A.

Contributions to an ABLE account must be made in cash and are not deductible for Federal income tax purposes. Except in the case of a rollover contribution from another ABLE account, an ABLE account must provide that it may not receive aggregate contributions during a taxable year in excess of the amount under section 2503(b) of the Code (the annual gift tax exclusion). For 2017, this is $14,000.[258] Additionally, a qualified ABLE program must provide adequate safeguards to ensure that ABLE account contributions do not exceed the limit imposed on accounts under the qualified tuition program of the State maintaining the qualified ABLE program. Amounts in the account accumulate on a tax-deferred basis (*i.e.*, income on accounts under the program is not subject to current income tax).

Explanation of Provision

The provision temporarily allows for amounts from qualified tuition programs (also known as "529 accounts"') to be rolled over to an ABLE account without penalty, provided that the ABLE account is owned by the designated beneficiary of that 529 account, or a member of such designated beneficiary's family.[259] Such rolled-over amounts count towards the annual limitation on amounts that can be contributed to an ABLE account within a taxable year.[260] Any amount rolled over that is in excess of this limitation shall be includible in the gross income of the distributee in a manner provided by section 72.[261]

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

Effective Date

The provision applies to distributions after the date of enactment (December 22, 2017).

F. Treatment of Certain Individuals Performing Services in the Sinai Peninsula of Egypt (sec. 11026 of the Act and secs. 2, 112, 692, 2201, 3401, 4253, 6013, and 7508 of the Code)

Prior Law

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

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[258] The 2503(b) amount is indexed for inflation. In the case that contributions to an ABLE account exceed the annual limit, an excise tax in the amount of six percent of the excess contribution to such account is imposed on the designated beneficiary. Such tax does not apply in the event that the trustee of such account makes a corrective distribution of such excess amounts by the due date (including extensions) of the individual's tax return for the year in which the excess contribution was made.

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

[260] Sec. 529A(b)(2)(B)(i).

[261] Sec. 529(c)(3)(A).

1. An exclusion from gross income of certain military pay received for any month during which the member served in a combat zone or was hospitalized as a result of serving in a combat zone;[262]

2. An exemption from taxes on death while serving in a combat zone or dying as a result of wounds, disease, or injury incurred while so serving;[263]

3. Special estate tax rules where death occurs in a combat zone;[264]

4. Special benefits to surviving spouses in the event of a service member's death or missing status;[265]

5. An extension of time limits governing the filing of returns and other rules regarding timely compliance with Federal income tax rules;[266] and

6. An exclusion from telephone excise taxes.[267]

The land area (not including airspace) of Egypt has been designated as an imminent danger pay area since January 29, 1997,[268] but is not a designated combat zone.

Explanation of Provision

The provision temporarily identifies the Sinai Peninsula of Egypt as a "qualified hazardous duty area" that is to be treated in the same manner as a combat zone for purposes of determining eligibility for the benefits available to members of the Armed Forces. This qualified hazardous duty area designation applies only during periods in which a member of the Armed Forces is entitled to special pay under 37 U.S.C. sec. 310 for duty subject to hostile fire or imminent danger for services performed in the Sinai Peninsula of Egypt.

The identification of the Sinai Peninsula of Egypt as a qualified hazardous duty area begins June 9, 2015, and includes the portion of the first taxable year ending after that date, as well as all subsequent taxable years beginning before January 1, 2026.[269]

Effective Date

The provision is generally effective beginning June 9, 2015. The portion of the provision that excludes qualified hazardous duty area pay from wage withholding applies to remuneration paid on or after the date of enactment (December 22, 2017).

G. Temporary Reduction in Medical Expense Deduction Floor (sec. 11027 of the Act and sec. 213 of the Code)

Prior Law

Individuals may claim an itemized deduction for unreimbursed medical expenses, but only to the extent that the expenses exceed

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[262] Sec. 112; see also, sec. 3401(a)(1), exempting such income from wage withholding.
[263] Sec. 692.
[264] Sec. 2201.
[265] Secs. 2(a)(3) and 6013(f)(1).
[266] Sec. 7508.
[267] Sec. 4253(d).
[268] Dept. of Defense reg. sec. 7000.14–R, Vol. 7A, Chapter 10, Figure 10–1, November 2016.
[269] The IRS has provided guidance on how to claim these benefits retroactively in Publication 3, Armed Forces' Tax Guide, p. 13, 2017, and in the instructions for Form 1040X, rev. January 2018, p. 5.

10 percent of adjusted gross income.[270] For taxable years beginning before January 1, 2017, the 10-percent threshold was reduced to 7.5 percent in the case of a taxpayer who attained age 65 before the close of the taxable year. In the case of a married taxpayer, the 7.5-percent threshold applies if either the taxpayer or the taxpayer's spouse attained age 65 before the close of the taxable year.

For all individuals the threshold is 10 percent for purposes of the alternative minimum tax ("AMT").

Explanation of Provision

Under the provision, for taxable years beginning after December 31, 2016, and ending before January 1, 2019, the threshold for deducting medical expenses is 7.5 percent of adjusted gross income for all individuals. For these years, this threshold applies for purposes of the AMT as well as the regular tax.

Effective Date

The provision is effective for taxable years beginning after December 31, 2016.

H. Relief for 2016 Disaster Areas (sec. 11028 of the Act and secs. 72(t), 165, 401–403, 408, 457, and 3405 of the Code)

Prior Law

Distributions from tax-favored retirement plans

A distribution from a qualified retirement plan, a tax-sheltered annuity plan (a "section 403(b) plan"), an eligible deferred compensation plan of a State or local government employer (a "governmental section 457(b) plan"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed.[271] These plans are referred to collectively as "eligible retirement plans." In addition, unless an exception applies, a distribution from a qualified retirement plan, a section 403(b) plan, or an IRA received before age 59½ is subject to a 10-percent additional tax (referred to as the "early withdrawal tax") on the amount includible in income.[272]

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

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[270] Sec. 213. The threshold was amended by the Patient Protection and Affordable Care Act (Pub. L. No. 111–118). For taxable years beginning before January 1, 2013, the threshold was 7.5 percent for regular tax purposes and 10 percent for AMT purposes.

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

[272] Sec. 72(t). The 10-percent early withdrawal tax does not apply to distributions from a governmental section 457(b) plan.

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

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

Itemized deduction for casualty losses

A taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.[273] For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.

Explanation of Provision

In general

The provision provides tax relief, as described below, relating to any area with respect to which a major disaster was declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act during calendar year 2016 (a "2016 disaster area").

Distributions from eligible retirement plans

Under the provision, an exception to the 10-percent early withdrawal tax applies in the case of a qualified 2016 disaster distribution from a qualified retirement plan, a section 403(b) plan, or an IRA. In addition, as discussed further, income attributable to a qualified 2016 disaster distribution may be included in income ratably over three years, and the amount of a qualified 2016 disaster distribution may be recontributed to an eligible retirement plan within three years.

A qualified 2016 disaster distribution is a distribution from an eligible retirement plan made on or after January 1, 2016, and before January 1, 2018, to an individual whose principal place of abode at any time during calendar year 2016 was located in a 2016 disaster area and who has sustained an economic loss by reason of the events giving rise to the Presidential disaster declaration.

The total amount of distributions to an individual from all eligible retirement plans that may be treated as qualified 2016 disaster distributions is $100,000. Thus, any distributions in excess of

[273] Sec. 165.

$100,000 during the applicable period are not qualified 2016 disaster distributions.

Any amount required to be included in income as a result of a qualified 2016 disaster is included in income ratably over the three-year period beginning with the year of distribution unless the individual elects not to have ratable inclusion apply.

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

A qualified 2016 disaster distribution is a permissible distribution from a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan, regardless of whether a distribution otherwise would be permissible.[274] A plan is not treated as violating any Code requirement merely because it treats a distribution as a qualified 2016 disaster distribution, provided that the aggregate amount of such distributions from plans maintained by the employer and members of the employer's controlled group or affiliated service group does not exceed $100,000. Thus, a plan is not treated as violating any Code requirement merely because an individual might receive total distributions in excess of $100,000, taking into account distributions from plans of other employers or IRAs.

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

[274] A qualified 2016 disaster distribution is subject to income tax withholding unless the recipient elects otherwise. Mandatory 20-percent withholding does not apply.

Modification of rules related to casualty losses

Under the provision, in the case of a personal casualty loss which arose on or after January 1, 2016, in a 2016 disaster area and was attributable to the events giving rise to the Presidential disaster declaration, such losses are deductible without regard to whether aggregate net losses exceed 10 percent of a taxpayer's adjusted gross income. Under the provision, to be deductible, the losses must exceed $500 per casualty. Additionally, such losses may be claimed in addition to the standard deduction.

Effective Date

The provision is effective on the date of enactment (December 22, 2017). The casualty loss relief under the provision applies to losses arising in taxable years beginning after December 31, 2015, and before January 1, 2018.

PART IV—EDUCATION

A. Treatment of Student Loans Discharged on Account of Death or Disability (sec. 11031 of the Act and sec. 108 of the Code)

Prior Law

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.[275]

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

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

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

[275] Sec. 108(f).

grams, or any amount received by an individual under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by the State).

Explanation of Provision

The provision temporarily modifies the exclusion of student loan discharges from gross income by expanding the exclusion to include certain discharges on account of death or disability. Loans eligible for the exclusion under the provision are (1) loans made by the United States[276] (or an instrumentality or agency thereof), (2) loans made by a State (or any political subdivision thereof), (3) loans made by certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, (4) loans made by an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation, or (5) private education loans (for this purpose, private education loan is defined in section 140(7) of the Consumer Credit Protection Act).[277]

Under the provision, the discharge of a loan as described above is excluded from gross income if the discharge was pursuant to the death or total and permanent disability of the student.[278] The provision does not apply to loans discharged after December 31, 2025.

Effective Date

The provision applies to discharges of loans after December 31, 2017.

B. 529 Account Funding for Elementary and Secondary Education (sec. 11032 of the Act and sec. 529 of the Code)

Prior Law

In general

A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program"). Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified

[276] A technical correction may be needed to reflect the intent to include Parent PLUS loans.
[277] 15 U.S.C. sec. 1650(7).
[278] Although the provision makes specific reference to those provisions of the Higher Education Act of 1965 that discharge William D. Ford Federal Direct Loan Program loans, Federal Family Education Loan Program loans, and Federal Perkins Loan Program loans in the case of death and total and permanent disability, the provision also contains a catch-all exclusion in the case of a student loan discharged on account of the death or total and permanent disability of the student, in addition to those specific statutory references.

tuition programs.[279] In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program"). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary. Decisions with respect to the contract or account are typically made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an "account owner")[280] whom the program administrator (oftentimes a third-party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.

Qualified higher education expenses

Distributions for the purpose of meeting the designated beneficiary's higher education expenses are generally not subject to tax. For purposes of receiving a distribution from a qualified tuition program that qualifies for this favorable tax treatment, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time. Qualified higher education expenses include the purchase of any computer technology or equipment, or Internet access or related services, if such technology or services were to be used pri-

[279] For purposes of this description, the term "account" is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

[280] Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term "account owner," which is a commonly used term among qualified tuition programs.

marily by the beneficiary during any of the years a beneficiary is enrolled at an eligible institution.

Contributions to qualified tuition programs

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

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

Explanation of Provision

The provision modifies section 529 plans to allow such plans to distribute not more than $10,000 in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, private, or religious elementary or secondary school.[281] This limitation applies on a per-student basis, rather than a per-account basis. Thus, under the provision, although an individual may be the designated beneficiary of multiple accounts, that individual may receive a maximum of $10,000 in distributions free of tax, regardless of whether the funds are distributed from multiple accounts. Any excess distributions received by the individual would be treated as a distribution subject to tax under the general rules of section 529.

Effective Date

The provision applies to distributions made after December 31, 2017.

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[281] This special treatment of elementary and secondary school tuition expenses is pursuant to section 529(c)(7), which provides that these expenses are treated as qualified higher education expenses for purposes of this subsection (*i.e.*, sec. 529(c)). Thus, elementary and secondary school tuition is not treated as a qualified higher education expense for purposes of section 529 other than with respect to the tax treatment of distributions. For instance, for purposes of section 529(b)(6), which requires that a 529 plan must provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of such beneficiary, the maximum contribution amounts for purposes of such a prohibition should remain unchanged. See Prop. Treas. Reg. sec. 1.529–2(i)(2) (providing for a safe harbor under this requirement if the 529 plan limits the total account balance to actuarial estimates of the amount needed to pay tuition, required fees and room and board expenses of the designated beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program).

PART V—DEDUCTIONS AND EXCLUSIONS

A. Suspension of Deduction for Personal Exemptions (sec. 11041 of the Act and sec. 151 of the Code)

Prior Law

In determining taxable income, an individual reduces adjusted gross income by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer (both taxpayers in the case of a joint return) and any dependents of the taxpayer.[282] For 2017, the amount deductible for each personal exemption is $4,050. This amount is indexed annually for inflation. The personal exemption amount is phased out in the case of an individual with AGI in excess of $313,800 for married taxpayers filing jointly, $287,650 for heads of household, $156,900 for married taxpayers filing separately, and $261,500 for all other filers. In addition, no deduction for a personal exemption is allowed to a dependent if a personal exemption deduction for the dependent is allowable to another taxpayer or if an individual's TIN is not included on the return claiming the exemption.

Withholding rules

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

Filing requirements

An unmarried individual is required to file a tax return for a taxable year if the individual has gross income for the year which equals or exceeds the sum of the exemption amount plus the standard deduction applicable to such individual (*i.e.*, single, head of household, or surviving spouse). An individual entitled to file a

[282] In addition, a married taxpayer filing a separate return may claim a personal exemption deduction for a spouse if the spouse has no gross income and is not a dependent of another taxpayer.

joint return is required to do so unless that individual's gross income, when combined with the individual's spouse's gross income for the taxable year, is less than the sum of twice the exemption amount plus the basic standard deduction applicable to a joint return, provided that the individual and his spouse, at the close of the taxable year, had the same household as their home, the individual's spouse did not make a separate return, and no other taxpayer is entitled to an exemption for the individual's spouse.

Trusts and estates

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

Explanation of Provision

Under the provision, for taxable years 2018 through 2025, the amount of a personal exemption is zero.[283]

The Act modifies the provision relating to persons required to file an income tax return to take account of the reduction of the exemption amount to zero. Under the provision, as under prior law, every individual who has gross income for the taxable year is required to file an income tax return. However, an unmarried individual is exempt from the filing requirement if the individual's gross income for the taxable year is less than or equal to the individual's applicable standard deduction. A married individual is exempt from the filing requirement if the individual's gross income, when combined with the individual's spouse's gross income, for the taxable year, is more than the standard deduction applicable to the joint return of the individuals, provided that: (i) such individual and his spouse, at the close of the taxable year, had the same household as their home; (ii) the individual's spouse does not make a separate return; and (iii) neither the individual nor his spouse is a dependent of another taxpayer who has income (other than earned income) in excess of $500 (indexed for inflation).

Under the provision, the Secretary of the Treasury is to develop rules to determine the amount of tax required to be withheld by employers from a taxpayer's wages.

Effective Date

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

Under the provision, the Secretary may administer the withholding rules under section 3402 for taxable years beginning before January 1, 2019, without regard to the provision. Thus, at the Sec-

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

retary's discretion, wage withholding rules may remain the same as under prior law for 2018.

B. Limitation on Deduction for State and Local, etc. Taxes (sec. 11042 of the Act and sec. 164 of the Code)

Prior Law

Individuals are permitted a deduction for certain taxes paid or accrued, whether or not incurred in a taxpayer's trade or business or activity for the production of income. These taxes are: (i) State and local, and foreign, real property taxes;[284] (ii) State and local personal property taxes;[285] and (iii) State and local, and foreign, income, war profits, and excess profits taxes.[286] At the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes.[287] An individual may elect to claim a credit rather than a deduction for foreign income, war profits, and excess profits taxes.[288]

Property taxes may be allowed as a deduction in computing adjusted gross income if incurred in connection with property used in a trade or business; otherwise they are an itemized deduction. In the case of State and local income taxes, the deduction is an itemized deduction notwithstanding that the tax may be imposed on profits from a trade or business.[289]

Individuals also are permitted a deduction for Federal and State generation skipping transfer tax ("GST tax") imposed on certain income distributions that are included in the gross income of the distributee.[290] In addition, individuals are permitted a deduction for one-half of self-employment taxes.[291]

In determining an individual's alternative minimum taxable income, no itemized deduction for property, income, or sales tax is allowed.[292]

Explanation of Provision

Under the provision, in the case of an individual,[293] the itemized deduction for the aggregate of (i) State and local property taxes not

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[284] Sec. 164(a)(1).
[285] Sec. 164(a)(2).
[286] Sec. 164(a)(3).
[287] Sec. 164(b)(5).
[288] Sec. 901.
[289] See H. Rep. No. 1365 to accompany Individual Income Tax Bill of 1944 (78th Cong., 2d. Sess.), reprinted at 19 C.B. 839 (1944); S. Rep. No. 884 to accompany Individual Income Tax Bill of 1944 (78th Cong, 2d Sess.), reprinted at 19 C.B. 878 (1944).
[290] Sec. 164(a)(4).
[291] Sec. 164(f).
[292] Sec. 56(b)(1)(A)(ii).
[293] The $10,000 limitation applies to all tax returns of individuals other than married taxpayers filing separate returns, for whom the limitation is $5,000. The use of the phrase "in the case of an individual" in the statute distinguishes those taxpayers to whom the limit applies from corporate taxpayers (for whom the limit is not applicable). The use of the term "individual" does not allow each spouse filing a joint return to deduct up to $10,000. Rather, the limit applies to the tax-filing unit. This is consistent with longstanding usage elsewhere in the Code. See, *e.g.*, section 21 (limitations on child care credit understood to apply to the tax filing unit in the aggregate, notwithstanding the credit applying "in the case of an individual"), section 36 (maximum allowable credit understood to apply to the tax filing unit in the aggregate, notwithstanding that the credit is provided "in the case of an individual who is a first-time homebuyer"), section 67 (two-percent floor on miscellaneous itemized deductions understood to apply

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paid or accrued in carrying on a trade or business, or an activity described in section 212, and (ii) State and local income, war profits, and excess profits taxes (or sales taxes in lieu of income, *etc.* taxes) paid or accrued in the taxable year, is limited to $10,000 ($5,000 for a married taxpayer filing a separate return). It is intended that the limitation apply to the deduction for amounts paid or accrued to a cooperative housing corporation by a tenant-stockholder under section 216(a)(1) (relating to real estate taxes) in the same manner as the limitation applies to real estate taxes under section 164.[294] Under the provision, foreign real property taxes may not be deducted.

Thus, under the provision, in the case of an individual,[295] as a general matter, State, local, and foreign property taxes and State and local sales taxes are not subject to the above-described limitation only when paid or accrued in carrying on a trade or business, or an activity described in section 212 (relating to expenses for the production of income).[296] Thus, the provision does not limit those deductions for State, local, and foreign property taxes, and sales taxes which are taken into account in computing items of income on Schedule C, Schedule E, or Schedule F of the individual's income tax return. For instance, in the case of property taxes, an individual may deduct these taxes if imposed on business assets (such as residential rental property).

The limitation applies to taxable years beginning after December 31, 2017, and beginning before January 1, 2026.

In the case of an amount paid in a taxable year beginning before January 1, 2018, with respect to a State or local income tax imposed for a taxable year beginning after December 31, 2017, the payment shall be treated as paid on the last day of the taxable year for which such tax is so imposed for purposes of applying the provision limiting the dollar amount of the deduction. Thus, under the provision, an individual may not claim an itemized deduction in 2017 on a prepayment of income tax for a future taxable year

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to the tax filing unit in the aggregate, notwithstanding that the floor is applied "in the case of an individual"), section 165 (per-loss limitations understood to apply to the tax filing unit, notwithstanding that the limitations apply in the case of "any loss of an individual"), and section 1411 (measurement of net investment income understood to apply to the tax-filing unit, notwithstanding that the adjusted gross income threshold upon which the tax is measured is stated "in the case of an individual").

Many other Code sections use the term "in the case of an individual" to specify that a particular credit or deduction is not available to corporate taxpayers, and provide further evidence that limitations on those credits or deductions are meant to apply on a per-tax filing units by describing limitations in terms of the "taxpayer." See, *e.g.*, secs. 23, 25A, 25C, 25D, 32, 35, 151, 170(b)(1)(A), 221, and 222. The Conference Report to the Act explicitly states "Under the provision a *taxpayer* may claim an itemized deduction of up to $10,000 ($5,000 for married taxpayers filing a separate return) for the aggregate of . . ." (emphasis added).

The $5,000 limitation applicable to married taxpayers filing a separate return is consistent with a $10,000 limitation applying to married taxpayers filing jointly, with such limitation applying to the tax-filing unit. There is no Code provision wherein a specific limitation provided for married taxpayers who file separately is anything other than half of the limitation imposed on married taxpayers filing jointly (other than those instances in which married taxpayers filing separately are forbidden from claiming the benefit altogether).

[294] A technical correction may be needed to achieve this result.

[295] See section 641(b) regarding the computation of taxable income of an estate or trust in the same manner as an individual.

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

in order to avoid the dollar limitation applicable for taxable years beginning after 2017.

Effective Date

The provision is effective for taxable years beginning after December 31, 2016.

C. Limitation on Deduction for Qualified Residence Interest (sec. 11043 of the Act and sec. 163(h) of the Code)

Prior Law

As a general matter, personal interest is not deductible.[297] Qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations.[298] Qualified residence interest means interest paid or accrued during the taxable year on either acquisition indebtedness or home equity indebtedness. A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

Acquisition indebtedness

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

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

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

Home equity indebtedness

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

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

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

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[297] Sec. 163(h)(1).
[298] Sec. 163(h)(2)(D) and (h)(3).

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

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

Explanation of Provision

Under the provision, in the case of taxable years beginning after December 31, 2017, and beginning before January 1, 2026, the maximum amount treated as acquisition indebtedness is $750,000 ($375,000 in the case of a married person filing a separate return). However, in the case of acquisition indebtedness incurred before December 15, 2017,[299] the limitation remains at $1,000,000 ($500,000 in the case of married taxpayers filing separately).[300] For taxable years beginning after December 31, 2025, a taxpayer may treat up to $1,000,000 ($500,000 in the case of married taxpayers filing separately) of indebtedness as acquisition indebtedness, regardless of when the indebtedness was incurred.

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

To illustrate the operation of the provision, assume a taxpayer incurred $700,000 acquisition indebtedness prior to December 15, 2017. On May 1, 2018, the taxpayer incurs a home equity loan of $100,000, none of the proceeds of which are used to finance a substantial improvement to the taxpayer's residence. Interest on the acquisition indebtedness remains deductible in 2018 and thereafter. No interest on the home equity loan is deductible. However, if the proceeds of the home equity loan are used to make substantial improvements on the taxpayer's residence, then the loan is considered acquisition indebtedness for purposes of the home mortgage

[299] Under the provision, a taxpayer who has entered into a binding written contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, shall be considered to have incurred acquisition indebtedness prior to December 15, 2017.

[300] Special rules apply in the case of indebtedness from refinancing existing acquisition indebtedness. Specifically, the $1,000,000 ($500,000 in the case of married taxpayers filing separately) limitation continues to apply to any indebtedness incurred on or after December 15, 2017, to refinance qualified residence indebtedness incurred before that date to the extent the amount of the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness, and the refinancing does not extend the term of indebtedness. Thus, the maximum dollar amount that may be treated as principal residence acquisition indebtedness will not decrease by reason of a refinancing.

interest deduction. Accordingly, the taxpayer may deduct interest on $50,000 of the $100,000 home equity loan ($50,000 equals $750,000 reduced by the pre-December 15 2017, acquisition indebtedness of $700,000). To the extent the principal of the old loan is reduced below $700,000, additional interest on the principal of the home equity loan becomes deductible.

Assume however, the taxpayer incurred $800,000 acquisition indebtedness prior to December 15, 2017. Interest on the $800,000 indebtedness remains deductible in 2018 and thereafter. No interest on the home equity interest loan incurred in 2018 is deductible notwithstanding that the loan proceeds may have been used for substantial improvements to the taxpayer's home. This is because the $750,000 limitation on acquisition indebtedness incurred after December 15, 2017, is reduced (but not below zero) by the $800,000 acquisition indebtedness incurred before December 15, 2017. If the taxpayer's old acquisition indebtedness is reduced to less than $750,000, interest on the portion of the taxpayer's home equity indebtedness may be deductible (to the extent that $750,000 exceeds the indebtedness of the old loan), assuming the indebtedness qualifies as acquisition indebtedness (*i.e.,* the loan proceeds were used for substantial improvements on the home).

Effective Date

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

D. Modification of Deduction for Personal Casualty Losses (sec. 11044 of the Act and sec. 165 of the Code)

Prior Law

A taxpayer may generally claim an itemized deduction for any loss sustained during the taxable year, not compensated by insurance or otherwise. For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft.[301] Personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.

Explanation of Provision

The provision temporarily modifies the itemized deduction for personal casualty and theft losses. Under the provision, an individual may claim an itemized deduction for a personal casualty loss (subject to the limitations described above) only if such loss was attributable to a disaster declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act. An exception applies to the extent a loss of an individual does not exceed the individual's personal casualty gains.

[301] Sec. 165(c).

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

Effective Date

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

E. Suspension of Miscellaneous Itemized Deductions (sec. 11045 of the Act and secs. 62, 67 and 212 of the Code)

Prior Law

Individuals may deduct certain expenses in computing taxable income that do not reduce adjusted gross income ("AGI"). These deductions are referred to as "itemized deductions". Some of these expenses ("miscellaneous itemized deductions") are deductible only if, in the aggregate, they exceed two percent of the taxpayer's AGI.[302] The deductions listed below are miscellaneous itemized deductions subject to the two-percent floor.

Expenses for the production or collection of income

Individuals may deduct all ordinary and necessary expenses paid or incurred for the production or collection of income. These expenses are defined as ordinary and necessary expenses paid or incurred in a taxable year: (1) for the production or collection of income;[303] (2) for the management, conservation, or maintenance of property held for the production of income;[304] or (3) in connection with the determination, collection, or refund of any tax.[305]

IRS guidance provides examples of items that may be deducted under this provision. This non-exhaustive list includes:[306]

- Appraisal fees for a casualty loss or charitable contribution;
- Casualty and theft losses from property used in performing services as an employee;
- Clerical help and office rent in caring for investments;
- Depreciation on home computers used for investments;
- Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust;
- Fees to collect interest and dividends;
- Hobby expenses, but generally not more than hobby income;
- Indirect miscellaneous deductions from pass-through entities;
- Investment fees and expenses;
- Loss on deposits in an insolvent or bankrupt financial institution;
- Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed;
- Repayments of income;

[302] Sec. 67(a).
[303] Sec. 212(1).
[304] Sec. 212(2).
[305] Sec. 212(3).
[306] See IRS Publication 529, *Miscellaneous Deductions* (2016), p. 9.

- Safe deposit box rental fees, except for storing jewelry and other personal effects;
- Service charges on dividend reinvestment plans;
- Tax preparation fees; and
- Trustee's fees for an IRA, if separately billed and paid.

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

In general, unreimbursed business expenses incurred by an employee are deductible, but only as an itemized deduction and only to the extent the expenses exceed two percent of adjusted gross income.[307]

IRS guidance provides examples of items that may be deducted under this provision. This non-exhaustive list includes:[308]

- Business bad debt of an employee;
- Business liability insurance premiums;
- Damages paid to a former employer for breach of an employment contract;
- Depreciation on a computer a taxpayer's employer requires him to use in his work;
- Dues to a chamber of commerce if membership helps the taxpayer perform his job;
- Dues to professional societies;
- Educator expenses;[309]
- Home office or part of a taxpayer's home used regularly and exclusively in the taxpayer's work;
- Job search expenses in the taxpayer's present occupation;
- Laboratory breakage fees;
- Legal fees related to the taxpayer's job;
- Licenses and regulatory fees;
- Malpractice insurance premiums;
- Medical examinations required by an employer;
- Occupational taxes;
- Passport fees for a business trip;
- Repayment of an income aid payment received under an employer's plan;
- Research expenses of a college professor;
- Rural mail carriers' vehicle expenses;
- Subscriptions to professional journals and trade magazines related to the taxpayer's work;
- Tools and supplies used in the taxpayer's work;
- Purchase of travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer's work;
- Union dues and expenses;
- Work clothes and uniforms if required and not suitable for everyday use; and
- Work-related education.

Other miscellaneous itemized deductions

Other miscellaneous itemized deductions include:

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[307] Secs. 62(a)(1) and 67.
[308] See IRS Publication 529, *Miscellaneous Deductions* (2016), p. 3.
[309] Under a special provision, these expenses are deductible "above the line" up to $250.

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

Explanation of Provision

The provision temporarily eliminates all miscellaneous itemized deductions that were subject to the two-percent floor under prior law.[310] Thus, under the provision, taxpayers may not claim an itemized deduction for any of the above-listed items. The provision does not apply for taxable years beginning after December 31, 2025.

Effective Date

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

F. Suspension of Overall Limitation on Itemized Deductions (sec. 11046 of the Act and sec. 68 of the Code)

Prior Law

The total amount of most otherwise allowable itemized deductions (other than the deductions for medical expenses, investment interest and casualty, theft or gambling losses) is limited for certain upper-income individuals.[311] All other limitations applicable to such deductions (such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced by three percent of the amount by which the taxpayer's adjusted gross income exceeds a threshold amount.

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

Explanation of Provision

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

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[310] Notwithstanding the temporary repeal of miscellaneous itemized deductions, working condition fringes continue to be excluded under section 132(d). Because section 132(d) provides that a working condition fringe is excluded from an employee's gross income to the extent that had the employee paid for the benefit, such payment would be allowable as a deduction to the employee under section 162 or 167, the provision does not affect the exclusion. A deduction for these items would still be *allowable* under section 162, notwithstanding that the deduction may have been subsequently disallowed under section 67. A similar result is achieved under prior law, wherein a working condition fringe was excludable in its entirety, notwithstanding that a deduction under section 162 was limited by the prior-law section 67 two-percent haircut on miscellaneous itemized deductions.

[311] Sec. 68.

Effective Date

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

G. Suspension of Exclusion for Qualified Bicycle Commuting Reimbursement (sec. 11047 of the Act and sec. 132(f) of the Code)

Prior Law

Qualified bicycle commuting reimbursements of up to $20 per qualifying bicycle commuting month in a calendar year are excludable from an employee's gross income.[312] A qualifying bicycle commuting month is any month during which the employee regularly uses the bicycle for a substantial portion of the travel between the employee's residence and place of employment and during which the employee does not receive any qualified transportation fringe benefit for transportation in a commuter highway vehicle (in connection with travel between the employee's residence and place of employment), a transit pass, or qualified parking.[313]

A qualified bicycle commuting reimbursement for a calendar year is an employer reimbursement during the 15-month period beginning with the first day of the calendar year for reasonable expenses incurred by the employee during such calendar year for the purchase of a bicycle and bicycle improvements, repair, and storage, if the bicycle is regularly used for travel between the employee's residence and place of employment.[314]

Qualified bicycle commuting reimbursements that are excludable from gross income for income tax purposes are also excluded from wages for employment tax purposes.

Explanation of Provision

The provision temporarily repeals the exclusion from gross income and wages for qualified bicycle commuting reimbursements.[315] The exclusion does not apply to taxable years beginning after December 31, 2017, and before January 1, 2026.

The Treasury Department has issued published guidance addressing this provision.[316]

Effective Date

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

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[312] Secs. 132(a)(5), 132(f)(1)(D), and 132((f)(5)(F)(ii).

[313] Sec. 132(f)(5)(F)(iii).

[314] Sec. 132(f)(5)(F)(i).

[315] A technical correction may be necessary to reflect that the suspension relates to the exclusion (under subsection (a)(5) of section 132) rather than the definition of a qualified bicycle commuting reimbursement as a qualified transportation fringe, so that such taxable benefits are excepted from the deduction disallowance of section 274(a). See description of section 13304 of the Act (Limitation on Deduction by Employers of Expenses for Fringe Benefits) and related footnote, *infra*.

[316] IRS Publication 15–B, *Employer's Tax Guide to Fringe Benefits* (revised Feb. 22, 2018), p. 21.

H. Suspension of Exclusion for Qualified Moving Expense Reimbursement (sec. 11048 of the Act and sec. 132(g) of the Code)

Prior Law

Qualified moving expense reimbursements are excluded from an employee's gross income,[317] and are defined as any amount received (directly or indirectly) by an individual from an employer as a payment for (or reimbursement of) expenses which would be deductible as moving expenses under section 217[318] if directly paid or incurred by the individual. However, any such amount actually deducted by the individual is not eligible for this exclusion. Qualified moving expense reimbursements that are excludible from gross income for income tax purposes are also excluded from wages for employment tax purposes.

Explanation of Provision

For taxable years beginning after December 31, 2017, and before January 1, 2026, the provision repeals the exclusion from gross income and wages for qualified moving expense reimbursements except in the case of a member of the Armed Forces of the United States on active duty who moves pursuant to a military order and incident to a permanent change of station.

If an employee incurs moving expenses in a taxable year beginning before January 1, 2018, an employer payment for (or reimbursement of) such expenses that would otherwise be excludable under prior law is excludable from gross income for income tax purposes and from wages for employment tax purposes, notwithstanding that the payment (or reimbursement) may occur in a taxable year beginning on or after January 1, 2018. However, if an employee incurs expenses in a taxable year beginning after December 31, 2017, and before January 1, 2026, any reimbursement for such expenses is not excludable (other than to a member of the Armed Forces to whom the exclusion continues to apply).

The Treasury Department has issued published guidance addressing this provision.[319]

Effective Date

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

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[317] Secs. 132(a)(6) and 132(g).

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

[319] Notice 2018–75, 2018–41 I.R.B. 556.

I. Suspension of Deduction for Moving Expenses (sec. 11049 of the Act, and sec. 217 of the Code)

Prior Law

Individuals are permitted an above-the-line deduction for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work.[320] Such expenses are deductible only if the move meets certain conditions related to distance from the taxpayer's previous residence and the taxpayer's status as a full-time employee in the new location.

Special rules apply in the case of a member of the Armed Forces of the United States. In the case of any such individual who is on active duty, who moves pursuant to a military order and incident to a permanent change of station, the limitations related to distance from the taxpayer's previous residence and status as a full-time employee in the new location do not apply.[321] Additionally, any moving and storage expenses that are furnished in kind to such an individual, spouse, or dependents, or if such expenses are reimbursed or an allowance for such expenses is provided, such amounts are excluded from gross income.[322] Rules also apply to exclude amounts furnished to the spouse and dependents of such an individual in the event that such individuals move to a location other than to where the member of the Armed Forces is moving.

Income exclusions apply to various benefits provided to members of the Armed Forces.[323]

Explanation of Provision

Generally, the provision temporarily eliminates the deduction for moving expenses for taxable years 2018 through 2025. However, during that period, the provision retains the deduction for moving expenses and the rules providing for exclusions of amounts attributable to in-kind moving and storage expenses (and reimbursements or allowances for these expenses) for members of the Armed Forces (or their spouses or dependents) on active duty who move pursuant to a military order and incident to a permanent change of station.

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

Effective Date

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

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[320] Sec. 217(a).
[321] Sec. 217(g).
[322] Sec. 217(g)(2).
[323] Sec. 134.

J. Limitation on Wagering Losses (sec. 11050 of the Act and sec. 165(d) of the Code)

Prior Law

Losses sustained during the taxable year on wagering transactions are allowed as a deduction only to the extent of the gains during the taxable year from such transactions.[324]

Explanation of Provision

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

The provision is intended to clarify that the limitation on losses from wagering transactions applies not only to the actual costs of wagers incurred by an individual, but to other expenses incurred by the individual in connection with the conduct of that individual's gambling activity.[325] The provision clarifies, for instance, that an individual's otherwise deductible expenses in traveling to or from a casino are subject to the limitation under section 165(d).

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

Effective Date

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

K. Repeal of Deduction for Alimony Payments (sec. 11051 of the Act and secs. 61, 71, 215, and 682 of the Code)

Prior Law

Alimony and separate maintenance payments are deductible by the payor spouse and includible in income by the recipient spouse.[326] Child support payments are not treated as alimony.[327] Also, certain income of an estate or trust in the case of a divorce, *etc.* are includible in the income of the recipient spouse.[328]

Explanation of Provision

Under the provision, alimony and separate maintenance payments are not deductible by the payor spouse. The provision also repeals the Code provisions that specify that alimony and separate maintenance payments are included in income. Thus, the intent of the provision is to adopt the approach reflected in the United States Supreme Court's holding in *Gould v. Gould*,[329] in which the Court held that such payments are not income to the recipient (in

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[324] Sec. 165(d).

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

[326] Secs. 215(a), 61(a)(8) and 71(a).

[327] Sec. 71(c).

[328] Sec. 682.

[329] 245 U.S. 151 (1917).

the absence of a specific statutory rule providing for the inclusion of such payments in income). Income used for alimony payments is taxed at the rates applicable to the payor spouse rather than the recipient spouse. The treatment of child support is not changed. The provision treating income of an estate or trust as income of the recipient spouse in the case of a divorce, *etc*. is repealed.

Effective Date

The provision is effective for any divorce or separation instrument executed after December 31, 2018, or for any divorce or separation instrument executed on or before December 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by this provision apply to such modification.

PART VI—INCREASE IN ESTATE AND GIFT TAX EXEMPTION

A. Increase in Estate and Gift Tax Exemption (sec. 11061 of the Act and secs. 2001 and 2010 of the Code)

Prior Law

In general

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

Income tax rules determine the recipient's tax basis in property acquired from a decedent or by gift. Gifts and bequests generally are excluded from the recipient's gross income.[330]

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

Unified credit (exemption) and tax rates

Unified credit.—A unified credit is available with respect to taxable transfers by gift and at death.[331] The unified credit offsets tax, computed using the applicable estate and gift tax rates, on a specified amount of transfers, referred to as the applicable exclusion amount, or exemption amount. The exemption amount was set at $5 million for 2011 and is indexed for inflation for later years. For 2017, the inflation-indexed exemption amount is $5.49 million.[332] Exemption used during life to offset taxable gifts reduces the amount of exemption that remains at death to offset the value of a decedent's estate. An election is available under which exemption that is not used by a decedent may be used by the decedent's surviving spouse (exemption portability).

Common tax rate table.—A common tax-rate table with a top marginal tax rate of 40 percent is used to compute gift tax and estate tax. The 40-percent rate applies to transfers in excess of $1 million (to the extent not exempt). Because the 2017 exemption amount shields the first $5.49 million in gifts and bequests from tax, transfers in excess of the exemption amount generally are subject to tax at the highest marginal rate (40 percent).

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[330] Sec. 102.

[331] Sec. 2010.

[332] For 2017, the $5.49 million exemption amount results in a unified credit of $2,141,800, after applying the applicable rates set forth in section 2001(c).

Generation-skipping transfer tax exemption and rate.—The generation-skipping transfer tax is a separate tax that can apply in addition to either the gift tax or the estate tax. The tax rate and exemption amount for generation-skipping transfer tax purposes, however, are set by reference to the estate tax rules. Generation-skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate (40 percent). Tax is imposed on cumulative generation-skipping transfers in excess of the generation-skipping transfer tax exemption amount in effect for the year of the transfer. The generation-skipping transfer tax exemption for a given year is equal to the estate tax exemption amount in effect for that year ($5.49 million for 2017).

Transfers between spouses.—A 100-percent marital deduction generally is permitted for the value of property transferred between spouses.[333] In addition, transfers of "qualified terminable interest property" also are eligible for the marital deduction. Qualified terminable interest property is property (1) that passes from the decedent, (2) in which the surviving spouse has a "qualifying income interest for life," and (3) to which an election under these rules applies. A qualifying income interest for life exists if (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse's life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

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

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

Transfers to charity.—Contributions to section 501(c)(3) charitable organizations and certain other organizations may be deducted from the value of a gift or from the value of the assets in an estate for Federal gift or estate tax purposes.[334] The effect of the deduction generally is to remove the full fair market value of assets transferred to charity from the gift or estate tax base; unlike the income tax charitable deduction, there are no percentage limits on the deductible amount. For estate tax purposes, the charitable deduction is limited to the value of the transferred property that is required to be included in the gross estate.[335] A charitable con-

[333] Secs. 2056 and 2523.
[334] Secs. 2055 and 2522.
[335] Sec. 2055(d).

tribution of a partial interest in property, such as a remainder or future interest, generally is not deductible for gift or estate tax purposes.[336]

The estate tax

Overview

The Code imposes a tax on the transfer of the taxable estate of a decedent who is a citizen or resident of the United States.[337] The taxable estate is determined by deducting from the value of the decedent's gross estate any deductions provided for in the Code. After applying tax rates to determine a tentative amount of estate tax, certain credits are subtracted to determine estate tax liability.[338]

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

Gross estate

A decedent's gross estate includes, to the extent provided for in other sections of the Code, the date-of-death value of all of a decedent's property, real or personal, tangible or intangible, wherever situated.[339] In general, the value of property for this purpose is the fair market value of the property as of the date of the decedent's death, although an executor may elect to value certain property as of the date that is six months after the decedent's death (the alternate valuation date).[340]

The gross estate includes not only property directly owned by the decedent, but also other property in which the decedent had a beneficial interest at the time of his or her death.[341] The gross estate also includes certain transfers made by the decedent prior to his or her death, including (1) certain gifts made within three years prior to the decedent's death;[342] (2) certain transfers of property in which the decedent retained a life estate;[343] (3) certain transfers taking effect at death;[344] and (4) revocable transfers.[345] In addition, the gross estate includes property with respect to which the decedent had, at the time of death, a general power of appointment (generally, the right to determine who will have beneficial owner-

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[336] Secs. 2055(e)(2) and 2522(c)(2).

[337] Sec. 2001(a).

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

This method of computation was designed to ensure that a taxpayer only gets one run up through the rate brackets for all lifetime gifts and transfers at death, at a time when the thresholds for applying the higher marginal rates exceeded the exemption amount. However, the higher ($5.49 million) 2017 exemption amount effectively renders the lower rate brackets irrelevant, because the top marginal rate bracket applies to all transfers in excess of $1 million. In other words, all transfers that are not exempt by reason of the $5.49 million exemption amount are taxed at the highest marginal rate of 40 percent.

[339] Sec. 2031(a).

[340] Sec. 2032.

[341] Sec. 2033.

[342] Sec. 2035.

[343] Sec. 2036.

[344] Sec. 2037.

[345] Sec. 2038.

ship).[346] The value of a life insurance policy on the decedent's life is included in the gross estate if the proceeds are payable to the decedent's estate or the decedent had incidents of ownership with respect to the policy at the time of his or her death.[347]

Deductions from the gross estate

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

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

State death taxes.—An estate tax deduction is permitted for death taxes (*e.g.*, any estate, inheritance, legacy, or succession taxes) actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent.[348] Such State taxes must have been paid and claimed before the expiration of the applicable limitations period, which is generally four years after the filing of the estate tax return.[349]

Other deductions.—A deduction is available for funeral expenses, estate administration expenses, and claims against the estate, including certain taxes.[350] A deduction also is available for uninsured casualty and theft losses incurred during the settlement of the estate.[351]

Credits against tax

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

Unified credit.—The most significant credit allowed for estate tax purposes is the unified credit, which is discussed in greater detail above.[352] For 2017, the value of the unified credit is $2,141,800, which has the effect of exempting $5.49 million in transfers from tax. The unified credit available at death is reduced by the amount of unified credit used to offset gift tax on gifts made during the decedent's life.

Other credits.—Estate tax credits also are allowed for (1) gift tax paid on certain pre-1977 gifts (before the estate and gift tax computations were integrated);[353] (2) estate tax paid on certain prior transfers (to limit the estate tax burden when estate tax is imposed on transfers of the same property in two estates by reason of

[346] Sec. 2041.
[347] Sec. 2042.
[348] Sec. 2058.
[349] Sec. 2058(b) provides that taxes must have been paid and deductions claimed before the later of (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.
[350] Sec. 2053.
[351] Sec. 2054.
[352] Sec. 2010.
[353] Sec. 2012.

deaths in rapid succession);[354] and (3) certain foreign death taxes paid (generally, where the property is situated in a foreign country but included in the decedent's U.S. gross estate).[355]

Provisions affecting small and family-owned businesses and farms

Special-use valuation.—An executor can elect to value for estate tax purposes certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value.[356] The maximum reduction in value for such real property is $750,000 (adjusted for inflation occurring after 1997; the inflation-adjusted amount for 2017 is $1,120,000). In general, real property qualifies for special-use valuation only if (1) at least 50 percent of the adjusted value of the decedent's gross estate (including both real and personal property) consists of a farm or closely-held business property in the decedent's estate and (2) at least 25 percent of the adjusted value of the gross estate consists of farm or closely held business real property. In addition, the property must be used in a qualified use (*e.g.,* farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

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

Installment payment of estate tax for closely held businesses.—Under prior law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10).[357] An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (*i.e.,* the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest.

This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first $1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2017 is $1,490,000) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of $1 million (adjusted for inflation) is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (*i.e.,* 45 percent of the sum of the Federal short-term rate and three percent-

[354] Sec. 2013.
[355] Sec. 2014. In certain cases, an election may be made to deduct foreign death taxes. See section 2053(d).
[356] Sec. 2032A.
[357] Sec. 6166.

age points).[358] Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

The gift tax

Overview

The Code imposes a tax for each calendar year on the transfer of property by gift during such year by any individual, whether a resident or nonresident of the United States.[359] The amount of taxable gifts for a calendar year is determined by subtracting from the total amount of gifts made during the year: (1) the gift tax annual exclusion (described below); and (2) allowable deductions.

Gift tax for the current taxable year is determined by: (1) computing a tentative tax on the combined amount of all taxable gifts for the current and all prior calendar years using the common gift tax and estate tax rate table; (2) computing a tentative tax only on all prior-year gifts; (3) subtracting the tentative tax on prior-year gifts from the tentative tax computed for all years to arrive at the portion of the total tentative tax attributable to current-year gifts; and, finally, (4) subtracting the amount of unified credit not consumed by prior-year gifts.

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

Transfers by gift

The gift tax applies to a transfer by gift regardless of whether (1) the transfer is made outright or in trust; (2) the gift is direct or indirect; or (3) the property is real or personal, tangible or intangible.[360] For gift tax purposes, the value of a gift of property is the fair market value of the property at the time of the gift.[361] Where property is transferred for less than full consideration, the amount by which the value of the property exceeds the value of the consideration is considered a gift and is included in computing the total amount of a taxpayer's gifts for a calendar year.[362]

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

By reason of statute, certain transfers are not treated as transfers by gift for gift tax purposes. These include, for example, certain transfers for educational and medical purposes,[363] transfers to

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[358] The interest rate on this portion adjusts with the Federal short-term rate.

[359] Sec. 2501(a). However, if the donor is neither a citizen nor a resident of the United States, the transfer is taxable only if the property is situated in the United States. Sec. 2511.

[360] Sec. 2511(a).

[361] Sec. 2512(a).

[362] Sec. 2512(b).

[363] Sec. 2503(e).

section 527 political organizations,[364] and transfers to tax-exempt organizations described in sections 501(c)(4), (5), or (6).[365]

Taxable gifts

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

Gift tax annual exclusion.—Under prior law, donors of lifetime gifts are provided an annual exclusion of $14,000 per donee in 2017 (indexed for inflation from the 1997 annual exclusion amount of $10,000) for gifts of present interests in property during the taxable year.[366] If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $28,000 per donee in 2017. In general, unlimited transfers between spouses are permitted without imposition of a gift tax. Special rules apply to the contributions to a qualified tuition program ("529 Plan") including an election to treat a contribution that exceeds the annual exclusion as a contribution made ratably over a five-year period beginning with the year of the contribution.[367]

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

The generation-skipping transfer tax

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

Exemption and tax rate

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

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate (40 percent) multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred indicates the amount of "generation-skipping transfer tax exemption" allocated to a trust (or to property transferred in a direct skip) relative to the total value of property

[364] Sec. 2501(a)(4).
[365] Sec. 2501(a)(6).
[366] Sec. 2503(b).
[367] Sec. 529(c)(2).

transferred.[368] If, for example, a taxpayer transfers $5 million in property to a trust and allocates $5 million of exemption to the transfer, the inclusion ratio is zero, and the applicable tax rate on any subsequent generation-skipping transfers from the trust is zero percent (40 percent multiplied by the inclusion ratio of zero). If, however, the taxpayer allocated only $2.5 million of exemption to the transfer, the inclusion ratio is 0.5, and the applicable tax rate on any subsequent generation-skipping transfers from the trust is 20 percent (40 percent multiplied by the inclusion ratio of 0.5). If the taxpayer allocates no exemption to the transfer, the inclusion ratio is one, and the applicable tax rate on any subsequent generation-skipping transfers from the trust is 40 percent (40 percent multiplied by the inclusion ratio of one).

Generation-skipping transfers

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

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

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

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

Income tax basis in property received

In general

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

A gift or bequest of appreciated (or loss) property is not an income tax realization event for the transferor. The Code provides

[368] The inclusion ratio is one minus the applicable fraction. The applicable fraction is the amount of exemption allocated to a trust (or to a direct skip) divided by the value of assets transferred.

special rules for determining a recipient's basis in assets received by lifetime gift or from a decedent.

Basis in property received by lifetime gift

Under prior law, property received from a donor of a lifetime gift generally takes a carryover basis.[369] "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If a donor's basis in property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss on a subsequent sale of the property, the donee's basis is the property's fair market value on the date of the gift.

Basis in property acquired from a decedent

Property acquired from a decedent's estate generally takes a stepped-up basis.[370] "Stepped-up basis" means that the basis of property acquired from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). Providing a fair market value basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death and eliminates the tax benefit from any unrealized loss.

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

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

[369] See sec. 1015.
[370] See sec. 1014.

Explanation of Provision

The provision doubles the estate and gift tax exemption for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026. This is accomplished by increasing the basic exclusion amount provided in section 2010(c)(3) of the Code from $5 million to $10 million. The $10 million amount is indexed for inflation occurring after 2011. For 2018, the basic exclusion amount is $11,180,000 for determining the amount of the unified credit against estate tax.[371] Because the generation-skipping transfer tax exemption under section 2631(c) is set by cross-reference to the basic exclusion amount in effect for estate tax purposes, this increase to the basic exclusion amount also increases the amount of generation-skipping transfer tax exemption available to be allocated from January 1, 2018, through December 31, 2025.[372]

As a conforming amendment to section 2001(g) (regarding computation of estate tax), the provision provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of the section with respect to differences between the basic exclusion amount in effect at the time of the decedent's death and at the time of any gifts made by the decedent. It is intended that such regulations will address in particular the computation of the estate tax where (1) a decedent dies in a year in which the basic exclusion amount is lower than the basic exclusion amount that was in effect when the decedent made taxable gifts during his or her life, and (2) such taxable gifts exceeded the basic exclusion amount in effect at the time of the decedent's death. Because the increase in the basic exclusion amount does not apply for estates of decedents dying after December 31, 2025, it is expected that this guidance will prevent the estate tax computation under section 2001(g) from recapturing, or "clawing back," all or a portion of the benefit of the increased basic exclusion amount used to offset gift tax for certain decedents who make taxable gifts between January 1, 2018, and December 31, 2025, and die after December 31, 2025.

Effective Date

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

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[371] Rev. Proc. 2018–18, 2018–10 I.R.B. 392, p. 397 (March 5, 2018).

[372] For example, assume that on March 15, 2016, T gave property with a value of $6,000,000 to a trust for the benefit of T's descendants (Trust A) and T's entire then-remaining generation-skipping transfer tax exemption of $5,400,000 was allocated to trust A on a timely filed 2016 gift tax return. As of the date of the 2016 gift, Trust A has an inclusion ratio of 0.100 [1 − ($5,400,000/$6,000,000)]. On July 1, 2018, when the property in Trust A has a fair market value of $7,000,000, T files a gift tax return and allocates $700,000 of generation-skipping transfer tax exemption to Trust A, reducing Trust A's inclusion ratio from 0.100 to zero [1 − (($700,000 + (90% x $7,000,000)) / $7,000,000))], effective on July 1, 2018. Absent additional contributions to Trust A, the generation-skipping transfer tax on taxable distributions from, or a taxable termination with respect to, Trust A on or after July 1, 2018, is determined using an inclusion ratio of zero.

PART VII—EXTENSION OF TIME LIMIT FOR CONTESTING IRS LEVY

A. Extension of Time Limit for Contesting IRS Levy (sec. 11071 of the Act and secs. 6343 and 6532 of the Code)

Prior Law

The IRS is authorized to return property that has been wrongfully levied upon.[373] In general, monetary proceeds from the sale of levied property may be returned within nine months of the date of the levy.

Generally, any person (other than the person against whom is assessed the tax out of which such levy arose) who claims an interest in levied property and that such property was wrongfully levied upon may bring a civil action for wrongful levy in a district court of the United States.[374] Generally, an action for wrongful levy must be brought within nine months from the date of levy.[375]

Explanation of Provision

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

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

Effective Date

The provision is effective with respect to: (1) levies made after the date of enactment (December 22, 2017); and (2) levies made on or before the date of enactment provided that the nine-month period has not expired as of the date of enactment.

[373] Sec. 6343.
[374] Sec. 7426.
[375] Sec. 6532.

PART VIII—INDIVIDUAL MANDATE

A. Elimination of Shared Responsibility Payment for Individuals Failing to Maintain Minimum Essential Coverage (sec. 11081 of the Act and sec. 5000A of the Code)

Prior Law

Under the Affordable Care Act,[376] individuals must have minimum essential coverage, qualify for an exemption, or make a shared responsibility payment (also referred to as a tax or penalty) for failure to maintain the coverage (commonly referred to as the "individual mandate").[377] Minimum essential coverage includes government-sponsored programs (including Medicare, Medicaid, and CHIP, among others), eligible employer-sponsored plans, plans in the individual market, grandfathered group health plans and grandfathered health insurance coverage, and other coverage as recognized by the Secretary of Health and Human Services ("HHS") in coordination with the Secretary of the Treasury.[378] The tax is imposed for any month that an individual does not have minimum essential coverage unless the individual qualifies for an exemption for the month as described below.

The tax for any calendar month is one-twelfth of the tax calculated as an annual amount. The annual amount is equal to the greater of a flat dollar amount or an excess income amount. The flat dollar amount is the lesser of (1) the sum of the individual annual dollar amounts for the members of the taxpayer's family and (2) 300 percent of the adult individual dollar amount. The individual adult annual dollar amount is $695 for 2017 and 2018.[379] For an individual who has not attained age 18, the individual annual dollar amount is one half of the adult amount. The excess income amount is 2.5 percent of the excess of the taxpayer's household income for the taxable year over the threshold amount of income for requiring the taxpayer to file an income tax return.[380] The total annual household payment may not exceed the national average annual premium for bronze level health plans for the applicable family size offered through Exchanges that year.[381]

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[376] Patient Protection and Affordable Care Act, Pub. L. No. 111–148, and Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111–152.

[377] Sec. 5000A. If an individual is a dependent, as defined in section 152, of another taxpayer, the other taxpayer is liable for any tax for failure to maintain the required coverage with respect to the individual. Sec. 5000A(b)(3)(A).

[378] Sec. 5000A(f)(1). Minimum essential coverage does not include coverage that consists of only certain excepted benefits, such as limited scope dental and vision benefits or long-term care insurance offered under a separate policy, certificate, or contract. Sec. 5000A(f)(3).

[379] For years after 2016, the $695 amount is indexed to CPI–U, rounded to the next lowest multiple of $50.

[380] The threshold amount is the amount of gross income specified in section 6012(a)(1) with respect to the taxpayer for the taxable year.

[381] Sec. 5000A(c).

Exemptions from the requirement to maintain minimum essential coverage are provided if an individual, with respect to any month, is: (1) an individual for whom coverage is unaffordable because the required contribution exceeds 8.16 percent of household income,[382] (2) an individual with household income below the income tax return filing threshold, (3) a member of an Indian tribe, (4) a member of certain recognized religious sects or a health care sharing ministry, (5) not a citizen or national of the United States or an alien not lawfully present in the United States,[383] (6) incarcerated, other than incarceration pending the disposition of charges, (7) an individual with a coverage gap for a continuous period of less than three months, or (8) determined by the Secretary of HHS to have suffered a hardship with respect to the capability to obtain coverage.[384]

Explanation of Provision

The provision reduces the amount of the individual shared responsibility payment, enacted as part of the Affordable Care Act, to zero.

Effective Date

The provision is effective for months beginning after December 31, 2018.

SUBTITLE B—ALTERNATIVE MINIMUM TAX

A. Repeal of Tax for Corporations; Credit for Prior Year Minimum Tax Liability of Corporations; Increased Exemption for Individuals (secs. 12001–12003 of the Act and secs. 53 and 55–59 of the Code)

Prior Law

Corporate alternative minimum tax

In general

An alternative minimum tax ("AMT") is imposed on a corporation to the extent the corporation's tentative minimum tax exceeds its regular tax. This tentative minimum tax is computed at the rate of 20 percent on the AMTI in excess of a $40,000 exemption amount that phases out. The exemption amount is phased out by an amount equal to 25 percent of the amount that the corporation's AMTI exceeds $150,000.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

A corporation with average gross receipts of less than $7.5 million for the prior three taxable years is exempt from the corporate

[382] For 2017. The rate applicable for 2018 is 8.05 percent of household income.

[383] In addition, certain individuals present or residing outside of the United States and *bona fide* residents of United States territories are deemed to maintain minimum essential coverage for any month in which the applicable requirements are met. Sec. 5000A(f)(4).

[384] Secs. 5000A(d) and (e).

minimum tax. The $7.5 million threshold is reduced to $5 million for the corporation's first three-taxable year period.

Preference items in computing AMTI

The corporate minimum tax preference items are:

1. The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

2. The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to an independent producer to the extent the preference would not reduce the producer's AMTI by more than 40 percent.

3. Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds, certain housing bonds, and bonds issued in 2009 and 2010) issued after August 7, 1986.

4. Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

Adjustments in computing AMTI

The adjustments that corporations must make in computing AMTI are:

1. Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence. Depreciation on property which is allowed "bonus depreciation" for the regular tax is computed without regard to any AMT adjustments.

2. Mining exploration and development costs must be capitalized and amortized over a 10-year period.

3. Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

4. The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

5. The special rules applicable to Merchant Marine construction funds are not applicable.

6. The special deduction allowable under section 833(b) for Blue Cross and Blue Shield organizations is not allowed.

7. The adjusted current earnings adjustment applies, as described below.

Adjusted current earning ("ACE") adjustment

The adjusted current earnings adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings of a corporation exceed its AMTI (determined without the ACE adjustment and the alternative tax net operating loss deduction). In determining ACE the following rules apply:

1. For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.
2. Amounts excluded from gross income under the regular tax but included for purposes of determining earnings and profits are generally included in determining ACE.
3. The inside build-up of a life insurance contract is included in ACE (and the related premiums are deductible).
4. Intangible drilling costs of integrated oil companies must be capitalized and amortized over a 60-month period.
5. The regular tax rules of section 173 (allowing circulation expenses to be amortized) and section 248 (allowing organizational expenses to be amortized) do not apply.
6. Inventory must be calculated using the FIFO, rather than LIFO, method.
7. The installment sales method generally may not be used.
8. No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.
9. Depletion (other than for oil and gas properties) must be calculated using the cost, rather than the percentage, method.
10. In certain cases, the assets of a corporation that has undergone an ownership change must be stepped down to their fair market values.

Other rules

The taxpayer's net operating loss carryover generally cannot reduce the taxpayer's AMT liability by more than 90 percent of AMTI determined without this deduction.

The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT. Certain exceptions apply.

If a corporation is subject to AMT in any year, the amount of AMT is allowed as an AMT credit in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in the subsequent year. Corporations are allowed to claim a limited amount of AMT credits in lieu of bonus depreciation.

A corporation may elect to write off certain expenditures paid or incurred with respect of circulation expenses, research and experimental expenses, intangible drilling and development expenditures, development expenditures, and mining exploration expenditures over a specified period (three years in the case of circulation expenses, 60 months in the case of intangible drilling and development expenditures, and 10 years in case of other expenditures).

The election applies for purposes of both the regular tax and the alternative minimum tax.

Individual alternative minimum tax

In general

An AMT is also imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. For taxable years beginning in 2017, the tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $187,800 ($93,900 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The breakpoints are indexed for inflation. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the taxable income adjusted to take account of specified tax preferences and adjustments.

The exemption amounts for taxable years beginning in 2017 are: (1) $84,500 in the case of married individuals filing a joint return and surviving spouses; (2) $54,300 in the case of other unmarried individuals; (3) $42,250 in the case of married individuals filing separate returns; and (4) $24,100 in the case of an estate or trust. For taxable years beginning in 2017, the exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $160,900 in the case of married individuals filing a joint return and surviving spouses, (2) $120,700 in the case of other unmarried individuals, and (3) $80,450 in the case of married individuals filing separate returns or an estate or a trust. The amounts are indexed for inflation.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

Preference items in computing AMTI

The minimum tax preference items are:

1. The excess of the deduction for percentage depletion over the adjusted basis of each mineral property (other than oil and gas properties) at the end of the taxable year.

2. The amount by which excess intangible drilling costs (*i.e.,* expenses in excess the amount that would have been allowable if amortized over a 10-year period) exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference applies to independent producers only to the extent it reduces the producer's AMTI (determined without regard to this preference and the net operating loss deduction) by more than 40 percent.

3. Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds, certain housing bonds, and bonds issued in 2009 and 2010) issued after August 7, 1986.

4. Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

5. Seven percent of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock).

In addition, losses from any tax shelter farm activity or passive activities are not taken into account in computing AMTI.

Adjustments in computing AMTI

The adjustments that individuals must make to compute AMTI are:

1. Depreciation on property placed in service after 1986 and before January 1, 1999, is computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence. Depreciation on property acquired after September 10, 2001, which is allowed an additional allowance under section 168(k) for the regular tax is computed without regard to any AMT adjustments.

2. Mining exploration and development costs are capitalized and amortized over a 10-year period.

3. Taxable income from a long-term contract (other than a home construction contract) is computed using the percentage of completion method of accounting.

4. The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), is calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

5. Miscellaneous itemized deductions are not allowed.

6. Itemized deductions for State, local, and foreign real property taxes; State and local personal property taxes; State, local, and foreign income, war profits, and excess profits taxes; and State and local sales taxes are not allowed.

7. Medical expenses are allowed only to the extent they exceed 10 percent of the taxpayer's adjusted gross income.

8. Deductions for interest on home equity loans are not allowed.

9. The standard deduction and the deduction for personal exemptions are not allowed.

10. The amount allowable as a deduction for circulation expenditures is capitalized and amortized over a three-year period.

11. The amount allowable as a deduction for research and experimentation expenditures from passive activities is capitalized and amortized over a 10-year period.

12. The regular tax rules relating to incentive stock options do not apply.

Other rules

The taxpayer's net operating loss deduction generally cannot reduce the taxpayer's AMTI by more than 90 percent of the AMTI (determined without the net operating loss deduction).

The alternative minimum tax foreign tax credit reduces the tentative minimum tax.

The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT. Certain exceptions apply.

If an individual is subject to AMT in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit (the "AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax liability in such subsequent year. The AMT credit is allowed only to the extent that the taxpayer's AMT liability is the result of adjustments that are timing in nature. The individual AMT adjustments relating to itemized deductions and personal exemptions are not timing in nature, and no minimum tax credit is allowed with respect to these items.

An individual may elect to write off certain expenditures paid or incurred with respect of circulation expenses, research and experimental expenses, intangible drilling and development expenditures, development expenditures, and mining exploration expenditures over a specified period (three years in the case of circulation expenses, 60 months in the case of intangible drilling and development expenditures, and 10 years in case of other expenditures). The election applies for purposes of both the regular tax and the alternative minimum tax.

Explanation of Provision

Corporate alternative minimum tax

The provision repeals the corporate alternative minimum tax.

In the case of a corporation, the provision allows the AMT credit to offset the entire regular tax liability for a taxable year. In addition, the AMT credit is allowable and is refundable for a taxable year beginning after 2017 and before 2022 in an amount equal to 50 percent (100 percent in the case of taxable years beginning in 2021) of the excess (if any) of the minimum tax credit for the taxable year over the amount of the credit allowed for the year against regular tax liability. For taxable years beginning after 2021, the amount of the minimum tax credit in the case of a corporation will be zero.

Individual alternative minimum tax

The provision temporarily increases the exemption amounts and the exemption amount phase-out thresholds for the individual AMT. For taxable years beginning after December 31, 2017, and beginning before January 1, 2026, the exemption amount is increased to $109,400 for married taxpayers filing a joint return and surviving spouses (half this amount for married taxpayers filing a separate return), and $70,300 for all other taxpayers (other than estates and trusts). The phase-out threshold is increased to $1,000,000 for married taxpayers filing a joint return and surviving

spouses, and $500,000 for all other taxpayers (other than estates and trusts). These amounts are indexed for inflation.

Effective Date

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

SUBTITLE C—BUSINESS-RELATED PROVISIONS

PART I—CORPORATE PROVISIONS

A. 21-Percent Corporate Tax Rate (sec. 13001 of the Act and sec. 11 of the Code)

Prior Law

Corporate taxable income is subject to tax under a four-step graduated rate structure.[385] The top corporate tax rate is 35 percent on taxable income in excess of $10 million. The corporate taxable income brackets and tax rates are as set forth in the table below.

Taxable income	Tax rate (percent)
Not over $50,000	15
Over $50,000 but not over $75,000	25
Over $75,000 but not over $10,000,000	34
Over $10,000,000	35

An additional five-percent tax is imposed on a corporation's taxable income in excess of $100,000. The maximum additional tax is $11,750. Also, a second additional three-percent tax is imposed on a corporation's taxable income in excess of $15 million. The maximum second additional tax is $100,000.

Certain personal service corporations pay tax on their entire taxable income at the rate of 35 percent.[386]

If the maximum corporate tax rate exceeds 35 percent, the maximum rate on a corporation's net capital gain will be 35 percent.[387]

Explanation of Provision

The provision taxes corporate taxable income at 21 percent, eliminating the graduated corporate rate structure and the special rate for personal service corporations.

The provision repeals the maximum corporate tax rate on net capital gain as obsolete.

In addition, for taxpayers subject to the normalization method of accounting (*e.g.,* regulated public utilities), the provision clarifies the normalization of excess tax reserves resulting from the reduction of the corporate income tax rate (with respect to prior depreciation or recovery allowances taken on assets placed in service as of the day before the corporate rate reduction takes effect).

The excess tax reserve is the excess of the reserve for deferred taxes as of the day before the corporate rate reduction takes effect over what the reserve for deferred taxes would be if the corporate rate reduction had been in effect for all prior periods. If an excess tax reserve is reduced more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method, the taxpayer will not be treated as using a normalization method with respect to the corporate rate reduction. If the taxpayer does not use a normalization method of accounting for the cor-

[385] Secs. 11(a) and (b)(1).
[386] Sec. 11(b)(2).
[387] Sec. 1201(a).

porate rate reduction, the taxpayer's tax for the taxable year shall be increased by the amount by which it reduces its excess tax reserve more rapidly than permitted under a normalization method of accounting and the taxpayer will not be treated as using a normalization method of accounting for purposes of section 168(f)(2) and (i)(9)(C).[388]

The average rate assumption method [389] reduces the excess tax reserve over the remaining regulatory lives of the property that gave rise to the reserve for deferred taxes during the years in which the deferred tax reserve related to such property is reversing. Under this method, the excess tax reserve is reduced as the timing differences (*i.e.,* differences between tax depreciation and regulatory depreciation with respect to the property) reverse over the remaining life of the asset. The reversal of timing differences generally occurs when the amount of the tax depreciation taken with respect to an asset is less than the amount of the regulatory depreciation taken with respect to the asset. To ensure that the deferred tax reserve, including the excess tax reserve, is reduced to zero at the end of the regulatory life of the asset that generated the reserve, the amount of the timing difference which reverses during a taxable year is multiplied by the ratio of (1) the aggregate deferred taxes as of the beginning of the period in question to (2) the aggregate timing differences for the property as of the beginning of the period in question.

The following example illustrates the application of the average rate assumption method. A calendar year regulated utility placed property costing $100 million in service in 2016. For regulatory (book) purposes, the property is depreciated over 10 years on a straight line basis with a full year's allowance in the first year. For tax purposes, the property is depreciated over five years using the 200 percent declining balance method and a half-year placed in service convention.[390]

The excess tax reserve as of December 31, 2017, the day before the corporate rate reduction takes effect, is $4.5 million.[391] The taxpayer will begin taking the excess tax reserve into account in the 2021 taxable year, which is the first year in which the tax depreciation taken with respect to the property is less than the depreciation reflected in the regulated books of account. The annual adjustment to the deferred tax reserve for the 2021 through 2025 taxable years is multiplied by 31.1 percent, which is the ratio of the aggregate deferred taxes as of the beginning of 2021 ($13.77 million) to the aggregate timing differences for the property as of the beginning of 2021 ($44.24 million).

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[388] Section 168(f)(2) and (i)(9)(C) provide that if a taxpayer is required to use a normalization method of accounting with respect to public utility property and does not do so, such taxpayer must compute its depreciation allowances for Federal income tax purposes using the depreciation method, useful life determination, averaging convention, and salvage value limitation used for purposes of setting rates and reflecting operating results in its regulated books of account.

[389] See sec. 2.04 of Rev. Proc. 88–12, 1988–1 C.B. 637.

[390] The five-year tax and 10-year book lives are used for illustration purposes only. In general, public utility property may be depreciated over various periods ranging from five to 20 years under MACRS. For regulatory purposes, public utility property may, in certain cases, have a useful life of 30 years or more.

[391] The excess tax reserve of $4.5 million is equal to the cumulative deferred tax reserve as of December 31, 2017 ($11.2 million) minus the cumulative timing difference as of December 31, 2017 ($32 million) multiplied by 21 percent.

NORMALIZATION CALCULATION FOR CORPORATE RATE REDUCTION

[Millions of dollars]

	Year(s)										
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Total
Tax expense	20.00	32.00	19.20	11.52	11.52	5.76	0.00	0.00	0.00	0.00	100.00
Book depreciation	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	100.00
Timing difference	10.00	22.00	9.20	1.52	1.52	−4.24	−10.00	−10.00	−10.00	−10.00	0.00
Tax rate	35.00%	35.00%	21.00%	21.00%	21.00%	31.13%	31.13%	31.13%	31.13%	31.13%	
Annual adjustment to reserve	3.50	7.70	1.93	0.32	0.32	−1.32	−3.11	−3.11	−3.11	−3.11	0.00
Cumulative deferred tax reserve	3.50	11.20	13.13	13.45	13.77	12.45	9.34	6.23	3.11	0.00	0.00
Annual adjustment at 21%	.....	.....	.....	.....	.....	(0.89)	(2.10)	(2.10)	(2.10)	(2.10)	(9.29)
Annual adjustment at average rate	.....	.....	.....	.....	.....	(1.32)	(3.11)	(3.11)	(3.11)	(3.11)	(13.77)
Excess tax reserve	.....	.....	.....	.....	.....	0.43	1.01	1.01	1.01	1.01	4.48

* Details may not add to totals due to rounding.

Instead of the average rate assumption method, a taxpayer may also use the alternative method as its normalization method if certain requirements are met. If, as of the first day of the taxable year that includes December 22, 2017 (*i.e.,* the date of enactment of the Act), (i) the taxpayer was required by a regulatory agency to compute depreciation for public utility property on the basis of an average life or composite rate method, and (ii) the taxpayer's books and underlying records do not contain the vintage account data necessary to apply the average rate assumption method,[392] the taxpayer is treated as using a normalization method of accounting if, with respect to such jurisdiction, the taxpayer uses the alternative method for public utility property that is subject to the regulatory authority for that jurisdiction.[393] Under the alternative method, the taxpayer (i) computes the excess tax reserve on all public utility property included in the plant account based on the weighted average life or composite rate used to compute depreciation for regulatory purposes, and (ii) reduces the excess tax reserve ratably over the remaining regulatory life of the property.[394]

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

B. Reduction in Dividends-Received Deduction to Reflect Lower Corporate Income Tax Rates (sec. 13002 of the Act and sec. 243 of the Code)

Prior Law

Corporations are allowed a deduction with respect to dividends received from other taxable domestic corporations.[395] The amount of the deduction is generally equal to 70 percent of the dividend received.

In the case of any dividend received from a 20-percent owned corporation, the amount of the deduction is equal to 80 percent of the dividend received.[396] The term "20-percent owned corporation" means any corporation if 20 percent or more of the stock of such corporation (by vote and value) is owned by the taxpayer. For this purpose, certain preferred stock is not taken into account.

In the case of a dividend received from a corporation that is a member of the same affiliated group, a corporation is generally allowed a deduction equal to 100 percent of the dividend received.[397]

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[392] See sec. 2.05 of Rev. Proc. 88–12, 1988–1 C.B. 637.

[393] If a taxpayer is subject to the jurisdiction of more than one regulatory body, the determination of the adequacy of the vintage accounting records for each asset or group of assets shall be determined on a jurisdiction-by-jurisdiction basis. See sec. 3 of Rev. Proc. 88–12, 1988–1 C.B. 637.

[394] See, *e.g.,* sec. 4 of Rev. Proc. 88–12, 1988–1 C.B. 637.

[395] Sec. 243(a). These dividends are taxed at a maximum rate of 10.5 percent (30 percent of the top corporate tax rate of 35 percent).

[396] Sec. 243(c). These dividends are taxed at a maximum rate of seven percent (20 percent of the top corporate tax rate of 35 percent).

[397] Secs. 243(a)(3) and (b)(1). For this purpose, the term "affiliated group" generally has the meaning given such term by section 1504(a). Sec. 243(b)(2).

Explanation of Provision

The provision reduces the 70 percent dividends-received deduction to 50 percent and the 80 percent dividends-received deduction to 65 percent.[398]

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

[398] These dividends would be taxed at a maximum rate of 10.5 percent (50 percent of the top corporate tax rate of 21 percent) and 7.35 percent (35 percent of the top corporate tax rate of 21 percent), respectively.

PART II—SMALL BUSINESS REFORMS

A. Modifications of Rules for Expensing Depreciable Business Assets (sec. 13101 of the Act and sec. 179 of the Code)

Prior Law

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[399] The period for depreciation or amortization generally begins when the asset is placed in service by the taxpayer.[400] Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period,[401] and convention.[402]

Election to expense certain depreciable business assets

A taxpayer may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation. The maximum amount a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year.[403] The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,000,000.[404] The $500,000 and $2,000,000 amounts are indexed for inflation for taxable years beginning after 2015.[405]

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[399] See secs. 263(a) and 167. In general, only the tax owner of property (*i.e.,* the taxpayer with the benefits and burdens of ownership) is entitled to claim tax benefits such as cost recovery deductions with respect to the property. In addition, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.,* sec. 280A.

[400] See Treas. Reg. secs. 1.167(a)–10(b), –3, –14, and 1.197–2(f). See also Treas. Reg. sec. 1.167(a)–11(e)(1)(i).

[401] The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. Exercising authority granted by Congress, the Secretary issued Rev. Proc. 87–56, 1987–2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Rev. Proc. 88–22, 1988–1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Rev. Proc. 87–56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

[402] Sec. 168.

[403] Sec. 179(b)(1).

[404] Sec. 179(b)(2).

[405] Sec. 179(b)(6). For taxable years beginning in 2017, the total amount that may be expensed is $510,000 ($545,000 for qualified enterprise zone property under section 1397A), and the phase-out threshold amount is $2,030,000. See Section 3.25 of Rev. Proc. 2016–55, 2016–45 I.R.B. 707. For example, assume that during 2017 a calendar year taxpayer purchases and places in service $2,500,000 of section 179 property. The $510,000 section 179(b)(1) dollar amount for 2017 is reduced by the excess section 179 property cost amount of $470,000 ($2,500,000 − $2,030,000). The taxpayer's 2017 section 179 expensing limitation is $40,000 ($510,000 − $470,000). Note, however, that the taxpayer's remaining basis in the property may be eligible for bonus depreciation under section 168(k). See Treas. Reg. sec. 1.168(k)–1(a)(2)(iii).

In general, qualifying property is defined as depreciable tangible personal property[406] that is purchased for use in the active conduct of a trade or business. Qualifying property also includes off-the-shelf computer software and qualified real property (*i.e.,* qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).[407] Qualifying property excludes any property described in section 50(b) (*i.e.,* certain property not eligible for the investment tax credit).[408]

Passenger automobiles subject to the section 280F limitation are eligible for section 179 expensing only to the extent of the dollar limitations in section 280F.[409] For sport utility vehicles above the 6,000 pound weight rating and not more than the 14,000 pound weight rating, which are not subject to the limitation under section 280F, the maximum cost that may be expensed for any taxable year under section 179 is $25,000 (the "sport utility vehicle limitation").[410]

The amount eligible to be expensed for a taxable year may not exceed the taxable income for such taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision).[411] Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to limitations).

Amounts expensed under section 179 are allowed for both regular tax and the alternative minimum tax.[412] However, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.[413] In addition, if a corporation makes an election under section 179 to deduct expenditures, the full amount of the deduction does not reduce earnings and profits. Rather, the expenditures that are de-

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For a discussion of changes made to section 168(k) by the Act, see the description of section 13201 of the Act (Temporary 100-Percent Expensing for Certain Business Assets).

[406] For example, qualifying property includes a portable air conditioning or heating unit (such as a window air conditioning unit or portable plug-in unit heater), but generally excludes any component of a central air conditioning or heating system of a building as such property represents real property (*i.e.,* is a structural component of a building). See Treas. Reg. sec. 1.48–1(e)(2) and sec. 3.03(1) of Rev. Proc. 2017–33, 2017–19 I.R.B. 1236.

[407] Sec. 179(d)(1)(A)(ii) and (f), as in effect prior to the enactment of the Consolidated Appropriations Act, 2018, Pub. L. No. 115–141, sec. 401(b)(15), March 23, 2018, which, as part of repealing general deadwood-related provisions, struck former subsection (e) (relating to special rules for qualified disaster assistance property) and redesignated "subsection (f)" as "subsection (e)". Thus, if a component of a central air conditioning or heating system of a building meets the definition of qualified real property under section 179 (*e.g.,* constitutes qualified restaurant property), the component may qualify as section 179 property if the taxpayer so elects. See sec. 3.03(2) of Rev. Proc. 2017–33.

[408] Sec. 179(d)(1) flush language. Property described in section 50(b) is generally property used outside the United States, certain property used for lodging, property used by certain tax-exempt organizations, and property used by governmental units and foreign persons or entities.

[409] For a discussion of changes made to section 280F by the Act, see the description of section 13202 of the Act (Modifications to Depreciation Limitations on Luxury Automobiles and Personal Use Property).

[410] Sec. 179(b)(5). For this purpose, a sport utility vehicle is defined to exclude any vehicle that: (1) is designed for more than nine individuals in seating rearward of the driver's seat; (2) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length; or (3) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

[411] Sec. 179(b)(3).

[412] See the Senate Finance Committee Report to Accompany H.R. 3838, Tax Reform Act of 1986, S. Rep. No. 99–313, May 29, 1985, p. 522. See also the Instructions for Form 6251, Alternative Minimum Tax - Individuals (2017), p. 6.

[413] Sec. 179(d)(9).

ducted under section 179 reduce corporate earnings and profits ratably over a five-year period.[414]

An expensing election is made under rules prescribed by the Secretary.[415] In general, any election made under section 179, and any specification contained therein, may be revoked by the taxpayer with respect to any property without the consent of the Commissioner.[416] Such revocation, once made, is irrevocable.

Explanation of Provision

The provision increases the maximum amount a taxpayer may expense under section 179 to $1,000,000, and increases the phase-out threshold amount to $2,500,000. Thus, the provision provides that the maximum amount a taxpayer may expense for taxable years beginning after 2017 is $1,000,000 of the cost of section 179 property placed in service for the taxable year. The $1,000,000 amount is reduced (but not below zero) by the amount by which the cost of section 179 property placed in service during the taxable year exceeds $2,500,000.[417] The $1,000,000 and $2,500,000 amounts, as well as the $25,000 sport utility vehicle limitation (amount unchanged by the Act), are indexed for inflation for taxable years beginning after 2018.

The provision expands the definition of section 179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.[418]

As a conforming amendment to the elimination by the Act of the separate definitions of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property under section 168,[419] the provision replaces the references in section 179(f)[420] to qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property within the definition of qualified real property with a reference to qualified improvement property. Thus, for example, the provision allows section 179 expensing for qualified improvement property without regard to whether the improvements are property subject to a lease, placed in service more than three years after the

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[414] Sec. 312(k)(3)(B).

[415] Sec. 179(c)(1). Such election may be made on an amended return. See sec. 3.02 of Rev. Proc. 2017–33.

[416] Sec. 179(c)(2).

[417] For example, assume that during 2018 a calendar-year taxpayer purchases and places in service $3,000,000 of section 179 property. The $1,000,000 section 179(b)(1) dollar amount for 2018 is reduced by the excess section 179 property cost amount of $500,000 ($3,000,000 − $2,500,000). The taxpayer's 2018 section 179 expensing limitation is $500,000 ($1,000,000 − $500,000). Note, however, that the taxpayer's remaining basis in the property may be eligible for bonus depreciation under section 168(k). See Treas. Reg. sec. 1.168(k)–1(a)(2)(iii). For a discussion of changes made to section 168(k) by the Act, see the description of section 13201 of the Act (Temporary 100-Percent Expensing for Certain Business Assets).

[418] As defined in section 50(b)(2). Property used predominantly to furnish lodging or in connection with furnishing lodging generally includes, for example, beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let. See Treas. Reg. sec. 1.48–1(h).

[419] See the description of section 13204 of the Act (Applicable Recovery Period for Real Property).

[420] As in effect prior to the enactment of the Consolidated Appropriations Act, 2018, Pub. L. No. 115–141, sec. 401(b)(15), March 23, 2018, which, as part of repealing general deadwood-related provisions, struck former subsection (e) (relating to special rules for qualified disaster assistance property) and redesignated "subsection (f)" as "subsection (e)".

date the building was first placed in service, or made to a restaurant building. Restaurant building property placed in service after December 31, 2017, that does not meet the definition of qualified improvement property is not eligible for section 179 expensing.

The provision also expands the definition of qualified real property eligible for section 179 expensing to include any of the following improvements made by the taxpayer[421] to nonresidential real property and placed in service after the date such nonresidential real property was first placed in service: roofs; heating, ventilation, and air-conditioning property;[422] fire protection and alarm systems; and security systems. Thus, such improvements do not need to meet the definition of qualified improvement property to be eligible for section 179 expensing.

Effective Date

The provision applies to property placed in service in taxable years beginning after December 31, 2017.

B. Small Business Accounting Method Reform and Simplification (sec. 13102 of the Act and secs. 263A, 448, 460, and 471 of the Code)

Prior Law

General rule for methods of accounting

Section 446 generally allows a taxpayer to select the method of accounting to be used to compute taxable income, provided that such method clearly reflects the income of the taxpayer. The term "method of accounting" includes not only the overall method of accounting used by the taxpayer, but also the accounting treatment of any one item.[423] Permissible overall methods of accounting include the cash receipts and disbursements method ("cash method"), an accrual method, or any other method (including a hybrid method) permitted under regulations prescribed by the Secretary.[424] Examples of any one item for which an accounting method may be adopted include cost recovery,[425] revenue recognition,[426] and the timing of deductions.[427] For each separate trade or business, a taxpayer is entitled to adopt any permissible method, subject to certain restrictions.[428]

A taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for such year.[429] Except as otherwise provided, section 446(e) requires taxpayers to secure the consent of the Secretary before changing a method of accounting. The regulations under this section provide rules for determining: (1) what a method of accounting is, (2) how a method

[421] A technical correction may be necessary to reflect this intent.
[422] Heating, ventilation, and air-conditioning property includes all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts. Treas. Reg. sec. 1.48–1(e)(2).
[423] Treas. Reg. sec. 1.446–1(a)(1).
[424] Sec. 446(c).
[425] See, *e.g.,* secs. 167 and 168.
[426] See, *e.g.,* secs. 451 and 460.
[427] See, *e.g.,* secs. 461 and 467.
[428] Sec. 446(d); Treas. Reg. sec. 1.446–1(d).
[429] Treas. Reg. sec. 1.446–1(e)(1).

of accounting is adopted,[430] and (3) how a change in method of accounting is effectuated.[431]

Cash and accrual methods

Taxpayers using the cash method generally recognize items of income when actually or constructively received and items of expense when paid. The cash method is administratively easy and provides the taxpayer flexibility in the timing of income recognition. It is the method generally used by most individual taxpayers, including farm and nonfarm sole proprietorships.

Taxpayers using an accrual method generally accrue items of income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[432] Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all the 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.[433] Accrual methods of accounting generally result in a more accurate measure of economic income than does the cash method. The accrual method is often used by businesses for financial accounting purposes.

A C corporation, a partnership that has a C corporation as a partner, or a tax-exempt trust or corporation with unrelated business income generally may not use the cash method. Exceptions are made for farming businesses, qualified personal service corporations, and the aforementioned entities to the extent their average annual gross receipts[434] do not exceed $5 million for all prior years (including the prior taxable years of any predecessor of the entity) (the "gross receipts test"). The cash method may not be used by any tax shelter.[435] In addition, the cash method generally may

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[430] See also Rev. Rul. 90–38, 1990–1 C.B. 57 (holding that a taxpayer adopts a method of accounting (1) when it uses a permissible method of accounting on a single tax return, or (2) when it uses the same impermissible method of accounting on two or more consecutive tax returns).

[431] Treas. Reg. sec. 1.446–1(e).

[432] See, *e.g.,* sec. 451. For a discussion of changes made to section 451 by the Act, see the description of section 13221 of the Act (Certain Special Rules for Taxable Year of Inclusion).

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

[434] For this purpose, gross receipts are taken into account in the taxable year in which they are properly recognized under the taxpayer's method of accounting used in that taxable year. Gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include income from investments, income from incidental or outside sources, interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade or business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221(1), (3), (4), or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in section 1221(2) (relating to property used in a trade or business), gross receipts are reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (*e.g.,* a repayment of the principal amount of a loan held by a commercial lender). Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar State and local taxes if, under the applicable State or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax. See section 448(c)(3)(C) and Treas. Reg. sec. 1.448–1T(f)(2)(iv).

[435] Secs. 448(a)(3) and (d)(3) and 461(i)(3) and (4). For this purpose, a tax shelter includes: (1) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale; (2) any syndicate (within the meaning of section 1256(e)(3)(B)); or (3) any tax shelter as defined in section 6662(d)(2)(C)(ii). In the case of a farming trade or business, a tax shelter includes any tax shelter as defined in section 6662(d)(2)(C)(ii) or any partnership or any other enterprise other than a corporation

not be used if the purchase, production, or sale of merchandise is an income producing factor.[436] Such taxpayers generally are required to keep inventories and use an accrual method with respect to inventory items.[437]

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 (other than evergreen trees that are more than six years old at the time they are severed from their roots).[438] Such farming businesses are not precluded from using the cash method regardless of whether they meet the gross receipts test. However, section 447 generally requires a farming C corporation (and any farming partnership if a corporation is a partner in such partnership) to use an accrual method of accounting. Section 447 does not apply to nursery or sod farms, to the raising or harvesting of trees (other than fruit and nut trees), nor to farming C corporations meeting a gross receipts test with a $1 million threshold. For family farm C corporations, the threshold under the gross receipts test is $25 million.

A qualified personal service corporation is a corporation: (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and (2) substantially all of the stock of which (by value) is owned by current or former employees performing such services, their estates, or heirs.[439] Qualified personal service corporations are allowed to use the cash method without regard to whether they meet the gross receipts test.

Accounting for inventories

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is an income-producing factor to the taxpayer.[440] Treasury regulations also provide that in any case in which the use of inventories is necessary to clearly reflect income, the accrual method must be used with regard to purchases and sales.[441] However, an exception is provided for taxpayers whose average annual gross receipts do not exceed $1 million.[442] 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 prohib-

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which is not an S corporation engaged in the trade or business of farming, (1) if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale or (2) if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs. For this purpose, certain holdings held directly by individuals that are attributable to active farm management activities are not treated as being held by a limited partner or a limited entrepreneur. See the second section 461(j) (relating to farming syndicate defined), as in effect prior to the enactment of the Consolidated Appropriations Act, 2018, Pub. L. No. 115–141, section 401(a)(117), March 23, 2018, which, as part of repealing general deadwood-related provisions, redesignated the second "subsection (j)" (relating to farming syndicate defined) as "subsection (k)".

[436] Treas. Reg. secs. 1.446–1(c)(2) and 1.471–1.

[437] Sec. 471 and Treas. Reg. secs. 1.446–1(c)(2) and 1.471–1.

[438] Secs. 448(d)(1) and 263A(e)(4). See also Treas. Reg. sec. 1.263A–4(a)(4).

[439] Sec. 448(d)(2).

[440] Sec. 471(a) and Treas. Reg. sec. 1.471–1.

[441] Treas. Reg. sec. 1.446–1(c)(2).

[442] Rev. Proc. 2001-10, 2001–1 C.B. 272.

ited from using the cash method under section 448.[443] Such taxpayers may account for inventory as materials and supplies that are not incidental (*i.e.,* "non-incidental materials and supplies"').[444]

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 inventories 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,[445] and the last-in, first-out ("LIFO") method, which assumes that the items in ending inventory are those earliest acquired by the taxpayer.[446]

Uniform capitalization

The uniform capitalization rules require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.[447] For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

Section 263A provides a number of exceptions to the general uniform capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have $10 million or less of average annual gross receipts;[448] such taxpayers are not required to include additional section 263A costs in inventory. Another exception exists for taxpayers who raise, harvest, or grow trees.[449] 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 uniform capitalization rules do not apply to any plant having a preproductive period of two years or less or to any animal, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under section 447 or

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[443] Rev. Proc. 2002-28, 2002–1 C.B. 815.

[444] 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.

[445] See Treas. Reg. sec. 1.471–2(d).

[446] See sec. 472.

[447] Sec. 263A.

[448] Sec. 263A(b)(2)(B). No exception is available for small taxpayers who produce property subject to section 263A. However, a *de minimis* rule under Treasury regulations treats producers with total indirect costs of $200,000 or less as having no additional indirect costs beyond those normally capitalized for financial accounting purposes. Treas. Reg. sec. 1.263A–2(b)(3)(iv).

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

448(a)(3)).[450] Freelance authors, photographers, and artists also are exempt from section 263A for any qualified creative expenses.[451]

Accounting for long-term contracts

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method.[452] Under this method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year.[453] The percentage of the contract completed during the taxable year is determined by comparing costs allocated to the contract and incurred before the end of the taxable year with the estimated total contract costs.[454] Costs allocated to the contract typically include all costs (including depreciation) that directly benefit or are incurred by reason of the taxpayer's long-term contract activities.[455] The allocation of costs to a contract is made in accordance with regulations.[456] Costs incurred with respect to the long-term contract are deductible in the year incurred, subject to general accrual method of accounting principles and limitations.[457]

There are a number of types of long-term contracts excepted from the requirements to use the percentage-of-completion method to compute taxable income. One such exception is provided for certain construction contracts performed by small contractors ("small construction contracts").[458] Contracts within this exception are those contracts for the construction or improvement of real property if the contract: (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (2) is performed by a taxpayer whose average annual gross receipts for the prior three taxable years do not exceed $10 million.[459] Thus, long-term contract income from small construction contracts must be reported consistently using the taxpayer's exempt contract method.[460] Permissible exempt contract methods include the completed contract method, the exempt-contract percentage-of-completion method, the percentage-of-completion method, or any other permissible method.[461]

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[450] Sec. 263A(d).

[451] Sec. 263A(h). Qualified creative expenses are defined as amounts paid or incurred by an individual in the trade or business of being a writer, photographer, or artist (other than as an employee). However, such term does not include any expense related to printing, photographic plates, motion picture films, video tapes, or similar items.

[452] Sec. 460(a).

[453] See Treas. Reg. sec. 1.460–4. This calculation is done on a cumulative basis. Thus, the amount included in gross income in a particular year is that proportion of the expected contract price that the amount of costs incurred through the end of the taxable year bears to the total expected costs, reduced by the amounts of gross contract price included in gross income in previous taxable years.

[454] Sec. 460(b)(1).

[455] Sec. 460(c).

[456] Treas. Reg. sec. 1.460–5.

[457] Treas. Reg. secs. 1.460–4(b)(2)(iv) and 1.460–1(b)(8).

[458] Other exceptions are provided for home construction contracts, residential construction contracts, qualified ship construction contracts, and qualified naval ship contracts. See sec. 460(e); Treas. Reg. secs. 1.460–2(d), 1.460–3(b) and (c), and 1.460–4(e); and sec. 708 of the American Jobs Creation Act of 2004, Pub. L. No. 108–357 (2004).

[459] Secs. 460(e)(1)(B) and (4).

[460] Since such contracts involve the construction of real property, they are subject to the interest capitalization rules without regard to their duration. See Treas. Reg. sec. 1.263A–8.

[461] Treas. Reg. sec. 1.460–4(c)(1).

Explanation of Provision

The provision expands the universe of taxpayers that may use the cash method of accounting. Under the provision, the cash method of accounting may be used by taxpayers, other than tax shelters, that satisfy the gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. The gross receipts test allows taxpayers with average annual gross receipts[462] that do not exceed $25 million for the three prior taxable-year period (the "$25 million gross receipts test") to use the cash method. The $25 million amount is indexed for inflation for taxable years beginning after 2018.

The provision expands the universe of farming C corporations (and farming partnerships with a C corporation partner) that may use the cash method to include any farming C corporation (or farming partnership with a C corporation partner) that meets the $25 million gross receipts test.

The provision retains the exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations. Thus, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other passthrough entities are allowed to use the cash method without regard to whether they meet the $25 million gross receipts test, so long as the use of such method clearly reflects income.[463]

In addition, the provision exempts certain taxpayers from the requirement to keep inventories. Specifically, taxpayers that meet the $25 million gross receipts test are not required to account for inventories under section 471,[464] but rather may use a method of accounting for inventories that either (1) treats inventories as non-

[462] For purposes of the gross receipts test, items included in gross receipts are intended to be consistent with prior law. See section 448(c)(3)(C) and Treas. Reg. sec. 1.448–1T(f)(2)(iv).

[463] Consistent with prior and present law, the cash method generally may not be used by taxpayers, other than those that meet the $25 million gross receipts test, if the purchase, production, or sale of merchandise is an income-producing factor.

[464] In the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship is a corporation or partnership.

incidental materials and supplies,[465] or (2) conforms to the taxpayer's financial accounting treatment of inventories.[466]

The provision expands the exception for small taxpayers from the uniform capitalization rules. Under the provision, any producer or reseller that meets the $25 million gross receipts test is exempted from the application of section 263A.[467] The provision retains the exemptions from the uniform capitalization rules that are not based on a taxpayer's gross receipts.

Finally, the provision expands the exception for small construction contracts from the requirement to use the percentage-of-completion method. Under the provision, contracts within this exception are those contracts for the construction or improvement of real property if the contract (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract, and (2) is performed by a taxpayer that (for the taxable year in which the contract was entered into) meets the $25 million gross receipts test.[468]

Under the provision, a taxpayer who fails the $25 million gross receipts test for a taxable year is not eligible for any of the aforementioned exceptions (*i.e.,* from the accrual method, from keeping inventories, from applying the uniform capitalization rules, or from using the percentage-of-completion method) for such taxable year.

Application of any of the above provisions is a change in the taxpayer's method of accounting for purposes of section 481. Application of the exception for small construction contracts from the requirement to use the percentage-of-completion method is implemented on a cutoff basis for all similarly classified contracts (hence there is no adjustment under section 481(a) for contracts entered into before January 1, 2018). In addition, any change in method of accounting due to application of the above provisions is treated as

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[465] Consistent with prior and present law, 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. See Treas. Reg. sec. 1.162–3(a)(1). As the provision allows a taxpayer to treat inventories as non-incidental materials and supplies, a taxpayer may also be able to elect to deduct such non-incidental materials and supplies in the taxable year the amount is paid under the *de minimis* safe harbor election of Treas. Reg. sec. 1.263(a)–1(f). Under such election, a taxpayer with an applicable financial statement that has written accounting procedures in place that treat as an expense amounts paid for property costing less than a specified dollar amount may deduct amounts paid for non-incidental materials and supplies at the time of payment if the amount paid for the property does not exceed $5,000 per invoice (or per item as substantiated by the invoice). In addition, a taxpayer without an applicable financial statement that has accounting procedures in place that treat as an expense amounts paid for property costing less than a specified dollar amount may deduct amounts paid for non-incidental materials and supplies at the time of payment if the amount paid for the property does not exceed $500 per invoice (or per item as substantiated by the invoice). However, in either case, the taxpayer is not eligible to deduct inventory treated as non-incidental materials and supplies under this provision under the *de minimis* safe harbor election unless the taxpayer is also treating the amounts paid for such items as an expense in its applicable financial statement or its books and records, if the taxpayer does not have an applicable financial statement (*i.e.,* the taxpayer is not eligible to apply the *de minimis* safe harbor if the amounts paid for such items are treated as inventory for financial reporting purposes). See Treas. Reg. sec. 1.263(a)–1(f)(1)(i)(C) and (ii)(C). If a taxpayer elects to apply the *de minimis* safe harbor, the taxpayer must apply such safe harbor to all materials and supplies that otherwise meet the requirements of Treas. Reg. sec. 1.263(a)–1(f).

[466] The taxpayer's financial accounting treatment of inventories is determined by reference to the method of accounting used in the taxpayer's applicable financial statement (as defined in section 13221 of the Act (Certain Special Rules for Taxable Year of Inclusion)) or, if the taxpayer does not have an applicable financial statement, the method of accounting used in the taxpayer's books and records prepared in accordance with the taxpayer's accounting procedures.

[467] In the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship is a corporation or partnership.

[468] In the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship is a corporation or partnership.

initiated by the taxpayer and made with the consent of the Secretary.[469] For example, such change is made with the consent of the Secretary for any taxable year in which the taxpayer fails to meet the gross receipts test if the taxpayer met such test in the prior taxable year, and the taxpayer is changing from the cash method to an accrual method. In addition, such change is made with the consent of the Secretary for any taxable year in which the taxpayer meets the gross receipts test if the taxpayer failed to meet such test in the prior taxable year and the taxpayer is changing from an accrual method to the cash method.

The Treasury Department has issued published guidance addressing this provision.[470]

Effective Date

The provisions to expand the universe of taxpayers, including farming C corporations, eligible to use the cash method, exempt certain taxpayers from the requirement to keep inventories, and expand the exception from the uniform capitalization rules apply to taxable years beginning after December 31, 2017. Application of these rules is a change in the taxpayer's method of accounting for purposes of section 481.

The provision to expand the exception for small construction contracts from the requirement to use the percentage-of-completion method applies to contracts entered into after December 31, 2017, in taxable years ending after such date. Application of this rule is a change in the taxpayer's method of accounting for purposes of section 481. Application of the exception for small construction contracts from the requirement to use the percentage-of-completion method is implemented on a cutoff basis for all similarly classified contracts (hence there is no adjustment under section 481(a) for contracts entered into before January 1, 2018).

[469] See sections 263A(i)(3), 448(d)(7), 460(e)(2)(B), and 471(c)(4), all as amended by the Act.
[470] See Rev. Proc. 2018–40, 2018–34 I.R.B. 320, August 20, 2018.

PART III—COST RECOVERY AND ACCOUNTING METHODS

SUBPART A—COST RECOVERY

A. Temporary 100-Percent Expensing for Certain Business Assets (sec. 13201 of the Act and sec. 168(k) of the Code)

Prior Law

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[471] The period for depreciation or amortization generally begins when the asset is placed in service by the taxpayer.[472]

Tangible property

Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period,[473] and convention.[474]

Bonus depreciation

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property acquired and placed in service before January 1, 2020 (January 1, 2021, for certain property with a recovery period of at least 10 years or cer-

[471] See secs. 263(a) and 167. In general, only the tax owner of property (*i.e.,* the taxpayer with the benefits and burdens of ownership) is entitled to claim tax benefits such as cost recovery deductions with respect to the property. In addition, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.,* sec. 280A.

[472] See Treas. Reg. secs. 1.167(a)–10(b), –3, –14, and 1.197–2(f). See also Treas. Reg. sec. 1.167(a)–11(e)(1)(i).

[473] The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. Exercising authority granted by Congress, the Secretary issued Rev. Proc. 87–56, 1987–2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Rev. Proc. 88–22, 1988–1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Rev. Proc. 87–56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

[474] Sec. 168.

tain transportation property,[475] and certain aircraft[476]).[477] The 50-percent allowance is phased down for property placed in service after December 31, 2017 (after December 31, 2018, for longer production period property and certain aircraft). The bonus depreciation percentage rates are as follows.

Placed in Service Year	Bonus Depreciation Percentage	
	Qualified Property in General	Longer Production Period Property and Certain Aircraft
2017	50 percent	50 percent
2018	40 percent	50 percent[478]
2019	30 percent	40 percent
2020	None	30 percent[479]

The additional first-year depreciation deduction is allowed for both the regular tax and the alternative minimum tax ("AMT"),[480] but is not allowed in computing earnings and profits.[481] The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction.[482] The amount of the additional first-year depreciation deduction is not affected by a short taxable year.[483] The taxpayer may elect out of the additional first-year depreciation for any class of property for any taxable year.[484]

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2017 a taxpayer purchases new depreciable property and places it in service.[485] The property's cost is $10,000, and it is five-year property subject to the 200 percent declining balance method and half-year convention. The amount of additional first-year depreciation allowed is $5,000. The remaining $5,000 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, $1,000 also is al-

[475] Property qualifying for the extended placed-in-service date must have a recovery period of at least 10 years or constitute transportation property, have an estimated production period exceeding one year, and have a cost exceeding $1 million. Transportation property generally is defined as tangible personal property used in the trade or business of transporting persons or property. Section 168(k)(2)(B). Property defined in section 168(k)(2)(B) is hereinafter collectively referred to as "longer production period property."

[476] Certain aircraft which is not transportation property, other than for agricultural or firefighting uses, also qualifies for the extended placed-in-service date, if at the time of the contract for purchase, the purchaser made a nonrefundable deposit of the lesser of 10 percent of the cost or $100,000, and which has an estimated production period exceeding four months and a cost exceeding $200,000. Sec. 168(k)(2)(C).

[477] Sec. 168(k). The additional first-year depreciation deduction is generally subject to the rules regarding whether a cost must be capitalized under section 263A. For a discussion of changes made to section 263A by the Act, see the description of section 13102 of the Act (Small Business Accounting Method Reform and Simplification).

[478] In the case of longer production period property placed in service in 2018, 50 percent applies to the entire adjusted basis. Similarly, in the case of longer production period property placed in service in 2019, 40 percent applies to the entire adjusted basis.

[479] In the case of longer production period property described in section 168(k)(2)(B) and placed in service in 2020, 30 percent applies to the adjusted basis attributable to manufacture, construction, or production before January 1, 2020, and the remaining adjusted basis does not qualify for bonus depreciation. Thirty percent applies to the entire adjusted basis of certain aircraft described in section 168(k)(2)(C) and placed in service in 2020.

[480] Sec. 168(k)(2)(G). See also Treas. Reg. sec. 1.168(k)–1(d).

[481] Sec. 312(k)(3) and Treas. Reg. sec. 1.168(k)–1(f)(7).

[482] Sec. 168(k)(1)(B).

[483] *Ibid.*

[484] Sec. 168(k)(7). For the definition of a class of property, see Treas. Reg. sec. 1.168(k)–1(e)(2).

[485] Assume that the cost of the property is not eligible for expensing under section 179 or Treas. Reg. sec. 1.263(a)–1(f).

lowed as a depreciation deduction in 2017.[486] The total depreciation deduction with respect to the property for 2017 is $6,000. The remaining $4,000 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

Qualified property

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements:[487]

- The property must be: (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property;[488] (3) computer software other than computer software covered by section 197; or (4) qualified improvement property;[489]
- The original use[490] of the property must commence with the taxpayer;[491] and
- The property must be placed in service before January 1, 2020. However, as noted above, an extension of the placed-in-service date of one year (*i.e.*, before January 1, 2021) is provided for longer production period property and certain aircraft.

In the case of longer production period property and certain aircraft, the property must also be acquired (1) before January 1, 2020, or (2) pursuant to a written binding contract which was entered into before January 1, 2020. With respect to such property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property before January 1, 2020.[492] Additionally, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2020 ("progress expendi-

[486] $1,000 results from the application of the half-year convention and the 200 percent declining balance method to the remaining $5,000.

[487] Requirements relating to actions taken before 2008 are not described herein since they have little (if any) remaining effect. For a description of these actions, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress* (JCS–1–09), March 2009, pp. 81–84.

[488] As defined in section 168(e)(5).

[489] The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. Sec. 168(k)(2)(D)(i).

[490] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (*i.e.*, each fractional owner is considered the original user of its proportionate share of the property). Treas. Reg. sec. 1.168(k)–1(b)(3).

[491] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. If property is originally placed in service by a lessor, such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale. Sec. 168(k)(2)(E)(ii) and (iii).

[492] Sec. 168(k)(2)(E)(i).

tures") is eligible for the additional first-year depreciation deduction.[493]

For purposes of identifying qualified property, qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service by the taxpayer after the date such building was first placed in service by any taxpayer.[494] Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

Election to accelerate AMT credits in lieu of bonus depreciation

A corporation otherwise eligible for additional first-year depreciation may elect to claim additional AMT credits in lieu of claiming additional depreciation with respect to qualified property.[495] In the case of a corporation making this election, the straight line method is used for the regular tax and the AMT with respect to qualified property.[496]

A corporation making an election increases the tax liability limitation on the use of minimum tax credits under section 53(c) by the bonus depreciation amount. The aggregate increase in credits allowable by reason of the increased limitation is treated as refundable.

The bonus depreciation amount generally is equal to 20 percent of bonus depreciation for qualified property that could be claimed as a deduction absent an election under this provision.[497] As originally enacted, the bonus depreciation amount for all taxable years was limited to the lesser of (1) $30 million or (2) six percent of the minimum tax credits allowable to the adjusted net minimum tax imposed for taxable years beginning before January 1, 2006. However, extensions of this provision have provided that this limitation applies separately to property subject to each extension.

For taxable years ending after December 31, 2015, the bonus depreciation amount for a taxable year (as defined under prior law with respect to all qualified property) is limited to the lesser of (1) 50 percent of the minimum tax credit for the first taxable year ending after December 31, 2015 (determined before the application of any tax liability limitation) or (2) the minimum tax credit for the taxable year allowable to the adjusted net minimum tax imposed for taxable years ending before January 1, 2016 (determined before the application of any tax liability limitation and determined on a first-in, first-out basis).

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[493] Sec. 168(k)(2)(B)(ii). For purposes of determining the amount of eligible progress expenditures, rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

[494] Sec. 168(k)(3). See also section 4.02 of Rev. Proc. 2017–33, 2017–19 I.R.B. 1236. Qualified improvement property must also meet the requirements of section 168(k)(2)(A)(ii) and (iii) (*i.e.*, the original use and placed in service date requirements) to be eligible for bonus depreciation.

[495] Sec. 168(k)(4).

[496] Sec. 168(k)(4)(A)(ii).

[497] For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation determined if section 168(k)(1) applied to all qualified property placed in service during the taxable year and (ii) the amount of depreciation that would be so determined if section 168(k)(1) did not so apply. This determination is made using the most accelerated depreciation method and the shortest life otherwise allowable for each property.

All corporations treated as a single employer under section 52(a) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.[498]

In the case of a corporation making an election which is a partner in a partnership, for purposes of determining the electing partner's distributive share of partnership items, bonus depreciation does not apply to any qualified property and the straight line method is used with respect to that property.[499]

In the case of a partnership having a single corporate partner owning (directly or indirectly) more than 50 percent of the capital and profits interests in the partnership, each partner takes into account its distributive share of partnership depreciation in determining its bonus depreciation amount.[500]

Special rules

Passenger automobiles

The limitation under section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by $8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction).[501] The $8,000 amount is phased down from $8,000 by $1,600 per calendar year beginning in 2018. Thus, the section 280F increase amount for property placed in service during 2018 is $6,400, and during 2019 is $4,800. While the underlying section 280F limitation is indexed for inflation,[502] the section 280F increase amount is not indexed for inflation. The increase does not apply to a taxpayer who elects to accelerate AMT credits in lieu of bonus depreciation for a taxable year.

Certain plants bearing fruits and nuts

A special election is provided for certain plants bearing fruits and nuts.[503] Under the election, the applicable percentage of the adjusted basis of a specified plant which is planted or grafted after December 31, 2015, and before January 1, 2020, is deductible for regular tax and AMT purposes in the year planted or grafted by the taxpayer (rather than in the year the specified plant is placed in service by the taxpayer[504]), and the adjusted basis is reduced by the amount of the deduction.[505] The percentage is 50 percent for 2017, 40 percent for 2018, and 30 percent for 2019. A specified plant is any tree or vine that bears fruits or nuts, and any other plant that will have more than one crop or yield of fruits or nuts and generally has a preproductive period of more than two years from the time of planting or grafting to the time it begins bearing

[498] Sec. 168(k)(4)(B)(iii).
[499] Sec. 168(k)(4)(D)(ii).
[500] Sec. 168(k)(4)(D)(iii).
[501] Sec. 168(k)(2)(F).
[502] Sec. 280F(d)(7).
[503] See sec. 168(k)(5). Section 4.05 of Rev. Proc. 2017–33 provides the procedures for making a section 168(k)(5) election.
[504] In the case of any tree or vine bearing fruits or nuts, the placed in service date generally does not occur until the tree or vine first reaches an income-producing stage. See Treas. Reg. sec. 1.46–3(d)(2). See also, Rev. Rul. 80-25, 1980–1 C.B. 65; and Rev. Rul. 69–249, 1969–1 C.B. 31.
[505] Any amount deducted under this election is not subject to capitalization under section 263A.

a marketable crop or yield of fruits or nuts.[506] If the election is made with respect to any specified plant, such plant is not treated as qualified property eligible for bonus depreciation in the subsequent taxable year in which it is placed in service.[507] Once made, the election is revocable only with the consent of the Secretary.[508]

Long-term contracts

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method.[509] Solely for purposes of determining the percentage-of-completion under section 460(b)(1)(A), the cost of qualified property with a MACRS recovery period of seven years or less is taken into account as a cost allocated to the contract as if bonus depreciation had not been enacted for property placed in service before January 1, 2020 (January 1, 2021, in the case of longer production period property).[510]

Intangible property

Section 197 intangibles

Under section 197, when a taxpayer acquires intangible assets held in connection with a trade or business, any value properly attributable to a "section 197 intangible" is amortizable on a straight-line basis over 15 years.[511] No other depreciation or amortization deduction (such as bonus depreciation under section 168(k)) is allowable with respect to any section 197 intangible.[512] Such intangibles include: goodwill; going concern value; workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment; business books and records, operating systems, or other information base; any patent, copyright, formula, process, design, pattern, knowhow, format, or similar item; customer-based intangibles; supplier-based intangibles; and any other similar item.[513] The definition of a section 197 intangible also includes: any license, permit, or other rights granted by governmental units (even if the right is granted for an indefinite period or is reasonably expected to be renewed indefinitely);[514] any cov-

[506] A specified plant does not include any property that is planted or grafted outside of the United States.

[507] However, when placed in service, the remaining adjusted basis of the specified plant may be eligible for expensing under section 179. See section 4.05(3) of Rev. Proc. 2017-33. For a discussion of changes made to section 179 by the Act, see the description of section 13101 of the Act (Modification of Rules for Expensing).

[508] See section 4.05(2) of Rev. Proc. 2017-33 for guidance on revoking a section 168(k)(5) election.

[509] Sec. 460.

[510] Sec. 460(c)(6). Other dates involving prior years are not described herein.

[511] Secs. 197(a) and (c).

[512] Sec. 197(b).

[513] Sec. 197(d)(1).

[514] Sec. 197(d)(1)(D). Examples include a liquor license, a taxi-cab medallion, an airport landing or take-off right, a regulated airline route, or a television or radio broadcasting license. Renewals of such governmental rights are treated as the acquisition of a new 15-year asset. Treas. Reg. sec. 1.197–2(b)(8). A license, permit, or other right granted by a governmental unit is a franchise if it otherwise meets the definition of a franchise. Treas. Reg. sec. 1.197–2(b)(10). Section 197 intangibles do not include certain rights granted by a government not considered part of the acquisition of a trade or business. Sec. 197(e)(4)(B) and Treas. Reg. sec. 1.197–2(c)(13).

enant not to compete; and any franchise,[515] trademark, or trade name.[516]

Section 197 does not apply to certain intangible property, including certain property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.[517]

Films, videos, and sound recordings

MACRS does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years.[518] Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property is determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property if it is used in a trade or business or held for the production of income. In addition, the costs of motion picture films, video tapes, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation once the property is placed in service.[519]

Under the income forecast method, a property's depreciation deduction for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the gross income generated by the property during the year, and the denominator of which is the total forecasted or estimated gross income expected to be generated prior to the close of the tenth taxable year after the year the property is placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property is placed in service may be taken into account as depreciation in that year.[520]

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[515] A franchise is defined as "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." Secs. 197(f)(4) and 1253(b)(1). Thus, for example, 15-year amortization under section 197 generally applies to acquired sports franchises, including any intangible assets acquired in connection with the acquisition of such a franchise (including player contracts). See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, pp. 479-480. As section 197 intangibles, such assets are not eligible for bonus depreciation under section 168(k).

[516] Sec. 197(d)(1)(F).

[517] Secs. 197(c)(2) and (e)(4)(A).

[518] Secs. 168(f)(1), (3) and (4).

[519] Sec. 167(g)(6).

[520] Sec. 167(g)(1). In general, the adjusted basis of property that may be taken into account under the income forecast method only includes amounts that have been incurred under the economic performance requirements of section 461(h). An exception to this rule applies to participations and residuals. Specifically, solely for purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service (even if economic performance has not yet occurred) if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service. For this purpose, participations and residuals

Continued

Expensing of certain qualified film, television, and live theatrical productions

Under section 181, a taxpayer may elect[521] to deduct up to $15 million of the aggregate production costs of any qualified film, television, or live theatrical production, commencing prior to January 1, 2017,[522] in the year the costs are paid or incurred by the taxpayer, in lieu of capitalizing the costs and recovering them through depreciation allowances once the production is placed in service.[523] The dollar limitation is increased to $20 million if a significant amount of the production costs are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.[524]

A section 181 election may only be made by an owner of the production.[525] An owner of a production is any person that is required under section 263A to capitalize the costs of producing the production into the cost basis of the production, or that would be required to do so if section 263A applied to that person.[526] In addition, the aggregate production costs of a qualified production that is co-produced include all production costs, regardless of funding source, in determining if the applicable dollar limit is exceeded. Thus, the term "aggregate production costs" means all production costs paid or incurred by any person, whether paid or incurred directly by an owner or indirectly on behalf of an owner.[527] The costs of the production in excess of the applicable dollar limitation are capitalized

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are defined as costs the amount of which, by contract, varies with the amount of income earned in connection with such property. See sec. 167(g)(7).

[521] See Treas. Reg. sec. 1.181–2 for rules on making (and revoking) an election under section 181.

[522] Subsequent to the enactment of Pub. L. No. 115–97, section 181 was extended for productions commencing after December 31, 2016, and before January 1, 2018, by the Bipartisan Budget Act of 2018, Pub. L. No. 115–123, sec. 40308, February 9, 2018. For purposes of determining whether a production is eligible for section 181 expensing, a qualified film or television production is treated as commencing on the first date of principal photography. See the Conference Report to accompany H.R. 4520, American Jobs Creation Act of 2004, H.R. Rep. No. 108–755, October 7, 2004, p. 372. See also Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS–5–05), May 2005, p. 210. The date on which a qualified live theatrical production commences is the date of the first public performance of such production for a paying audience. See the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114–113, sec. 169(d), December 18, 2015. See also Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 2015* (JCS–1–16), March 2016, p. 187.

[523] Sec. 181(a)(2)(A). See Treas. Reg. sec. 1.181–1 for rules on determining eligible production costs. Eligible production costs under section 181 include participations and residuals paid or incurred. Treas. Reg. sec. 1.181–1(a)(3)(i). The special rule in section 167(g)(7) that allows taxpayers using the income forecast method of depreciation to include participations and residuals that have not met the economic performance requirements in the adjusted basis of the property for the taxable year the property is placed in service does not apply for purposes of section 181. Treas. Reg. sec. 1.181–1(a)(8). Thus, under section 181, a taxpayer may only include participations and residuals actually paid or incurred in eligible production costs. Further, production costs do not include the cost of obtaining a production after its initial release or broadcast. See Treas. Reg. sec. 1.181–1(a)(3). For this purpose, "initial release or broadcast" means the first commercial exhibition or broadcast of a production to an audience. Treas. Reg. sec. 1.181–1(a)(7). Thus, for example, a taxpayer may not expense the purchase of an existing film library under section 181. See T.D. 9551, 76 Fed. Reg. 64816, October 19, 2011.

[524] Sec. 181(a)(2)(B).

[525] Treas. Reg. sec. 1.181–1(a).

[526] Treas. Reg. sec. 1.181–1(a)(2)(i). For a discussion of the changes made to section 263A by the Act, see the description of section 13102 of the Act (Small Business Accounting Method Reform and Simplification).

[527] Treas. Reg. sec. 1.181–1(a)(4). See Treas. Reg. sec. 1.181–2(c)(3) for the information required to be provided to the Internal Revenue Service when more than one person will claim deductions under section 181 for a production (to ensure that the applicable deduction limitation is not exceeded).

and recovered under the taxpayer's method of accounting for the recovery of such property once placed in service.[528]

A qualified film, television, or live theatrical production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format), television program, or live staged play if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.[529] Solely for purposes of this rule, the term "compensation" does not include participations and residuals (as defined in section 167(g)(7)(B)).[530]

Each episode of a television series is treated as a separate production, and only the first 44 episodes of a particular series qualify under the provision.[531] Qualified productions do not include sexually explicit productions as referenced by section 2257 of title 18 of the U.S. Code.[532]

A qualified live theatrical production is defined as a live staged production of a play (with or without music) which is derived from a written book or script and is produced or presented by a commercial entity in any venue which has an audience capacity of not more than 3,000, or a series of venues the majority of which have an audience capacity of not more than 3,000.[533] In addition, qualified live theatrical productions include any live staged production which is produced or presented by a taxable entity no more than 10 weeks annually in any venue which has an audience capacity of not more than 6,500.[534] In general, in the case of multiple live-staged productions, each such live-staged production is treated as a separate production. Similar to the exclusion for sexually explicit productions from the definition of qualified film or television productions, qualified live theatrical productions do not include stage performances that would be excluded by section 2257(h)(1) of title 18 of the U.S. Code, if such provision were extended to live stage performances.[535]

For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as if it were a deduction allowable for amortization.[536] Thus, the deduction under section 181

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[528] See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress* (JCS–1–09), March 2009, p. 448; and Treas. Reg. sec. 1.181–1(c)(2). A production is generally considered to be placed in service at the time of initial release, broadcast, or live staged performance (*i.e.*, at the time of the first commercial exhibition, broadcast, or live staged performance of a production to an audience). See, *e.g.*, Rev. Rul. 79–285, 1979–2 C.B. 91; and Priv. Ltr. Rul. 9010011, March 9, 1990. See also, Treas. Reg. sec. 1.181–1(a)(7). However, a production generally may not be considered to be placed in service if it is only exhibited, broadcasted, or performed for a limited test audience in advance of the commercial exhibition, broadcast, or performance to general audiences. See Priv. Ltr. Rul. 9010011 and Treas. Reg. sec. 1.181–1(a)(7).

[529] Sec. 181(d)(3)(A).

[530] Sec. 181(d)(3)(B). Participations and residuals are defined as, with respect to any property, costs the amount of which by contract varies with the amount of income earned in connection with such property. See also Treas. Reg. sec. 1.181–3(c).

[531] Sec. 181(d)(2)(B).

[532] Sec. 181(d)(2)(C).

[533] Sec. 181(e)(2)(A).

[534] Sec. 181(e)(2)(D).

[535] Sec. 181(e)(2)(E).

[536] Sec. 1245(a)(2)(C). For a discussion of the recapture rules applicable to depreciation and amortization deductions, see Joint Committee on Taxation, *Background and Present Law Relating to Cost Recovery and Domestic Production Activities* (JCX–19–12), February 27, 2012, pp. 45–46.

may be subject to recapture as ordinary income in the taxable year in which (i) the taxpayer revokes a section 181 election, (ii) the production fails to meet the requirements of section 181, or (iii) the taxpayer sells or otherwise disposes of the production.[537]

Explanation of Provision

In general

The provision extends and modifies the additional first-year depreciation deduction through 2026 (through 2027 for longer production period property and certain aircraft). The 50-percent allowance is increased to 100 percent for property acquired and placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for longer production period property and certain aircraft), as well as for specified plants planted or grafted after September 27, 2017, and before January 1, 2023. The 100-percent allowance is phased down by 20 percent per calendar year for property acquired after September 27, 2017, and placed in service, and specified plants planted or grafted, in taxable years beginning after 2022 (after 2023 for longer production period property and certain aircraft).

The provision retains the prior-law phase down of bonus depreciation for property acquired before September 28, 2017, and placed in service after September 27, 2017.[538]

Under the provision, the bonus depreciation percentage rates are as follows.

Placed in Service Year[539]	Bonus Depreciation Percentage	
	Qualified Property in General/Specified Plants	Longer Production Period Property and Certain Aircraft
Portion of Basis of Qualified Property Acquired before Sept. 28, 2017		
Sept. 28, 2017–Dec. 31, 2017	50 percent	50 percent
2018	40 percent	50 percent
2019	30 percent	40 percent
2020	None	30 percent[540]
2021 and thereafter	None	None
Portion of Basis of Qualified Property Acquired after Sept. 27, 2017		
Sept. 28, 2017–Dec. 31, 2022	100 percent	100 percent
2023	80 percent	100 percent
2024	60 percent	80 percent
2025	40 percent	60 percent
2026	20 percent	40 percent
2027	None	20 percent[541]
2028 and thereafter	None	None

[537] See Treas. Reg. sec. 1.181–4.

[538] A technical correction may be necessary to reflect this intent due to the effective date of the provision.

[539] In the case of specified plants, this is the year of planting or grafting.

[540] Thirty percent applies to the adjusted basis attributable to manufacture, construction, or production before January 1, 2020, and the remaining adjusted basis does not qualify for bonus depreciation. Thirty percent applies to the entire adjusted basis of certain aircraft described in section 168(k)(2)(C) and placed in service in 2020.

Special rules

The provision maintains the prior-law section 280F increase amount of $8,000 for passenger automobiles placed in service after December 31, 2017. However, the provision also maintains the prior-law phase down of the section 280F increase amount for passenger automobiles acquired before September 28, 2017, and placed in service after September 27, 2017. Thus, the section 280F increase amount for passenger automobiles acquired before September 28, 2017, and placed in service after September 27, 2017, is $8,000 for 2017, $6,400 for 2018, and $4,800 for 2019.

The provision extends the special rule under the percentage-of-completion method for the allocation of bonus depreciation to a long-term contract for property placed in service before January 1, 2027 (January 1, 2028, in the case of longer production period property).

Application to used property

The provision expands the definition of qualified property to include certain qualified property for which the original use did not commence with the taxpayer. Thus, the provision applies to purchases of used as well as new items. However, qualified property only includes used property if such property was not previously used by the taxpayer prior to acquisition.[542] To avoid potential abuses, the additional first-year depreciation deduction applies only to property purchased in an arm's-length transaction. It does not apply to property received as a gift or from a decedent.[543] In the case of trade-ins, like-kind exchanges, or involuntary conversions, it applies only to any money paid in addition to the traded-in property or in excess of the adjusted basis of the replaced property.[544] It does not apply to property acquired in a nontaxable exchange such as a reorganization, to property acquired from a member of the taxpayer's family, including a spouse, ancestors, and lineal descendants, or from another related entity as defined in section 267, nor to property acquired from a person who controls, is controlled by, or is under common control with, the taxpayer.[545] Thus it does not apply, for example, if one member of an affiliated group of corporations purchases property from another member, or if an individual who controls a corporation purchases property from that corporation.

Application to qualified film, television, and live theatrical productions

The provision expands the definition of qualified property eligible for the additional first-year depreciation allowance to include the production costs of qualified film, television, and live theatrical pro-

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[541] Twenty percent applies to the adjusted basis attributable to manufacture, construction, or production before January 1, 2027, and the remaining adjusted basis does not qualify for bonus depreciation. Twenty percent applies to the entire adjusted basis of certain aircraft described in section 168(k)(2)(C) and placed in service in 2027.

[542] For purposes of determining whether an asset has been previously used by a taxpayer, it is intended that the term "used" means that the taxpayer previously had a depreciable interest in the asset (as determined for purposes of sections 167 and 168).

[543] By reference to section 179(d)(2)(C). See also Treas. Reg. sec. 1.179–4(c)(1)(iv).

[544] By reference to section 179(d)(3). See also Treas. Reg. sec. 1.179–4(d).

[545] By reference to section 179(d)(2)(A) and (B). See also Treas. Reg. sec. 1.179–4(c).

ductions[546] placed in service after September 27, 2017, and before January 1, 2027, for which a deduction otherwise would have been allowable under section 181 without regard to the dollar limitation or termination of such section.[547] For purposes of this provision, a qualified production is considered placed in service, and thus eligible for the additional first-year depreciation allowance, at the time of initial release, broadcast, or live staged performance (*i.e.*, at the time of the first commercial exhibition, broadcast, or live staged performance of a production to an audience).

Election to accelerate AMT credits in lieu of bonus depreciation

As a conforming amendment to the repeal of the corporate AMT, the election to accelerate AMT credits in lieu of bonus depreciation is repealed.[548]

Exception for certain businesses not subject to limitation on interest expense

The provision excludes from the definition of qualified property any property placed in service in taxable years beginning after December 31, 2017,[549] which is primarily used in the trade or business of the furnishing[550] or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.[551]

In addition, the provision excludes from the definition of qualified property any property used in a trade or business that has had floor plan financing indebtedness[552] if the floor plan financing interest related to such indebtedness was taken into account to increase the taxpayer's interest limitation under section

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[546] As defined in section 181(d) and (e).

[547] For example, similar to section 181, participations and residuals are only included in eligible production costs under section 168(k) to the extent such amounts are actually paid or incurred. Similarly, the taxpayer must be the owner of the qualified production to be eligible to claim the additional first-year depreciation allowance. Thus, for example, a taxpayer that acquires only a limited license or right to exploit a production prior to its initial release, broadcast, or live staged performance is not eligible to claim the additional first-year depreciation allowance for any production costs attributable to such production. See Treas. Reg. sec. 1.181–1(a)(2).

[548] See the description of section 12001 of the Act (Repeal of Tax for Corporations).

[549] A technical correction may be necessary to reflect this intent.

[550] The term "furnishing" includes generation, transmission, and distribution activities.

[551] See section 163(j)(7)(A)(iv) and the description of section 13301 of the Act (Limitation on Deduction for Interest). It is intended that this exception only apply to regulated public utility or electric cooperative trades or businesses excluded from the interest limitation under section 163(j)(7)(A)(iv). For example, property leased by a leasing trade or business to a regulated public utility would not be precluded by section 168(k)(9)(A) from claiming bonus depreciation on its qualified property because the leasing trade or business is not excluded from the interest limitation by section 163(j)(7)(A)(iv). However, if the leasing trade or business qualifies as an electing real property trade or business described in section 163(j)(7)(B), and the taxpayer elects to have such business excluded from the interest limitation, then the leasing trade or business is required to use ADS recovery periods, instead of MACRS recovery periods, for certain real property. See the description of section 13204 of the Act (Applicable Recovery Period for Real Property).

[552] As defined in section 163(j)(9). See the description of section 13301 of the Act (Limitation on Deduction for Interest).

163(j)(1)(C),[553] unless the taxpayer with such trade or business is not a tax shelter prohibited from using the cash method and is exempt from the interest limitation rules in section 13301 of the Act by meeting the $25 million gross receipts test of section 448(c).[554] Once a trade or business has taken floor plan financing interest into account under section 163(j)(1)(C) for a taxable year, any qualified property placed in service by that trade or business in such taxable year and subsequent taxable years is not eligible for bonus depreciation.

For example, assume that for 2018 a motor vehicle dealer does not meet the $25 million gross receipts test and has $20 of business interest income, $150 of business interest, $50 of floor plan financing interest, and $650 of adjusted taxable income.[555] Because the $150 of business interest is less than the $215 interest limitation ($20 + ($650 * 30 percent)) determined without regard to the floor plan financing interest, the floor plan financing interest need not be taken into account under section 163(j)(1)(C) to increase the interest limitation because all business interest is deductible based on the interest limitation otherwise applicable. As a result, qualified property placed in service by the motor vehicle dealer's trade or business during 2018 is eligible for bonus depreciation.

Alternatively, assume the same facts as previously stated, except that the motor vehicle dealer has adjusted taxable income of $50. The interest limitation, determined without taking into account floor plan financing interest under section 163(j)(1)(C), is $35 ($20 + ($50 * 30 percent)). If the taxpayer limits the business interest deduction to $35 for 2018, qualified property placed in service during 2018 remains eligible for bonus depreciation. However, if the taxpayer increases the interest limitation by taking into account the $50 floor plan financing interest under section 163(j)(1)(C) and deducts $85 of business interest for 2018, any property placed in service by the motor vehicle dealer's trade or business during 2018 and subsequent taxable years is not eligible for bonus depreciation.[556]

The Treasury Department has issued proposed regulations addressing this provision.[557]

Effective Date

The provision generally applies to property acquired and placed in service after September 27, 2017, and to specified plants planted or grafted after such date. The provision retaining the prior-law phase down of bonus depreciation applies to property acquired before September 28, 2017, and placed in service after September 27, 2017.[558] To determine the date of acquisition for purposes of apply-

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[553] As modified by section 13301 of the Act (Limitation on Deduction for Interest).

[554] As modified by section 13102 of the Act (Small Business Accounting Method Reform and Simplification).

[555] Determined as provided under section 13301 of the Act (Limitation on Deduction for Interest).

[556] Note, however, that the motor vehicle dealer's property may be eligible for expensing under section 179. For a discussion of changes made to section 179 by the Act, see the description of section 13101 of the Act (Modification of Rules for Expensing).

[557] See REG–104397–18, 83 Fed. Reg. 39292, August 8, 2018.

[558] A technical correction may be necessary to reflect this intent.

ing these effective dates, any property acquired pursuant to a written binding contract (including property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract) may not be treated as acquired after the date on which such contract is entered into. For example, property acquired by a taxpayer pursuant to a written binding contract that was entered into on September 1, 2017, will be subject to prior law when placed in service.

A transition rule provides that for a taxpayer's first taxable year ending after September 27, 2017, and beginning before January 1, 2018,[559] the taxpayer may elect to apply a 50-percent allowance instead of the 100-percent allowance.[560]

B. Modifications to Depreciation Limitations on Luxury Automobiles and Personal Use Property (sec. 13202 of the Act and sec. 280F of the Code)

Prior Law

Section 280F(a) limits the annual cost recovery deduction with respect to certain passenger automobiles. This limitation is commonly referred to as the "luxury automobile depreciation limitation" or the "section 280F limitation." For passenger automobiles placed in service in 2017, and for which the additional first-year depreciation deduction under section 168(k) is not claimed, the maximum amount of allowable depreciation is $3,160 for the year in which the vehicle is placed in service, $5,100 for the second year, $3,050 for the third year, and $1,875 for the fourth and later years in the recovery period.[561] This limitation is indexed for inflation and applies to the aggregate deduction provided for depreciation and section 179 expensing. Hence, passenger automobiles subject to section 280F are eligible for section 179 expensing only to the extent of the applicable limits contained in section 280F.[562] For passenger automobiles eligible for the additional first-year depreciation allowance in 2017, the first-year limitation is increased by an additional $8,000.[563]

For purposes of the section 280F limitation, passenger automobiles are defined broadly to include any four-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways and which are rated at 6,000 pounds unloaded gross vehicle weight or less.[564] In the case of a truck or a van, the section 280F limitation applies to vehicles that are rated at 6,000 pounds gross vehicle weight or less. Sport utility vehicles are treated as a truck for the purpose of applying the section 280F limitation.

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[559] A technical correction may be necessary to reflect this intent.

[560] Such election shall be made at such time and in such form and manner as prescribed by the Secretary.

[561] Rev. Proc. 2017-29, Table 3, 2017–14 I.R.B. 1065.

[562] For a discussion of changes made to section 179 by the Act, see the description of section 13101 of the Act (Modifications of Rules for Expensing Depreciable Business Assets).

[563] Sec. 168(k)(2)(F). For a discussion of changes made to section 168(k) by the Act, see the description of section 13201 of the Act (Temporary 100-Percent Expensing for Certain Business Assets).

[564] Sec. 280F(d)(5). Exceptions are provided for any ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in a trade or business, or any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

Basis not recovered in the recovery period of a passenger automobile is allowable as an expense in subsequent taxable years.[565] The expensed amount is limited in each such subsequent taxable year to the amount of the limitation in the fourth year in the recovery period.

Listed property

In the case of certain listed property, special rules apply. Listed property generally is defined as: (1) any passenger automobile; (2) any other property used as a means of transportation;[566] (3) any property of a type generally used for purposes of entertainment, recreation, or amusement; (4) any computer or peripheral equipment;[567] and (5) any other property of a type specified in Treasury regulations.[568]

First, if for the taxable year in which the property is placed in service, the use of the property for trade or business purposes does not exceed 50 percent of the total use of the property, then the depreciation deduction with respect to such property is determined under the alternative depreciation system.[569] The alternative depreciation system generally requires the use of the straight-line method and a recovery period equal to the class life of the property.[570] Second, if an individual owns or leases listed property that is used by the individual in connection with the performance of services as an employee, no depreciation deduction, expensing allowance, or deduction for lease payments is available with respect to such use unless the use of the property is for the convenience of the employer and required as a condition of employment.[571] Both limitations apply for purposes of section 179 expensing.

For listed property, no deduction is allowed unless the taxpayer adequately substantiates the expense and business usage of the property.[572] A taxpayer must substantiate the elements of each expenditure or use of listed property, including (1) the amount (*e.g.*, cost) of each separate expenditure and the amount of business or investment use, based on the appropriate measure (*e.g.*, mileage for automobiles), and the total use of the property for the taxable period, (2) the date of the expenditure or use, and (3) the business purposes for the expenditure or use.[573] The level of substantiation for business or investment use of listed property varies depending on the facts and circumstances. In general, the substantiation must

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[565] Sec. 280F(a)(1)(B).

[566] Property substantially all of the use of which is in a trade or business of providing transportation to unrelated persons for hire is not considered other property used as a means of transportation. Sec. 280F(d)(4)(C).

[567] Computer or peripheral equipment used exclusively at a regular business establishment and owned or leased by the person operating such establishment, however, is not listed property. Sec. 280F(d)(4)(B).

[568] Sec. 280F(d)(4)(A).

[569] Sec. 280F(b)(1). If for any taxable year after the year in which the property is placed in service the use of the property for trade or business purposes decreases to 50 percent or less of the total use of the property, then the amount of depreciation allowed in prior years in excess of the amount of depreciation that would have been allowed for such prior years under the alternative depreciation system is recaptured (*i.e.*, included in gross income) for such taxable year.

[570] Sec. 168(g).

[571] Sec. 280F(d)(3).

[572] Sec. 274(d)(4).

[573] Temp. Treas. Reg. sec. 1.274–5T(b)(6).

contain sufficient information as to each element of every business or investment use.[574]

Explanation of Provision

The provision increases the depreciation limitations under section 280F that apply to passenger automobiles. Specifically, for passenger automobiles placed in service after December 31, 2017, and for which the additional first-year depreciation deduction under section 168(k) is not claimed, the maximum amount of allowable depreciation is $10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period. The limitations are indexed for inflation for passenger automobiles placed in service after 2018.

The provision also removes computer or peripheral equipment from the definition of listed property. Such property is therefore not subject to the heightened substantiation requirements that apply to listed property.

The Treasury Department has issued published guidance addressing this provision for passenger automobiles placed in service during calendar year 2018.[575]

Effective Date

The provision is effective for property placed in service after December 31, 2017, in taxable years ending after such date.

C. Modifications of Treatment of Certain Farm Property (sec. 13203 of the Act and sec. 168 of the Code)

Prior Law

In general

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[576] The period for depreciation or amortization generally begins when the asset is placed in service by the taxpayer.[577] Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[578]

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[574] Temp. Treas. Reg. sec. 1.274–5T(c)(2)(ii)(C).

[575] See Rev. Proc. 2018–25, 2018–18 I.R.B. 543.

[576] See secs. 263(a) and 167. In general, only the tax owner of property (*i.e.,* the taxpayer with the benefits and burdens of ownership) is entitled to claim tax benefits such as cost recovery deductions with respect to the property. In addition, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.,* sec. 280A.

[577] See Treas. Reg. secs. 1.167(a)–10(b), –3, –14, and 1.197–2(f). See also Treas. Reg. sec. 1.167(a)–11(e)(1)(i). In the case of any tree or vine bearing fruits or nuts, the placed in service date generally does not occur until the tree or vine first reaches an income-producing stage. See Treas. Reg. sec. 1.46–3(d)(2). See also Rev. Rul. 80–25, 1980–1 C.B. 65; and Rev. Rul. 69–249, 1969–1 C.B. 31.

[578] Sec. 168.

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance.[579] The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[580] switching to the straight line method for the first taxable year where using the straight line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property. The straight line depreciation method is required for the aforementioned real property.

Farm property

Property used in a farming business is assigned various recovery periods in the same manner as other business property. For these purposes, the term "farming business" means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity (*e.g.,* the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals).[581] A farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products.[582] A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer.[583]

Farm recovery periods

Farm property that is generally assigned a three-year recovery period includes, for example, breeding hogs, breeding and working

[579] Exercising authority granted by Congress, the Secretary issued Rev. Proc. 87–56, 1987–2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Rev. Proc. 88–22, 1988–1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Rev. Proc. 87–56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

[580] Under the declining balance method the depreciation rate is determined by dividing the appropriate percentage (here 150 or 200) by the appropriate recovery period. This leads to accelerated depreciation when the declining balance percentage is greater than 100. The table below illustrates depreciation for an asset with a cost of $1,000 and a seven-year recovery period under the 200-percent declining balance method, the 150-percent declining balance method, and the straight line method.

Recovery method	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Total
200-percent declining balance	285.71	204.08	145.77	104.12	86.77	86.77	86.77	1,000.00
150-percent declining balance	214.29	168.37	132.29	121.26	121.26	121.26	121.26	1,000.00
Straight-line	142.86	142.86	142.86	142.86	142.86	142.86	142.86	1,000.00

* Details may not add to totals due to rounding.

[581] Sec. 263A(e)(4) and Treas. Reg. sec. 1.263A–4(a)(4)(i).

[582] Sec. 263A(e)(4) and Treas. Reg. sec. 1.263A–4(a)(4)(ii).

[583] Sec. 263A(e)(4) and Treas. Reg. sec. 1.263A–4(a)(4)(i).

horses more than 12 years old when placed in service, and over-the-road tractor units.[584] Examples of five-year farm property include dairy or breeding cattle, breeding goats and sheep, and trucks.[585] Farm property assigned a recovery period of seven years includes machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agriculture, animal husbandry, and horticultural services.[586] Cotton ginning assets and breeding and working horses 12 years old or less when placed in service are also assigned a recovery period of seven years.[587] Any single purpose agricultural or horticultural structure,[588] and any tree or vine bearing fruit or nuts are assigned a recovery period of 10 years.[589] Land improvements such as drainage facilities, paved lots, and water wells are assigned a recovery period of 15 years.[590] Farm buildings that do not meet the definition of a single purpose agricultural or horticultural structure are assigned a recovery period of 20 years.[591]

A five-year recovery period was assigned to new farm machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which was used in a farming business (as defined above), the original use of which commenced with the taxpayer after December 31, 2008, and which was placed in service before January 1, 2010.[592]

Any property used in a farming business (other than nonresidential real property,[593] residential rental property,[594] and trees or

[584] See Rev. Proc. 87–56, asset class 01.23, Hogs, Breeding; asset class 01.222, any breeding or work horse that is more than 12 years old at the time it is placed in service; and asset class 00.26, Tractor Units for Use Over-the-Road.

[585] See Rev. Proc. 87–56, asset class 01.21, Cattle, Breeding or Dairy; asset class 01.24, Sheep and Goats, Breeding; asset class 00.241, Light General Purpose Trucks; and asset class 00.242, Heavy General Purpose Trucks.

[586] Rev. Proc. 87–56, asset class 01.1, Agriculture.

[587] Rev. Proc. 87–56, asset class 01.11, Cotton ginning assets; and asset class 01.221, any breeding or work horse that is 12 years old or less at the time it is placed in service.

[588] A single purpose agricultural (livestock) structure is any enclosure or structure specifically designed, constructed, and used for (i) housing, raising, and feeding a particular type of livestock (including poultry) and their produce, and (ii) housing the equipment (including any replacements) necessary for the housing, raising, and feeding of such livestock. Sec. 168(i)(13)(B)(i) and (iv). For example, a single purpose agricultural structure includes a structure used to breed chicken or hogs, produce milk from dairy cattle, or produce feeder cattle or pigs, broiler chickens, or eggs, if an integral part of the structure is the equipment necessary to house, raise, and feed the livestock. See IRS Publication 225, Farmer's Tax Guide (2017). A single purpose horticultural structure is (i) a greenhouse specifically designed, constructed and used for the commercial production of plants, and (ii) a structure specifically designed, constructed, and used for the commercial production of mushrooms. Sec. 168(i)(13)(B)(ii). If a structure includes work space, the work space must be solely for (i) the stocking, caring for, or collecting of livestock or plants (as the case may be) or their produce, (ii) the maintenance of the enclosure or structure, and (iii) the maintenance or replacement of the equipment or stock enclosed or housed therein. Sec. 168(i)(13)(B)(iii). See also Rev. Proc. 87–56, asset class 01.4, Single purpose agricultural or horticultural structures.

[589] Sec. 168(e)(3)(D)(i) and (ii).

[590] Rev. Proc. 87–56, asset class 00.3, Land improvements. See also IRS Publication 225, Farmer's Tax Guide (2017).

[591] Rev. Proc. 87–56, asset class 01.3, Farm buildings except structures included in asset class 01.4.

[592] Sec. 168(e)(3)(B)(vii).

[593] Sec. 168(b)(3)(A).

[594] Sec. 168(b)(3)(B).

vines bearing fruits or nuts[595]) is subject to the 150-percent declining balance method.[596]

Under a special accounting rule, certain taxpayers engaged in the business of farming who elect to deduct preproductive period expenditures of plants produced in such business are required to depreciate all farming assets using the alternative depreciation system (*i.e.,* using longer recovery periods and the straight line method).[597]

Explanation of Provision

The provision shortens the recovery period from seven to five years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business,[598] the original use of which commences with the taxpayer and which is placed in service after December 31, 2017.

The provision also repeals the required use of the 150-percent declining balance method for certain property used in a farming business (*i.e.,* for three-, five-, seven-, and 10-year property), allowing such property to use the 200-percent declining balance method. The 150-percent declining balance method will continue to apply to any 15-year or 20-year property used in a farming business to which the straight line method does not apply, or to property for which the taxpayer elects the use of the 150-percent declining balance method.

Effective Date

The provision is effective for property placed in service after December 31, 2017, in taxable years ending after such date.

D. Applicable Recovery Period for Real Property (sec. 13204 of the Act and sec. 168 of the Code)

Prior Law

In general

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[599] The period for depreciation or amortization generally begins when the asset is placed in service by the taxpayer.[600] Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines de-

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[595] Sec. 168(b)(3)(E).

[596] Sec. 168(b)(2)(B).

[597] Secs. 263A(d)(3) and (e)(2), and 168(g)(2). For a discussion of changes made to the applicability of section 263A by the Act, see the description of section 13102 of the Act (Small Business Accounting Method Reform and Simplification).

[598] For purposes of the provision, "farming business" is defined consistent with prior law (*i.e.,* under section 263A(e)(4)).

[599] See secs. 263(a) and 167. In general, only the tax owner of property (*i.e.,* the taxpayer with the benefits and burdens of ownership) is entitled to claim tax benefits such as cost recovery deductions with respect to the property. In addition, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.,* sec. 280A.

[600] See Treas. Reg. secs. 1.167(a)–10(b), –3, –14, and 1.197–2(f). See also Treas. Reg. sec. 1.167(a)–11(e)(1)(i).

preciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[601]

Recovery periods and depreciation methods

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance.[602] The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[603] switching to the straight line method for the first taxable year where using the straight line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property. The straight line depreciation method is required for the aforementioned real property.

Placed-in-service conventions

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention.[604] Under MACRS, nonresidential real property, residential rental property, and any railroad grading or tunnel bore generally are subject to the mid-month convention, which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month.[605] All other property generally is subject to the half-year convention, which treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year to reflect the assumption that assets are placed in service ratably throughout the year.[606] However, if substantial property is placed in service during the last three months of a taxable year, a special rule requires use

[601] Sec. 168.

[602] Exercising authority granted by Congress, the Secretary issued Rev. Proc. 87–56, 1987–2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Rev. Proc. 88–22, 1988–1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Rev. Proc. 87–56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

[603] Under the declining balance method the depreciation rate is determined by dividing the appropriate percentage (here 150 or 200) by the appropriate recovery period. This leads to accelerated depreciation when the declining balance percentage is greater than 100. The table below illustrates depreciation for an asset with a cost of $1,000 and a seven-year recovery period under the 200-percent declining balance method, the 150-percent declining balance method, and the straight line method.

Recovery method	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Total
200-percent declining balance	285.71	204.08	145.77	104.12	86.77	86.77	86.77	1,000.00
150-percent declining balance	214.29	168.37	132.29	121.26	121.26	121.26	121.26	1,000.00
Straight-line	142.86	142.86	142.86	142.86	142.86	142.86	142.86	1,000.00

* Details may not add to totals due to rounding.

[604] Treas. Reg. sec. 1.167(a)–10(b).

[605] Secs. 168(d)(2) and (4)(B).

[606] Secs. 168(d)(1) and (4)(A).

of the mid-quarter convention,[607] designed to prevent the recognition of disproportionately large amounts of first-year depreciation under the half-year convention.

Depreciation of additions or improvements to property

The recovery period for any addition or improvement to real or personal property begins on the later of (1) the date on which the addition or improvement is placed in service, or (2) the date on which the property with respect to which such addition or improvement is made is placed in service.[608] Any MACRS deduction for an addition or improvement to any property is to be computed in the same manner as the deduction for the underlying property would be if such property were placed in service at the same time as such addition or improvement. Thus, for example, the cost of an improvement to a building that constitutes nonresidential real property is recovered over 39 years using the straight line method and mid-month convention. However, exceptions apply to certain leasehold improvements.

Depreciation of leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.[609] This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions to the 39-year recovery period exist for certain qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

Qualified leasehold improvement property

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property. Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met.[610] The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. If a lessor makes

[607] The mid-quarter convention treats all property placed in service (or disposed of) during any quarter as placed in service (or disposed of) on the mid-point of such quarter. Sec. 168(d)(3) and (4)(C).
[608] Sec. 168(i)(6).
[609] Sec. 168(i)(8).
[610] Sec. 168(e)(6).

an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for nonrecognition treatment.

Qualified leasehold improvement property is generally recovered using the straight-line method and a half-year convention,[611] and is eligible for the additional first-year depreciation deduction if the other requirements of section 168(k) are met.[612]

Qualified restaurant property

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property. Qualified restaurant property is any section 1250 property[613] that is a building or an improvement to a building, if more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals.[614] Qualified restaurant property is recovered using the straight-line method and a half-year convention.[615] Additionally, qualified restaurant property is not eligible for the additional first-year depreciation deduction unless it also satisfies the definition of qualified improvement property.[616]

Qualified retail improvement property

Section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period for qualified retail improvement property. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public[617] and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service.[618] Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.[619] In the case of an improvement made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.[620]

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[611] Secs. 168(b)(3)(G) and (d).

[612] Secs. 168(k)(2)(A)(i)(IV) and (3), prior to amendment by section 13201 of the Act (Temporary 100-Percent Expensing for Certain Business Assets).

[613] Depreciable real property, other than that included within the definition of section 1245 property, is known as section 1250 property. Sec. 1250(c). Section 1250 property includes, for example, a building or its structural components. Treas. Reg. sec. 1.1250–1(e)(3). Depreciable real property that may be classified as section 1245 property includes, for example, real property that performs specific functions in a business, but does not include buildings or structural components of buildings. Sec. 1245(a)(3).

[614] Sec. 168(e)(7).

[615] Secs. 168(b)(3)(H) and (d).

[616] Sec. 168(e)(7)(B).

[617] Improvements to portions of a building not open to the general public (*e.g.*, stock room in back of retail space) do not qualify under the provision.

[618] Sec. 168(e)(8).

[619] Sec. 168(e)(8)(C).

[620] Sec. 168(e)(8)(B). Rules similar to section 168(e)(6)(B) apply in the case of death and certain transfers of property that qualify for nonrecognition treatment.

Retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores, and convenience stores. Establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. Generally, it is intended that businesses defined as a store retailer under the current North American Industry Classification System (industry subsectors 441 through 453) qualify while those in other industry classes do not qualify.[621]

Qualified retail improvement property is recovered using the straight-line method and a half-year convention,[622] and is eligible for the additional first-year depreciation deduction if the other requirements of section 168(k) are met.[623]

Expensing of certain improvements

Improvements that meet the definition of qualified leasehold improvement property, qualified restaurant property, or qualified retail improvement property (as defined above) are eligible for section 179 expensing.[624] Similarly, improvements that constitute "qualified improvement property" are eligible for the additional first-year depreciation deduction if the other requirements of section 168(k) are met.[625]

Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service by the taxpayer after the date such building was first placed in service by any taxpayer.[626] Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

Alternative depreciation system

The alternative depreciation system ("ADS") is required to be used for tangible property used predominantly outside the United States, certain tax-exempt use property, tax-exempt bond financed property, and certain imported property covered by an Executive order.[627] An election to use ADS is available to taxpayers for any

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[621] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress* (JCS–1–09), March 2009, p. 402.

[622] Secs. 168(b)(3)(I) and (d).

[623] Secs. 168(k)(2)(A)(i)(IV) and (3), prior to amendment by section 13301 of the Act (Temporary 100-Percent Expensing for Certain Business Assets).

[624] Sec. 179(f), as in effect prior to amendment by section 13101 of the Act (Modifications of Rules for Expensing) and the enactment of the Consolidated Appropriations Act, 2018, Pub. L. No. 115–141, sec. 401(b)(15), March 23, 2018, which, as part of repealing general deadwood-related provisions, struck former subsection (e) (relating to special rules for qualified disaster assistance property) and redesignated "subsection (f)" as "subsection (e)".

[625] Secs. 168(k)(2)(A)(i)(IV) and (3), prior to amendment by section 13201 of the Act (Temporary 100-Percent Expensing for Certain Business Assets). Note that the amount of the additional first-year depreciation deduction is determined after basis adjustments for any section 179 expensing. See Treas. Reg. sec. 1.168(k)–1(a)(2)(iii).

[626] Sec. 168(k)(3). See also section 4.02 of Rev. Proc. 2017–33, 2017–19 I.R.B. 1236. Qualified improvement property must also meet the requirements of section 168(k)(2)(A)(ii) and (iii) (*i.e.*, the original use and placed in service date requirements) to be eligible for the additional first-year depreciation deduction.

[627] Sec. 168(g).

class of property for any taxable year.[628] Under ADS, all property is depreciated using the straight line method over recovery periods which generally are equal to the class life of the property, with certain exceptions.[629] For example nonresidential real and residential rental property have a 40-year ADS recovery period, while qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property have a 39-year ADS recovery period.[630]

Explanation of Provision

The provision eliminates the separate definitions of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property,[631] and provides a general 15-year recovery period[632] for qualified improvement property made by the taxpayer[633] and a 20-year ADS recovery period for such property.[634] Thus, for example, qualified improvement property placed in service after December 31, 2017, is generally depreciable over 15 years using the straight line method and half-year convention, without regard to whether the improvements are property subject to a lease, placed in service more than three years after the date the building was first placed in service, or made to a restaurant building. Restaurant building property placed in service after December 31, 2017, that does not meet the definition of qualified improvement property is depreciable over 39 years as nonresidential real property, using the straight line method and the mid-month convention.

The provision also requires a real property trade or business[635] electing out of the interest limitation under section 163(j) to use ADS to depreciate any of its nonresidential real property, residential rental property, qualified improvement property, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.[636]

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[628] Sec. 168(g)(7).

[629] Secs. 168(g)(2) and (3).

[630] Sec. 168(g)(3).

[631] For a description of a conforming amendment made to section 179 to provide that qualified improvement property (in lieu of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) is eligible for section 179 expensing, see the description of section 13101 of the Act (Modifications of Rules for Expensing Depreciable Business Assets).

[632] A technical correction may be necessary to reflect this intent. Note that as 15-year property, qualified improvement property is generally eligible for the additional first-year depreciation deduction under section 168(k). For a discussion of changes made to section 168(k) by the Act, see the description of section 13201 of the Act (Temporary 100-Percent Expensing for Certain Business Assets).

[633] A technical correction may be necessary to reflect this intent.

[634] A technical correction may be necessary to reflect this intent.

[635] As defined in section 163(j)(7)(B), by cross reference to section 469(c)(7)(C) (*i.e.*, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business). Note that a mortgage broker who is a broker of financial instruments is not in a real property trade or business for this purpose. See, *e.g.*, CCA 201504010 (December 17, 2014). For a discussion of changes made to section 163(j) by the Act, see the description of section 13301 of the Act (Limitation on Deduction for Interest).

[636] A technical correction may be necessary to reflect that an electing real property trade or business is also required to use ADS to depreciate its qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property (as defined under prior law) that was placed in service prior to 2018 and is owned by the taxpayer as of the beginning of the year of the election out of the interest limitation. Congress intends that an election out of the interest limitation and resulting required use of ADS be treated as a change in use of the property. See sec. 168(i)(5) and Treas. Reg. sec. 1.168(i)–4.

In addition, the provision shortens the ADS recovery period for residential rental property from 40 years to 30 years.

Effective Date

The provision is generally effective for property placed in service after December 31, 2017.

The provision relating to electing real property trades or businesses applies to taxable years beginning after December 31, 2017.

E. Use of Alternative Depreciation System for Electing Farming Businesses (sec. 13205 of the Act and sec. 168 of the Code)

Prior Law

In general

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[637] The period for depreciation or amortization generally begins when the asset is placed in service by the taxpayer.[638] Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[639]

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance.[640] The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[641] switch-

[637] See secs. 263(a) and 167. In general, only the tax owner of property (*i.e.*, the taxpayer with the benefits and burdens of ownership) is entitled to claim tax benefits such as cost recovery deductions with respect to the property. In addition, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.*, sec. 280A.

[638] See Treas. Reg. secs. 1.167(a)–10(b), –3, –14, and 1.197–2(f). See also Treas. Reg. sec. 1.167(a)–11(e)(1)(i). In the case of any tree or vine bearing fruits or nuts, the placed in service date generally does not occur until the tree or vine first reaches an income-producing stage. See Treas. Reg. sec. 1.46–3(d)(2). See also, Rev. Rul. 80–25, 1980–1 C.B. 65; and Rev. Rul. 69–249, 1969–1 C.B. 31.

[639] Sec. 168.

[640] Exercising authority granted by Congress, the Secretary issued Rev. Proc. 87–56, 1987–2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Rev. Proc. 88–22, 1988–1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Rev. Proc. 87–56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

[641] Under the declining balance method the depreciation rate is determined by dividing the appropriate percentage (here 150 or 200) by the appropriate recovery period. This leads to accelerated depreciation when the declining balance percentage is greater than 100. The table below illustrates depreciation for an asset with a cost of $1,000 and a seven-year recovery period under the 200-percent declining balance method, the 150-percent declining balance method, and the straight line method.

Continued

ing to the straight line method for the first taxable year where using the straight line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property. The straight line depreciation method is required for the aforementioned real property.

Farm property

Property used in a farming business is assigned various recovery periods in the same manner as other business property. For these purposes, the term "farming business" means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity (*e.g.*, the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals).[642] A farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products.[643] A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer.[644]

Farm property recovery periods

Farm property that is generally assigned a three-year recovery period includes, for example, breeding hogs, breeding and working horses more than 12 years old when placed in service, and over-the-road tractor units.[645] Examples of five-year farm property include dairy or breeding cattle, breeding goats and sheep, and trucks.[646] Farm property assigned a recovery period of seven years includes machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agriculture, animal husbandry, and horticultural services.[647] Cotton ginning assets and breeding and working horses 12 years old or less when placed in service are also assigned a recovery period of seven years.[648] Any single purpose agricultural or horticultural struc-

Recovery method	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Total
200-percent declining balance	285.71	204.08	145.77	104.12	86.77	86.77	86.77	1,000.00
150-percent declining balance	214.29	168.37	132.29	121.26	121.26	121.26	121.26	1,000.00
Straight-line	142.86	142.86	142.86	142.86	142.86	142.86	142.86	1,000.00

* Details may not add to totals due to rounding.

[642] Sec. 263A(e)(4) and Treas. Reg. sec. 1.263A–4(a)(4)(i).

[643] Sec. 263A(e)(4) and Treas. Reg. sec. 1.263A–4(a)(4)(ii).

[644] Sec. 263A(e)(4) and Treas. Reg. sec. 1.263A–4(a)(4)(i).

[645] See Rev. Proc. 87–56, asset class 01.23, Hogs, Breeding; asset class 01.222, any breeding or work horse that is more than 12 years old at the time it is placed in service; and asset class 00.26, Tractor Units for Use Over-the-Road.

[646] See Rev. Proc. 87–56, asset class 01.21, Cattle, Breeding or Dairy; asset class 01.24, Sheep and Goats, Breeding; asset class 00.241, Light General Purpose Trucks; and asset class 00.242, Heavy General Purpose Trucks.

[647] Rev. Proc. 87–56, asset class 01.1, Agriculture.

[648] Rev. Proc. 87–56, asset class 01.11, Cotton ginning assets; and asset class 01.221, Any breeding or work horse that is 12 years old or less at the time it is placed in service.

ture,[649] and any tree or vine bearing fruit or nuts are assigned a recovery period of 10 years.[650] Land improvements such as drainage facilities, paved lots, and water wells are assigned a recovery period of 15 years.[651] Farm buildings that do not meet the definition of a single purpose agricultural or horticultural structure are assigned a recovery period of 20 years.[652]

A five-year recovery period was assigned to new farm machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which was used in a farming business (as defined above), the original use of which commenced with the taxpayer after December 31, 2008, and which was placed in service before January 1, 2010.[653]

Any property used in a farming business (other than nonresidential real property,[654] residential rental property,[655] and trees or vines bearing fruits or nuts[656]) is subject to the 150-percent declining balance method.[657]

Alternative depreciation system

The alternative depreciation system ("ADS") is required to be used for tangible property used predominantly outside the United States, certain tax-exempt use property, tax-exempt bond financed property, and certain imported property covered by an executive order.[658] An election to use ADS is available to taxpayers for any class of property for any taxable year.[659] Under ADS, all property is depreciated using the straight line method over recovery periods which generally are equal to the class life of the property, with cer-

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[649] A single purpose agricultural (livestock) structure is any enclosure or structure specifically designed, constructed, and used for (i) housing, raising, and feeding a particular type of livestock (including poultry) and their produce, and (ii) housing the equipment (including any replacements) necessary for the housing, raising, and feeding of such livestock. Sec. 168(i)(13)(B)(i) and (iv). For example, a single purpose agricultural structure includes a structure used to breed chicken or hogs, produce milk from dairy cattle, or produce feeder cattle or pigs, broiler chickens, or eggs, if an integral part of the structure is the equipment necessary to house, raise, and feed the livestock. See IRS Publication 225, Farmer's Tax Guide (2017). A single purpose horticultural structure is (i) a greenhouse specifically designed, constructed and used for the commercial production of plants, and (ii) a structure specifically designed, constructed, and used for the commercial production of mushrooms. Sec. 168(i)(13)(B)(ii). If a structure includes work space, the work space must be solely for (i) the stocking, caring for, or collecting of livestock or plants (as the case may be) or their produce, (ii) the maintenance of the enclosure or structure, and (iii) the maintenance or replacement of the equipment or stock enclosed or housed therein. Sec. 168(i)(13)(B)(iii). See also Rev. Proc. 87–56, asset class 01.4, Single purpose agricultural or horticultural structures.

[650] Secs. 168(e)(3)(D)(i) and (ii).

[651] Rev. Proc. 87–56, asset class 00.3, Land improvements. See also IRS Publication 225, Farmer's Tax Guide (2017).

[652] Rev. Proc. 87–56, asset class 01.3, Farm buildings except structures included in asset class 01.4.

[653] Sec. 168(e)(3)(B)(vii). However, section 13203 of the Act (Modifications of Treatment of Certain Farm Property) also shortens the recovery period from seven to five years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business, the original use of which commences with the taxpayer and is placed in service after December 31, 2017.

[654] Sec. 168(b)(3)(A).

[655] Sec. 168(b)(3)(B).

[656] Sec. 168(b)(3)(E).

[657] Sec. 168(b)(2)(B). However, section 13203 of the Act (Modifications of Treatment of Certain Farm Property) repeals the required use of the 150-percent declining balance method for property used in a farming business (*i.e.,* for three-, five-, seven-, and 10-year property). The 150-percent declining balance method will continue to apply to any 15-year or 20-year property used in the farming business to which the straight line method does not apply, or to property for which the taxpayer elects the use of the 150-percent declining balance method.

[658] Sec. 168(g).

[659] Sec. 168(g)(7).

tain exceptions.[660] For example, any single purpose agricultural or horticultural structure has a 15-year ADS recovery period,[661] while any tree or vine bearing fruit or nuts has a 20-year ADS recovery period.[662] Similarly, land improvements such as drainage facilities, paved lots, and water wells have an ADS recovery period of 20 years.[663] Farm buildings that do not meet the definition of a single purpose agricultural or horticultural structure have an ADS recovery period of 25 years.[664]

Under a special accounting rule, certain taxpayers engaged in the business of farming who elect to deduct preproductive period expenditures of plants produced in such business are required to depreciate all farming assets using ADS.[665]

Explanation of Provision

The provision requires an electing farming business[666] (*i.e.*, a farming business electing out of the limitation on the deduction for interest)[667] to use ADS to depreciate any property with a MACRS recovery period of 10 years or more (*e.g.*, property such as single purpose agricultural or horticultural structures, trees or vines bearing fruit or nuts, farm buildings, and certain land improvements).[668]

Effective Date

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

F. Amortization of Research and Experimental Expenditures (sec. 13206 of the Act and sec. 174 of the Code)

Prior Law

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful

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[660] Secs. 168(g)(2) and (3).

[661] Sec. 168(g)(3)(B).

[662] Sec. 168(g)(3)(B).

[663] Rev. Proc. 87–56, asset class 00.3, Land improvements.

[664] Rev. Proc. 87–56, asset class 01.3, Farm buildings except structures included in asset class 01.4.

[665] Secs. 263A(d)(3) and (e)(2), and 168(g)(2). For a discussion of changes made to the applicability of section 263A by the Act, see the description of section 13102 of the Act (Small Business Accounting Method Reform and Simplification).

[666] As defined in section 163(j)(7)(C), which defines an electing farming business as (i) a farming business as defined in section 263A(e)(4), or (ii) any trade or business of a specified agricultural or horticultural cooperative as defined in section 199A(g)(4) (a clerical correction may be necessary to correct this reference). See the description of section 13301 of the Act (Limitation on Deduction for Interest). Note that the treatment of income relating to cooperatives under section 199A (as originally enacted December 22, 2017) was modified by the Consolidated Appropriations Act, 2018, Pub. L. No. 115–141, enacted March 23, 2018. The description of the modification was originally published as Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the House Amendment to the Senate Amendment to H.R. 1625 (Rules Committee Print 115–66)* (JCX–6–18), March 22, 2018, pages 5–27, which is reproduced in the Appendix.

[667] See section 13301 of the Act (Limitation on Deduction for Interest). Section 13301 of the Act also includes an exception from the limitation on the deduction for interest for taxpayers meeting the $25 million gross receipts test.

[668] Congress intends that an election out of the interest limitation and resulting required use of ADS be treated as a change in use of the property. See sec. 168(i)(5) and Treas. Reg. sec. 1.168(i)–4.

life.[669] Taxpayers, however, may elect to deduct currently the amount of certain reasonable research or experimental expenditures paid or incurred in connection with a trade or business.[670] Taxpayers may elect to forgo a current deduction, capitalize their research or experimental expenditures, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months.[671] Taxpayers, alternatively, may elect to amortize their research or experimental expenditures over a period of 10 years.[672] Research and experimental expenditures deductible under section 174 are not subject to capitalization under either section 263(a)[673] or section 263A.[674] In addition, section 174 deductions are generally reduced by the amount of the taxpayer's research credit under section 41.[675]

Amounts defined as research or experimental expenditures under section 174 generally include all costs incurred in the experimental or laboratory sense related to the development or improvement of a product.[676] In particular, qualifying costs are those incurred for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.[677] Uncertainty exists when information available to the taxpayer is not sufficient to ascertain the capability or method for developing, improving, and/or appropriately designing the product.[678] The determination of whether expenditures qualify as deductible research expenses depends on the nature of the activity to which the costs relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Examples of qualifying costs include salaries for those engaged in research or experimentation efforts, amounts incurred to operate and maintain research facilities (*e.g.*, utilities, depreciation, rent, etc.), and expenditures for materials and supplies used and consumed in the course of research or experimentation (including amounts incurred in conducting

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[669] Secs. 167 and 263(a).

[670] Secs. 174(a) and (e).

[671] Sec. 174(b). Taxpayers generating significant short-term losses often choose to defer the deduction for their research and experimental expenditures under this section. Additionally, section 174 amounts are excluded from the definition of "start-up expenditures" under section 195 (section 195 generally provides that start-up expenditures in excess of $5,000 either are not deductible or are amortizable over a period of not less than 180 months once an active trade or business begins). So as not to generate significant losses before beginning its trade or business, a taxpayer may choose to defer the deduction and amortize its section 174 costs beginning with the month in which the taxpayer first realizes benefits from the expenditures (*i.e.*, the month in which its active trade or business begins).

[672] Secs. 174(f)(2) and 59(e). This special 10-year election is available to mitigate the effect of the alternative minimum tax ("AMT") adjustment for research expenditures set forth in section 56(b)(2) (for a discussion of the repeal of the corporate AMT, see the description of section 12001 of the Act (Repeal of Tax for Corporations)). Taxpayers with significant losses also may elect to amortize their otherwise deductible research and experimental expenditures to reduce amounts that could be subject to expiration under the net operating loss carryforward regime (for changes to section 172 made by the Act, see the description of section 13302 of the Act (Modification of Net Operating Loss Deduction)).

[673] Sec. 263(a)(1)(B).

[674] Sec. 263A(c)(2).

[675] Sec. 280C(c). Taxpayers may alternatively elect to claim a reduced research credit amount under section 41 in lieu of reducing deductions otherwise allowed. Sec. 280C(c)(3).

[676] Treas. Reg. sec. 1.174–2(a)(1) and (2). Product is defined to include any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license. Treas. Reg. sec. 1.174–2(a)(11), Example 10, provides an example of new process development costs eligible for section 174 treatment.

[677] Treas. Reg. sec. 1.174–2(a)(1).

[678] *Ibid.*

trials).[679] In addition, under administrative guidance, the costs of developing computer software have been accorded treatment similar to research and experimental expenditures.[680]

Research or experimental expenditures under section 174 do not include expenditures for quality control testing; efficiency surveys; management studies; consumer surveys; advertising or promotions; the acquisition of another's patent, model, production or process; or research in connection with literary, historical, or similar projects.[681] For purposes of section 174, quality control testing means testing to determine whether particular units of materials or products conform to specified parameters, but does not include testing to determine if the design of the product is appropriate.[682]

Generally, no current deduction under section 174 is allowable for expenditures for the acquisition or improvement of land or of depreciable or depletable property used in connection with any research or experimentation.[683] In addition, no current deduction is allowed for any expenditure incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.[684]

Explanation of Provision

Under the provision, amounts defined as specified research or experimental expenditures are required to be capitalized and amortized ratably over a five-year period beginning with the midpoint of the taxable year in which the specified research or experimental expenditures were paid or incurred. Specified research or experimental expenditures that are attributable to research that is conducted outside of the United States[685] are required to be capitalized and amortized ratably over the 15-year period beginning with the midpoint of the taxable year in which such expenditures were paid or incurred. Specified research or experimental expenditures subject to capitalization include expenditures for software development.

Specified research or experimental expenditures do not include expenditures for the acquisition or improvement of land or for depreciable or depletable property used in connection with the research or experimentation, but do include the depreciation and depletion allowances of such property. Also excluded are exploration expenditures incurred for ore or other minerals (including oil and gas).

In the case of retired, abandoned, or disposed property with respect to which specified research or experimental expenditures are paid or incurred, any remaining basis may not be recovered in the

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[679] See Treas. Reg. sec. 1.174–4(c). The definition of research and experimental expenditures also includes the costs of obtaining a patent, such as attorneys' fees incurred in making and perfecting a patent application. Treas. Reg. sec. 1.174–2(a)(1).

[680] Rev. Proc. 2000–50, 2000–2 C.B. 601.

[681] Treas. Reg. sec. 1.174–2(a)(6).

[682] Treas. Reg. sec. 1.174–2(a)(7).

[683] Sec. 174(c). However, depreciation and depletion allowances may be considered section 174 expenditures. *Ibid.*

[684] Sec. 174(d). Special rules apply with respect to geological and geophysical costs (section 167(h)), qualified tertiary injectant expenses (section 193), intangible drilling costs (sections 263(c) and 291(b)), and mining exploration and development costs (sections 616 and 617).

[685] For this purpose, the term "United States" includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States.

year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

The application of this rule is treated as a change in the taxpayer's method of accounting for purposes of section 481 initiated by the taxpayer and made with the consent of the Secretary. This rule is applied on a cutoff basis to research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2021 (hence there is no adjustment under section 481(a) for research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2022).

The provision makes conforming changes to sections 41 and 280C.[686]

Effective Date

The provision applies to amounts paid or incurred in taxable years beginning after December 31, 2021.

G. Expensing of Certain Costs of Replanting Citrus Plants Lost by Reason of Casualty (sec. 13207 of the Act and sec. 263A of the Code)

Prior Law

In general

The uniform capitalization rules require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be either capitalized into the basis of such property or included in inventory, as applicable.[687] For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be either capitalized into the basis of such property or included in inventory, as applicable.

Section 263A generally requires the capitalization of the direct and indirect costs allocable to the production of any property in a farming business,[688] including animals and plants without regard to the length of their preproductive period.[689] The costs of a plant generally required to be capitalized under section 263(a) include

[686] Thus, if a taxpayer's research credit under section 41 for a taxable year beginning after 2021 exceeds the amount allowed as an amortization deduction under the provision for such taxable year, the amount chargeable to capital account under the provision for such taxable year must be reduced by that excess amount. A taxpayer may alternatively elect to claim a reduced research credit amount under section 41 in lieu of reducing its section 174 expenditures for the taxable year. If such an election is made, the research credit is reduced by an amount equal to that credit multiplied by the highest corporate tax rate.

[687] Sec. 263A. For a discussion of the changes made by the Act to the applicability of section 263A, see the description of section 13102 of the Act (Small Business Accounting Method Reform and Simplification).

[688] For purposes of section 263A, the term "farming business" means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity (*e.g.*, the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals). A farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products. A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer. See sec. 263A(e)(4) and Treas. Reg. sec. 1.263A–4(a)(4).

[689] Treas. Reg. sec. 1.263A–4(b)(1).

preparatory costs incurred so that the plant's growing process may begin, such as the acquisition costs of the seed, seedling, or plant. Under section 263A, the costs of producing a plant generally required to be capitalized also include the preproductive period costs of planting, cultivating, maintaining, and developing the plant during the preproductive period.[690] Preproductive period costs may include management, irrigation, pruning, soil and water conservation, fertilizing, frost protection, spraying, harvesting, storage and handling, upkeep, electricity, tax depreciation and repairs on buildings and equipment used in raising the plants, farm overhead, taxes, and interest, as applicable.[691]

Special rules for plant farmers

Section 263A provides an exception to the general capitalization requirements for taxpayers who raise, harvest, or grow trees.[692] 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 section 263A rules do not apply to any plant having a preproductive period of two years or less, that 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)).[693] Hence, in general, the section 263A rules apply to the production of plants that have a preproductive period of more than two years, and to taxpayers required to use an accrual method of accounting.

Plant farmers otherwise required to capitalize preproductive period costs may elect to deduct such costs currently, provided the alternative depreciation system described in section 168(g)(2) is used on all farm assets and the preproductive period costs are recaptured upon disposition of the product.[694] The election is not available to taxpayers required to use the accrual method of accounting. Moreover, the election is not available with respect to certain costs attributable to planting, cultivating, maintaining, or developing citrus or almond groves.

Section 263A does not apply to costs incurred in replanting edible crops for human consumption following loss or damage due to freezing temperatures, disease, drought, pests, or casualty.[695] The same type of crop as the lost or damaged crop must be replanted. However, the exception to capitalization still applies if the replanting occurs on a parcel of land other than the land on which the damage occurred provided the acreage of the new land does not ex-

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[690] Treas. Reg. sec. 1.263A–4(b)(1)(i).

[691] *Ibid.*

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

[693] Sec. 263A(d). For a discussion of the changes made by the Act to taxpayers allowed to use the cash method rather than an accrual method, see the description of section 13102 of the Act (Small Business Accounting Method Reform and Simplification).

[694] Sec. 263A(d)(3), (e)(1), and (e)(2).

[695] Sec. 263A(d)(2). Such replanting costs generally include costs attributable to the replanting, cultivating, maintaining, and developing of the plants that were lost or damaged that are incurred during the preproductive period. Treas. Reg. sec. 1.263A–4(e)(1). The acquisition costs of the replacement trees or seedlings must still be capitalized under section 263(a) (see, *e.g.,* T.D. 8897, 65 FR 50638, Treas. Reg. sec. 1.263A–4(e)(3), Examples 1–3, and TAM 9547002 (July 18, 1995)), potentially subject to the special additional first-year depreciation deduction in the year of planting under section 168(k)(5). For a discussion of changes made by the Act to section 168(k), see the description of section 13201 of the Act (Temporary 100-Percent Expensing for Certain Business Assets).

ceed that of the land to which the damage occurred and the new land is located in the United States. This exception may also apply to costs incurred by persons other than the taxpayer who incurred the loss or damage, provided (1) the taxpayer who incurred the loss or damage retains an equity interest of more than 50 percent in the plants for which the loss or damage occurred at all times during the taxable year in which the replanting costs are paid or incurred, and (2) such other person claiming the deduction holds a minority equity interest and materially participates in the planting, maintenance, cultivation, or development of such plants during the taxable year in which the replanting costs are paid or incurred.[696]

Explanation of Provision

The provision expands the special rule for costs incurred by persons (other than the taxpayer who incurred the loss or damage) in connection with replanting an edible crop for human consumption following loss or damage due to casualty. Under the provision, with respect to replanting costs paid or incurred after December 22, 2017 (*i.e.,* incurred after the date of enactment), but no later than December 22, 2027 (*i.e.,* the date which is 10 years after such date of enactment), for citrus plants lost or damaged due to casualty, such replanting costs may also be deducted by a person (other than the taxpayer who incurred the loss or damage) if (1) the taxpayer has an equity interest of not less than 50 percent in the replanted citrus plants at all times during the taxable year in which the replanting costs are paid or incurred and such other person holds any part of the remaining equity interest, or (2) such other person acquires all of the taxpayer's equity interest in the land on which the lost or damaged citrus plants were located at the time of such loss or damage, and the replanting is on such land.

The Treasury Department has issued published guidance addressing this provision.[697]

Effective Date

The provision is effective for costs paid or incurred after December 22, 2017 (*i.e.*, after the date of enactment).

[696] Sec. 263A(d)(2)(B). Material participation for this purpose is determined in a similar manner as under section 2032A(e)(6) (relating to qualified use valuation of farm property upon death of the taxpayer).

[697] See Rev. Proc. 2018-31, 2018–22 I.R.B. 637.

SUBPART B—ACCOUNTING METHODS

A. Certain Special Rules for Taxable Year of Inclusion (sec. 13221 of the Act and sec. 451 of the Code)

Prior Law

Realization of gross income

In general

Under section 61(a), gross income generally includes all income from whatever source derived, except as otherwise provided in Subtitle A of the Code.[698] Gross income generally includes all items that are clearly realized accessions to wealth in any form.[699] Gross income is clearly realized when an item is sufficiently fixed and definite to be treated as gross income.[700] Realization generally occurs when a taxpayer takes the last step by which the economic gain comes to fruition.[701] Generally, there must be a transaction involving the taxpayer for there to be a clearly realized accession to wealth.[702] For a transaction involving a capital asset, gross income is realized at the time the asset is sold, exchanged, or otherwise disposed.[703]

Gross income generally includes income realized in any form, whether in money, property, services, payment of the taxpayer's indebtedness, or relief from a liability, except to the extent provided in other sections of the Code.[704]

If the consideration to be received by the taxpayer cannot be valued at the time of the transaction, a taxpayer is not required to include any gain in income at that time.[705] Instead, the transaction remains open until such consideration is received or can be valued. As a result, open transactions generally arise in connection with sales or property in exchange for contingent payments. However, only in rare and extraordinary circumstances will property be considered not to have an ascertainable fair market value.[706] In addition, Congress has limited a taxpayer's ability to treat a transaction as an open transaction by enacting rules addressing the realization and recognition of income from installment sales, in particular contingent payment installment sales for which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs.[707] Under these rules, the taxpayer has a closed transaction and has realized income at the time the sale or disposition of the property occurs.

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[698] See sections 101 through 140 for items specifically excluded from gross income.

[699] Treas. Reg. sec. 1.61–1 and *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426, 429–430 (1955).

[700] *Eisner* v. *Macomber,* 252 U.S. 189, 207 (1920).

[701] *Helvering v. Horst,* 311 U.S. 112, 115 (1940).

[702] *Baldwin Locomotive Works v. McCoach,* 221 Fed. 59, 60 (3d Cir. 1915).

[703] Sec. 1001.

[704] Treas. Reg. sec. 1.61–1. See also *Helvering v. Bruun,* 309 U.S. 461, 469 (1940).

[705] *Burnet v. Logan,* 283 U.S. 404 (1931).

[706] *Simmonds Precision Prods. v. Commissioner,* 75 T.C. 103 (1980). See also Treas. Reg. sec. 15A.453–1(d)(2)(iii). In the case of an arm's-length transaction, an asset with an unascertainable value is presumed to have a value equal to that of the property for which it was exchanged. See *United States v. Davis,* 370 U.S. 65 (1962).

[707] See section 453 and Treas. Reg. sec. 15A.453–1(c). A taxpayer may elect out of the installment sale rules under section 453(d).

Constructive realization

In certain situations, Congress has prescribed the time at which realization is deemed to occur by requiring taxpayers, or allowing taxpayers to elect, to include in gross income amounts that may otherwise be unrealized income or gain. For example, under the mark to market rules, a taxpayer that is a dealer in securities who holds as of the end of a taxable year a security that is not inventory in the hands of the taxpayer must realize and recognize gain or loss during the year on that security, even though the taxpayer has not yet sold or disposed of the security.[708] To determine the amount of gain or loss, the taxpayer is deemed to have sold the security for its fair market value on the last day of the taxable year.[709] Dealers in commodities and traders in securities or commodities may elect to mark to market the commodities or securities they hold.[710] Similarly, under the mark to market rules applicable to a section 1256 contract,[711] a taxpayer must treat each section 1256 contract as if it were sold for its fair market value on the last business day of the taxable year, with any gain or loss taken into account for the taxable year, even though the taxpayer has not yet sold or disposed of the contract.[712] In addition, in certain situations, a taxpayer is treated as having made a constructive sale of an appreciated financial position.[713] In that case, the taxpayer must realize and recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale.[714]

Special rules govern the timing of realization with respect to income from debt instruments. For example, amounts received by a holder upon retirement of any debt instrument are considered amounts received in exchange therefor.[715] Such amounts are not realized any earlier than when the debt instrument is retired, sold, or exchanged. In addition, gain on the disposition of any market discount bond is treated as ordinary income to the extent it does not exceed the accrued market discount on such bond.[716] A taxpayer does not realize such gain, including market discount, until disposition of the bond or receipt of partial principal payments on the bond.[717] However, a taxpayer may elect out of these default realization rules for market discount and instead realize market discount currently as it accrues.[718]

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[708] Sec. 475(a)(2).

[709] Sec. 475(a)(2)(A). Adjustments are made in subsequent years for the amount of any gain or loss previously realized and recognized by the taxpayer.

[710] Sec. 475(e) and (f).

[711] A section 1256 contract is any regulated futures contract, any foreign currency contract, any nonequity option, any dealer equity option, and any dealer securities futures contract. Sec. 1256(b)(1). A section 1256 contract does not include any securities future contract or option on such a contract unless such contract or option is a dealer securities futures contract or any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement. Sec. 1256(b)(2).

[712] Sec. 1256(a). As under the mark to market rules under section 475, adjustments are made in subsequent years for the amount of any gain or loss previously realized and recognized by the taxpayer on the contract.

[713] Sec. 1259(c).

[714] Sec. 1259(a). As under sections 475 and 1256, adjustments are made in subsequent years for the amount of any gain previously realized and recognized by the taxpayer on the position.

[715] Sec. 1271(a)(1).

[716] Sec. 1276(a).

[717] Sec. 1276(a).

[718] Sec. 1278(b).

Gross income derived from certain businesses

For businesses involving the sale of property to others (*e.g.*, manufacturing, merchandising, mining, etc.), gross income is total sales less the cost of goods sold, plus any income from investment and from incidental or outside sources.[719] Gross income is determined on an annual or taxable year basis with the amount of each item of gross income (*e.g.*, total sales) for the taxable year determined under the taxpayer's method of accounting for each item.[720] In determining gross income, the amount of total sales included as an item of gross income is determined in accordance with the taxpayer's method of accounting under the income recognition rules.[721]

The amount of cost of goods sold included as a subtraction from total sales is determined in accordance with the taxpayer's methods of accounting for items included in cost of goods sold.[722] An amount may not be taken into account in the computation of cost of goods sold, and thus reduce total sales, any earlier than the taxable year in which economic performance occurs with respect to such amount.[723] Once economic performance occurs, amounts may only be taken into account in the computation of cost of goods sold if they are not required to be capitalized and are not subject to any other provision of the Code that requires the deduction to be taken in a taxable year later than the year when economic performance occurs.[724] For example, generally a taxpayer must maintain inventories whenever the production, purchase, or sale of merchandise is an income-producing factor.[725] In addition, such merchandise remains in inventory, and is not included in cost of goods sold, if title thereto is still vested in the taxpayer.[726] Section 263A and the regulations thereunder also require that direct costs and certain indirect costs incurred by the taxpayer (*i.e.*, costs for which economic

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[719] Treas. Reg. sec. 1.61–3(a).

[720] See *Automobile Club of New York, Inc. v. Commissioner,* 32 T.C. 906, 914 (1959), aff'd 304 F.2d 781 (2nd Cir. 1962) (". . . net income under the statute is computed on an annual basis, and . . . there is no necessary correlation in any given year between receipts and expenses. Expenses with respect to income not yet earned are deductible when paid or accrued; and conversely, income is reportable when received or accrued, notwithstanding that some, or even all, expenses allocable thereto have not yet been incurred"); and *Hagen Advertising Displays, Inc. v. Commissioner*, 47 T.C. 139 (1966), aff'd 407 F.2d 1105 (6th Cir. 1969) ("Nothing in [Treas. Reg. sec. 1.61–3(a)] suggests that an attempt must be made to match a particular purchase with a particular sale or a particular item in inventory").

[721] See, *e.g.,* sec. 451. See discussion below of the income recognition rules. See also, *e.g.,* line 1a of Form 1120, Form 1120S, or Form 1065, or line 1 of Schedule C (Form 1040).

[722] Treas. Reg. sec. 1.61–3(a). See, *e.g.,* sections 263A, 461(h), and 471. See also, *e.g.*, line 2 of Form 1120, Form 1120S, or Form 1065, or line 4 of Schedule C (Form 1040), as well as Form 1125–A. A taxpayer's gross profit is generally determined by subtracting returns and allowances and cost of goods sold from gross receipts or sales. See line 3 of Form 1120, Form 1120S, or Form 1065, or line 5 of Schedule C (Form 1040).

[723] Treas. Reg. secs. 1.61–3(a), 1.263A–1(c)(2)(ii), and 1.446–1(c)(1)(ii). For a liability that arises out of the provision of services or property to the taxpayer by another person, economic performance occurs as the other person provides such services, as the other person provides such property, or as the taxpayer uses such property. For a liability that requires the taxpayer to provide property to others, economic performance occurs as the taxpayer provides the property to the other person. Sec. 461(h)(2)(A) and (B). A liability includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. See Treas. Reg. secs. 1.446–1(c)(1)(ii)(B) and 1.461–4(c)(1) and T.D. 8408, 1992–1 C.B. 155.

[724] Conference Report to accompany H.R. 4170, Deficit Reduction Act of 1984, H.R. Rep. No. 98–861, June 23, 1984, p. 871.

[725] Sec. 471 and Treas. Reg. sec. 1.471–1.

[726] Sec. 471 and Treas. Reg. sec. 1.471–1. Whether the requirement that title be vested in the taxpayer has been met is generally determined based on whether the taxpayer has the benefits and burdens of ownership.

performance has occurred) must be capitalized and included in the basis of property produced or acquired for resale by the taxpayer with the capitalized costs recovered by including such amounts in cost of goods sold when the underlying inventory or property is sold.[727]

Income recognition

In general

Once it is determined that gross income is clearly realized for Federal income tax purposes, section 451 and the regulations thereunder provide the general rules as to the timing of when sales, gross receipts, and other items of income are recognized by including such items in gross income under the taxpayer's method of accounting.[728]

A taxpayer generally is required to include sales, gross receipts, or other items of income in gross income no later than the time of its actual or constructive receipt, unless the item[729] is properly accounted for in a different period under the taxpayer's method of accounting.[730] If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount whether or not the taxpayer makes the demand and actually receives the payment.[731]

In general, for a cash basis taxpayer, sales, gross receipts, and other items of income are included in gross income when actually or constructively received.[732] For an accrual basis taxpayer, sales, gross receipts, and other items of income are included in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (*i.e.*, when the "all events test" is met), unless an exception permits deferral or exclusion or a special method of accounting applies.[733] Generally, all the events that fix the right to receive income occur upon the earlier of when (i) payment is earned through performance, (ii) payment is due to the taxpayer, or (iii) payment is received by the taxpayer.[734] Amounts are earned upon performance by the taxpayer. For example, performance takes place when all services are provided (except for ministerial duties),[735] the sale takes place, or, in the case of interest and rent,

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[727] Sec. 263A and Treas. Reg. sec. 1.263A–1(c)(4).

[728] Treas. Reg. sec. 1.61–1(b)(3).

[729] Methods of accounting include both the taxpayer's overall method of accounting (*e.g.,* the cash method and an accrual method), as well as any special methods of accounting for any "item" of income or expense. See Treas. Reg. sec. 1.446–1(a)(1). Generally, an item is any income or expense that differs in some way that is relevant to the determination of taxable income. For example, late fee income is treated as a separate item from interchange fee income, over-limit fees, finance charges, and cash advance fees because late fee income is earned for different reasons than the other types of income. See *Capital One Financial Corp. and Subsidiaries v. Commissioner,* 133 T.C. No. 8 (2009).

[730] Sec. 451(a).

[731] See Treas. Reg. sec. 1.451–2.

[732] Treas. Reg. secs. 1.446–1(c)(1)(i) and 1.451–1(a).

[733] Treas. Reg. secs. 1.446–1(c)(1)(ii) and 1.451–1(a).

[734] See Rev. Rul. 2003–10, 2003–1 C.B. 288.

[735] With respect to whether a taxpayer earned income from unbilled receivables, income from the provision of services generally accrues when performance is complete, not as the taxpayer engages in the activity. See, *e.g., Decision, Inc.* v. *Commissioner,* 47 T.C. 58, 63 (1966), *acq.* 1967–2 C.B. 2. However, if services are severable, a portion of the income is proportionally allocated to each service provided under the contract. See Rev. Rul. 79–195, 1979–1 C.B. 177, and Tech. Adv. Mem. 200803017, January 18, 2008, and 200903079, January 16, 2009.

the use of money or property is provided. An amount is considered due based on the terms of the arrangement between the taxpayer and the other party. The taxpayer does not have to have a legally enforceable right for an amount to be considered due for purposes of the all events test.

Advance payments

In general

Various methods of accounting are provided to address situations in which an accrual method taxpayer receives an advance payment for goods, services, or other items of income. An advance payment generally occurs when a taxpayer receives payment before the taxpayer provides goods, services, or other items to its customer. These methods of accounting generally allow taxpayers to either (i) include the advance payment in gross income in the year of receipt, or (ii) defer the recognition of the advance payment under various methods of accounting, with the cost of satisfying the taxpayer's future obligation to provide goods, services, or other items taken into account when such costs are incurred at a later date. However, special rules were also historically provided that allowed taxpayers to instead accelerate the deduction or adjustment to gross income for the estimated cost of the goods or property to be provided in the future and take such deduction or adjustment generally in the same taxable year for which the related advance payment was included in gross income (*i.e.*, generally in the taxable year the advance payment was received).

Inclusion in gross income in year of receipt

A taxpayer that receives an advance payment for goods, services, or other items of income may include such amount in gross income in the year of receipt (*i.e.*, the "full inclusion method").[736] A taxpayer using the full inclusion method to account for an advance payment for services does not take an offsetting deduction for the cost of providing such services until the taxable year in which the taxpayer provides such services to the customer and economic performance occurs for such costs.[737] Similarly, a taxpayer using the full inclusion method to account for an advance payment for goods does not take an offsetting adjustment for its actual or estimated basis in the goods to be sold until such time that economic performance occurs for the cost to acquire or produce the goods and the goods in question have been provided to the customer.[738]

Deferral of advance payments

A number of exceptions exist that allow taxpayers to defer the recognition of advance payments from goods, services, and other items in gross income. These exceptions often allow tax deferral of the advance payments to mirror the financial accounting deferral of such payments[739] (*e.g.*, the advance payments are included in

[736] See, *e.g.*, sec. 451(a), Treas. Reg. sec. 1.451–5(b)(1)(i), and Rev. Proc. 2004–34, 2004–1 C.B. 991, as modified and clarified by Rev. Proc. 2011–18, 2011–5 I.R.B. 443, and Rev. Proc. 2013–29, 2013–33 I.R.B. 141.

[737] See sec. 461(h)(2)(B).

[738] See secs. 263A, 461(h)(2)(B), and 471. See also PLR 200638015, September 22, 2006.

[739] See Treas. Reg. sec. 1.451–5.

gross income as the goods are provided or the services are performed) or limit the initial tax deferral of the advance payments to the financial accounting deferral of such payments.[740] Under each of these exceptions, a taxpayer receiving an advance payment for services does not take an offsetting deduction for the cost of providing such services until the taxable year in which the taxpayer provides such services to the customer and economic performance occurs for such costs.[741] In addition, a taxpayer receiving an advance payment for goods does not take an offsetting adjustment for its actual or estimated basis in the goods to be sold until such time that economic performance occurs for the cost to acquire or produce the goods and the goods in question have been provided to the customer.[742]

A taxpayer receiving an advance payment for goods, services, and other items[743] may elect to include in gross income in the year of receipt[744] only the portion of the advance payment that is included in revenue in the taxpayer's applicable financial statement[745] and include the remaining amount in gross income in the next succeeding taxable year (*i.e.*, a one-year deferral of the advance payment). If the taxpayer dies or ceases to exist, or the taxpayer's obligation with respect to the advance payment is satisfied or otherwise ends, the taxpayer must include in gross income any portion of the advance payment not previously recognized.[746]

Taxpayers receiving substantial advance payments for inventoriable goods may also elect a two-year deferral of the advance payment.[747] A taxpayer has received a substantial advance payment with respect to an agreement if the advance payments received during the taxable year and preceding taxable years equal or exceed the total costs and expenditures reasonably estimated as

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[740] See Rev. Proc. 2004–34, 2004–1 C.B. 991, as modified and clarified by Rev. Proc. 2011–18, 2011–5 I.R.B. 443, and Rev. Proc. 2013–29, 2013–33 I.R.B. 141.

[741] See sec. 461(h)(2)(B).

[742] See secs. 263A, 461(h)(2)(B), and 471. See also Announcement 2004–48, 2004–1 C.B. 998 ("Taxpayers that use the deferral method in [Rev. Proc. 2004–34] must use the general rules under section 461 and the regulations thereunder for determining when a liability (including cost of goods sold) is incurred."). However, see discussion below for a limited exception to this treatment for a taxpayer electing a two-year deferral of an advance payment for inventoriable goods.

[743] Such other items include advance payments for the use (including by license or lease) of intellectual property; the occupancy or use of property if the occupancy or use is ancillary to the provision of services; the sale, lease or license of computer software; guaranty or warranty contracts ancillary to any of the preceding items, as well as services or the sale of goods; subscriptions, whether or not provided in a tangible or intangible format; memberships in an organization; or any combination of the preceding items. See sec. 4.01 of Rev. Proc. 2004–34, 2004–1 C.B. 991, as modified and clarified by Rev. Proc. 2011–18, 2011–5 I.R.B. 443, and Rev. Proc. 2013–29, 2013–33 I.R.B. 141.

[744] An advance payment is considered received by a taxpayer if it is actually or constructively received, or if it is due or payable to the taxpayer. See sec. 4.04 of Rev. Proc. 2004–34, 2004–1 C.B. 991, as modified and clarified by Rev. Proc. 2011–18, 2011–5 I.R.B. 443, and Rev. Proc. 2013–29, 2013–33 I.R.B. 141.

[745] Alternatively, if the taxpayer does not have an applicable financial statement, the taxpayer includes in gross income in the year of receipt only the portion of such advance payment that is earned in that taxable year. See sec. 5.02(3)(b) of Rev. Proc. 2004–34, 2004–1 C.B. 991, as modified and clarified by Rev. Proc. 2011–18, 2011–5 I.R.B. 443, and Rev. Proc. 2013–29, 2013–33 I.R.B. 141.

[746] See sec. 5.02(5) of Rev. Proc. 2004–34, 2004–1 C.B. 991, as modified and clarified by Rev. Proc. 2011–18, 2011–5 I.R.B. 443, and Rev. Proc. 2013–29, 2013–33 I.R.B. 141.

[747] See Treas. Reg. sec. 1.451–5(c). If the taxpayer receives an advance payment under an agreement to provide both goods and services, where the services are not performed as an integral part of providing the goods, only the portion of the advance payment properly allocable to the provision of goods is eligible for the two-year deferral. However, if the portion of the advance payment allocable to the provision of services is less than five percent of the total contract price, the advance payment is also eligible for the two year-deferral. See Treas. Reg. sec. 1.451–5(a)(3).

includible in inventory with respect to the agreement.[748] Advance payments for which the goods or type of goods to be sold are not identifiable in the year the payment is received, such as gift certificates and gift cards, are treated as substantial advance payments.[749] If the taxpayer (i) receives a substantial advance payment during the taxable year and (ii) has on hand (or available through the normal source of supply) goods of substantially similar kind and in sufficient quantity to satisfy the agreement in such taxable year, then any advance payments received by the last day of the second taxable year following the year in which the substantial advance payment is received are included in gross income no later than such second taxable year (adjusted for any amounts previously included in gross income as goods are provided to customers).[750] Any additional advance payments received with respect to the agreement in taxable years following the second taxable year are included in gross income in the year of receipt.[751]

Taxpayers receiving an advance payment for goods may also apply a multiyear deferral of the advance payment.[752] For this purpose, an advance payment for goods includes any amount received during the taxable year which is (i) for the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business, or (ii) for the building, installing, constructing, or manufacturing by the taxpayer of items where the agreement is not completed within such taxable year.[753] The taxpayer includes such amounts in gross income in (i) the taxable year in which such amounts are properly included in gross income under the taxpayer's accrual method of accounting, or (ii) the taxable year in which such amounts are included in revenue in the taxpayer's financial statements, whichever occurs first.[754] If the taxpayer dies or ceases to exist, or the taxpayer's obligation with respect to the advance payment is satisfied or otherwise ends, the taxpayer must include in gross income any portion of the advance payment not previously recognized.[755]

Acceleration of related deductions or adjustments to gross income

As noted above, special rules were also historically provided that allowed taxpayers to instead accelerate the deduction for the estimated cost of the goods or property to be provided in the future and take such deduction, or adjustment to gross income, generally in the same taxable year for which the related advance payment was included in gross income (*i.e.*, generally in the taxable year the advance payment was received). If an accrual method taxpayer

[748] Treas. Reg. sec. 1.451–5(c)(3).
[749] *Ibid.*
[750] Treas. Reg. sec. 1.451–5(c)(1)(i).
[751] Treas. Reg. sec. 1.451–5(c)(2).
[752] Treas. Reg. sec. 1.451–5(b)(1)(ii). If the taxpayer receives an advance payment under an agreement to provide both goods and services, where the services are not performed as an integral part of providing the goods, only the portion of the advance payment properly allocable to the provision of goods is eligible for the multiyear deferral. However, if the portion of the advance payment allocable to the provision of services is less than five percent of the total contract price, such advance payments are also eligible for the multiyear deferral. See Treas. Reg. sec. 1.451–5(a)(3).
[753] Treas. Reg. sec. 1.451–5(a)(1).
[754] Treas. Reg. sec. 1.451–5(b)(1).
[755] Treas. Reg. sec. 1.451–5(f).

issued trading stamps or premium coupons with sales, or if an accrual method taxpayer engaged in the business of selling trading stamps or premium coupons (*i.e.*, a "trading stamp company"), and such stamps or coupons were redeemable by such taxpayer in merchandise, cash, or other property, the taxpayer was allowed to reduce gross receipts by the estimated cost of future redemptions of trading stamps or premium coupons outstanding as of the close of the taxable year.[756] To be eligible to use such method, the taxpayer must have satisfied a book conformity requirement under which the taxpayer's estimated future redemptions and estimated average cost of redeeming each stamp or coupon could be no greater than the estimates that the taxpayer used for purposes of all reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes.[757]

Similarly, section 466 previously allowed taxpayers that issue discount coupons to deduct the estimated cost of future redemptions that occurred during the six-month period after the end of a taxable year.

In addition, a taxpayer electing a two-year deferral of advance payments for inventoriable goods was provided with a one-time acceleration of its adjustment to gross income for estimated cost of goods sold. In particular, a taxpayer electing a two-year deferral was allowed to reduce gross income for the second taxable year following the year in which the substantial advance payment is received (*i.e.*, the taxable year in which any remaining advance payment is included in gross income) by the costs and expenditures included in inventory with respect to the goods to which the remaining advance payment relates, even though such goods had not yet been provided to the customer.[758] In addition, if all or a portion of the goods to which the remaining advance payment relates are not on hand by the last day of such taxable year, the taxpayer could also reduce gross income for such taxable year for the estimated

[756] Treas. Reg. sec. 1.451–4.

[757] Treas. Reg. sec. 1.451–4(d). Under prior generally accepted accounting principles, two approaches were available to account for customer loyalty programs: (i) incremental cost accrual method (revenue is generally recognized at the time of initial sale along with the estimated expense for the anticipated costs of satisfying the award credits) or (ii) multiple-element revenue model (revenue is allocated between the goods or services sold and the award credits based on their relative fair value, with revenue allocable to the award credits deferred until they are redeemed or expire, with any costs of redemption also taken into account at the time redemption takes place). See ASC 605–25, *Revenue Recognition—Multiple-Element Arrangements*, and 605–50, *Revenue Recognition—Customer Payments and Incentives*, prior to their repeal by Accounting Standards Update ("ASU") No. 2014–09, *Revenue from Contracts with Customers*. Accordingly, only taxpayers using the incremental cost accrual method for financial statement purposes were previously eligible to use the method provided in Treas. Reg. sec. 1.451–4 for Federal income tax purposes. Under current generally accepted accounting principles in ASC 606, *Revenue from Contracts with Customers*, if the taxpayer is acting as a principal, customer loyalty programs are accounted for in a manner similar to the multiple-element revenue model, with any costs of redemption taken into account at the time redemption takes place. However, if the taxpayer is acting as an agent, the taxpayer recognizes fee or commission income from the exchange at the time redemption takes place. The amount of the fee or commission is deemed to be equal to the net amount that the taxpayer retains in the exchange (*i.e.*, the revenue deferred from the prior sale or issuance of the points less any costs of redemption incurred at the time redemption takes place). See ASC 606–10–55–36 through 55-40, *Revenue from Contracts with Customers—Overall—Implementation Guidance and Illustrations—Principal versus Agent Considerations*, and ASC 606–10–55–353 through 55–356, *Revenue from Contracts with Customers—Overall—Implementation Guidance and Illustrations—Example 52–Customer Loyalty Program*. As the incremental cost accrual method is no longer allowed for financial statement purposes, taxpayers may not be able to meet the book conformity requirement contained in Treas. Reg. sec. 1.451–4(d) and may no longer be eligible for the method provided in Treas. Reg. sec. 1.451–4.

[758] Treas. Reg. sec. 1.451–5(c)(1)(ii).

cost of the goods necessary to satisfy the agreement, even though such goods had not yet been acquired or produced by the taxpayer and had not yet been provided to the customer.[759] However, the reduction of gross income in such taxable year by actual or estimated cost of goods to be provided to the customer in the future was not permitted if the goods or type of goods with respect to which the advance payment was received were not identified in the year the advance payments are required to be included in gross income (*e.g.*, gift certificates and gift cards).[760] In addition, if the taxpayer receives additional advance payments after the second taxable year following the year in which the substantial advance payment is received, the reduction of gross income by actual or estimated cost of goods to be provided to the customer in the future was also not permitted for estimated cost of goods sold related to such additional advance payments, even though the taxpayer is required under the two-year deferral method to include such advance payments in gross income in the year received.

Each of these methods allowing the acceleration of deductions or adjustments to gross income for the estimated future costs of providing goods, property, or other items related to advance payments included in gross income predates and is inconsistent with the economic performance rules in section 461(h)[761] enacted in 1984 and the related repeal of section 466[762] in 1986.[763] Congress enacted the economic performance rules in section 461(h) and repealed section 466 to ensure that no liability is treated as incurred any earlier than when economic performance takes place.[764] The economic performance rules provide that a liability[765] that requires the taxpayer to provide property or services to others not be taken into account any earlier than as the taxpayer provides the property or services to the other person.[766] For a liability that arises out of the provision of services or property to the taxpayer by another person, economic performance occurs as the other person provides such services, as the other person provides such property, or as the taxpayer uses such property.[767] If the liability is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance

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[759] *Ibid.*

[760] Treas. Reg. sec. 1.451–5(c)(1)(iii).

[761] Deficit Reduction Act of 1984, Pub. L. No. 98–369, sec. 91, July 18, 1984.

[762] Tax Reform Act of 1986, Pub. L. No. 99–514, sec. 823, October 22, 1986.

[763] In addition, the acceleration of adjustments to gross income for costs and expenditures included in inventory as part of the two-year deferral method is inconsistent with the requirement to maintain inventories under section 471 and the requirements of the uniform capitalization rules under section 263A to capitalize direct costs and certain indirect costs related to goods produced or acquired for resale by the taxpayer until such time that the goods are sold to customers and the benefits and burdens of ownership of such goods are transferred to the customer.

[764] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of The Deficit Reduction Act of 1984* (JCS–41–84), December 1984, pp. 260–261. See also Report to accompany H.R. 3838, Tax Reform Act of 1986, S. Rpt. No. 99–313, May 29, 1985, pp. 158–159.

[765] A liability includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. See Treas. Reg. secs. 1.446–1(c)(1)(ii)(B) and 1.461–4(c)(1) and T.D. 8408, 1992–1 C.B. 155.

[766] Sec. 461(h)(2)(B).

[767] Sec. 461(h)(2)(A).

occurs as payment is made to the person to which the liability is owed.[768]

The economic performance rules were enacted to address Congressional concerns regarding court decisions that, in some cases, permitted accrual method taxpayers to deduct expenses that were not yet economically incurred (*i.e.*, that were attributable to activities to be performed or amounts to be paid in the future).[769] In particular, Congress observed that allowing a taxpayer to take deductions currently for an amount to be paid in the future overstates the true cost of the expense to the extent that the time value of money is not taken into account.[770] Accordingly, in order to prevent deductions for future expenses in excess of their true cost, while avoiding the complexity of a system of discounted valuation, Congress believed that expenses should be treated as incurred only when economic performance occurs.[771]

In addition, in repealing section 466 two years later, Congress noted that "the provision of prior law allowing a deduction for discount coupons received for redemption after the close of the taxable year resulted in an incorrect measurement of taxable income" and that prior law

> "provided an unwarranted exception to the general rules of tax accounting. An accrual basis taxpayer normally is allowed to recognize an expense only when all events establishing its obligation to pay the amount claimed as a deduction have occurred, the amount thereof can be determined with reasonable accuracy, and there has been economic performance with respect to the item. Absent the special provision of prior law for discount coupons, such costs would not have been considered deductible until the coupons actually were redeemed." [772]

As a result of the enactment of section 461(h) and the repeal of section 466 the deduction acceleration provisions discussed above are no longer consistent with the Code. Under prior law, taxpayers receiving advance payments could either account for such items by including the advanced payment in gross income in the year of receipt or by applying the one-year, two-year, or multiyear deferral method discussed above.[773]

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[768] Treas. Reg. sec. 1.461–4(g)(3). This rule applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold. In the case of a rebate or refund made as a reduction in the price of goods or services to be provided in the future by the taxpayer "payment" is deemed to occur as the taxpayer would otherwise be required to recognize income resulting from a disposition at an unreduced price.

[769] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of The Deficit Reduction Act of 1984* (JCS–41–84), December 1984, pp. 260–261.

[770] *Ibid.*

[771] *Ibid.*

[772] Report to accompany H.R. 3838, Tax Reform Act of 1986, S. Rpt. No. 99–313, May 29, 1985, pp. 158–159.

[773] Upon the enactment of the economic performance rules, Congress noted that it "expected that the Treasury Department would review existing regulations and rulings to determine whether they are consistent with the policies and principles set forth [in section 461(h)]. Until new regulations are issued under these provisions or the existing rulings are revoked or clarified, taxpayers may continue to rely on these rulings to the extent they are not inconsistent with the general principles of economic performance." See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of The Deficit Reduction Act of 1984* (JCS–41–84), December 1984, p. 266.

Special methods of accounting

In a number of situations, Congress has prescribed the proper time for including sales, gross receipts, and other items of income in gross income by providing special methods of accounting[774] for such items in the Code. For example, Congress has provided special methods of accounting for (i) amounts received by accrual method taxpayers in the year of the taxpayer's death, (ii) employee tips, (iii) crop insurance proceeds and disaster payments, (iv) proceeds from livestock sold on account of drought, flood, or other weather-related conditions, (v) income from the sale or furnishing of utility services, (vi) interest on frozen deposits in certain financial institutions, (vii) qualified prizes including a cash option, and (viii) sales or dispositions to implement Federal energy regulatory commission or State electric restructuring policy.[775] Congress has also prescribed the proper time for including gross profit from installment sales,[776] prepaid subscription income,[777] prepaid membership dues,[778] and adjustments for certain returned merchandise[779] in gross income. In addition, Congress has prescribed the proper time for including in gross income any income from certain long-term contracts[780] and rental income from certain arrangements for the use of property or services.[781]

Interest income

A taxpayer generally must include in gross income the amount of interest received or accrued within the taxable year on indebtedness held by the taxpayer.[782]

Original issue discount

The holder of a debt instrument with original issue discount ("OID") generally accrues and includes the OID in gross income as interest over the term of the instrument, regardless of when the stated interest (if any) is paid.[783]

The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the adjusted issue price of the debt instrument.[784] The stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments.[785] The holder includes in gross income an amount equal to the sum of the daily portions of the OID for each day during the taxable year the holder held such debt instrument. The daily portion is determined by allo-

[774] Methods of accounting include both the taxpayer's overall method of accounting, as well as any special methods of accounting for any "item" of income or expense. Examples of overall methods are the cash receipts and disbursements method, an accrual method, and combinations of the foregoing with various special methods provided for the accounting treatment of items of income or expense. Except for deviations permitted or required by special methods of accounting, taxable income is computed under the taxpayer's overall method of accounting (*i.e.*, the cash receipts and disbursements method or an accrual method). See Treas. Reg. sec. 1.446–1(a)(1).

[775] See sec. 451(d)–(k), as redesignated by the Act.

[776] See sec. 453.

[777] See sec. 455.

[778] See sec. 456.

[779] See sec. 458.

[780] See sec. 460.

[781] See sec. 467.

[782] Secs. 61(a)(4) and 451.

[783] Sec. 1272.

[784] Sec. 1273(a)(1).

[785] Sec. 1273(a)(2) and Treas. Reg. sec. 1.1273–1(b).

cating to each day in any accrual period its ratable portion of the increase during such accrual period in the adjusted issue price of the debt instrument.[786] The adjustment to the issue price is determined by multiplying the adjusted issue price (*i.e.*, the issue price increased by adjustments prior to the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period. Thus, to compute the amount of OID and the portion of OID allocable to a period, the stated redemption price at maturity and the term must be known. Issuers of OID instruments accrue and deduct the amount of OID as interest expense in the same manner as the holder.[787]

Debt instruments subject to acceleration

Special rules for determining the amount of OID allocated to a period apply to certain instruments that may be subject to prepayment. If a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt.[788] In addition, in the case of (1) any regular interest in a real estate mortgage investment conduit ("REMIC") or qualified mortgages held by a REMIC, or (2) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, the daily portions of the OID on such debt instruments are determined by taking into account an assumption regarding the prepayment of principal for such instruments.[789]

The Taxpayer Relief Act of 1997[790] extended these rules to any pool of debt instruments the payments on which may be accelerated by reason of prepayments.[791] Thus, if a taxpayer holds a pool of credit card receivables that require interest to be paid only if the borrowers do not pay their accounts by a specified date ("grace-period interest"), the taxpayer is required to accrue interest or OID on such pool based upon a reasonable assumption regarding the timing of the payments of the accounts in the pool. Under these rules, certain amounts (other than grace-period interest) related to credit card transactions, such as late-payment fees,[792] cash-advance fees,[793] and interchange fees,[794] have been determined to create OID or increase the amount of OID on the pool of credit card receivables to which the amounts relate.[795]

Stripped bonds

Special rules are provided with respect to the buyer and seller of stripped bonds.[796] A "stripped bond" is defined as a debt instrument in which there has been a separation in ownership between the underlying debt instrument and any interest coupon that has

[786] Secs. 1272(a)(1) and (3).
[787] Sec. 163(e).
[788] Treas. Reg. sec. 1.1272–1(c)(5).
[789] Sec. 1272(a)(6).
[790] Pub. L. No. 105–34, sec. 1004(a).
[791] Sec. 1272(a)(6)(C)(iii).
[792] Rev. Proc. 2004–33, 2004–1 C.B. 989.
[793] Rev. Proc. 2005–47, 2005–2 C.B. 269.
[794] *Capital One Financial Corp. and Subsidiaries v. Commissioner,* 133 T.C. No. 8 (2009); IRS Chief Counsel Notice CC–2010–018, September 27, 2010.
[795] See also Rev. Proc. 2013–26, 2013–22 I.R.B. 1160, for a safe harbor method of accounting for OID on a pool of credit card receivables for purposes of section 1272(a)(6).
[796] Sec. 1286.

not yet become payable.[797] In general, upon the disposition of either the stripped bond or the detached interest coupons, the retained portion and the portion that is disposed of are each treated as a new bond that is purchased at a discount and is payable at a fixed amount on a future date. Accordingly, both the stripped bond and the detached interest coupons are treated as individual bonds that are newly issued with OID on the date of disposition.

A taxpayer who purchases a stripped bond or one or more stripped coupons is treated as holding a new bond that is issued on the purchase date with OID in an amount that is equal to the excess of the stated redemption price at maturity (or, in the case of a coupon, the amount payable on the due date) over the ratable share of the purchase price of the stripped bond or coupon, determined on the basis of the respective fair market values of the stripped bond and coupons on the purchase date.[798] The OID on the stripped bond or coupon is includible in gross income under the general OID periodic income inclusion rules.

A taxpayer who strips a bond and disposes of either the stripped bond or one or more stripped coupons must allocate the taxpayer's basis, immediately before the disposition, in the bond (with the coupons attached) between the retained and disposed items.[799] Special rules require that interest or market discount accrued on the bond before such disposition must be included in the taxpayer's gross income (to the extent not previously included in gross income) at the time the stripping occurs, and the taxpayer increases the pre-disposition basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the taxpayer's basis allocable to such retained items, the difference is treated as OID that is required to be included under the general OID rules.[800]

Mortgage servicing rights

Income from "normal" mortgage servicing rights is included in income upon the earlier of when earned or received under the all events test of section 451 (*i.e.*, not averaged over the life of the mortgage).[801] Income from "excess" mortgage servicing rights is

[797] Sec. 1286(d)(2), as redesignated by the Consolidated Appropriations Act, 2018, Pub. L. No. 115–141, March 23, 2018.

[798] Sec. 1286(a).

[799] Sec. 1286(b). Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

[800] Special rules are provided with respect to stripping transactions involving tax-exempt obligations that treat OID (computed under the stripping rules) in excess of OID computed on the basis of the bond's coupon rate (or higher rate if originally issued at a discount) as income from a debt instrument that is not tax-exempt (sec. 1286(c), as redesignated by the Consolidated Appropriations Act, 2018, Pub. L. No. 115–141, March 23, 2018).

[801] See Rev. Rul. 70–142, 1970–1 C.B. 115.

treated as income from stripped coupons under section 1286 and therefore subject to the OID rules.[802]

Nonrecognition rules

Congress has provided that, in certain situations in which income or gain has been clearly realized by the taxpayer, such income or gain realized is nonetheless excluded either in whole or in part from gross income.[803] To receive nonrecognition treatment for such income or gain, taxpayers generally must meet certain requirements and comply with any applicable restrictions or adjustments to basis.

Explanation of Provision

Modification to the all events test for income recognition

The provision revises the rules associated with the timing of income recognition under the all events test of section 451. Specifically, the provision requires an accrual method taxpayer with an applicable or other specified financial statement[804] that is subject to the all events test to include sales, gross receipts, and other items of income in gross income no later than the taxable year in which such income is taken into account as revenue[805] in an applicable financial statement or another financial statement under rules specified by the Secretary. Under the provision, an accrual method taxpayer with an applicable or other specified financial statement includes sales, gross receipts, and other items of income in gross income upon the earlier of when the all events test is met or when the taxpayer includes such item in revenue in an applicable or other specified financial statement (*i.e.,* upon the earlier of

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[802] See Rev. Rul. 91–46, 1991–2 C.B. 358, and Rev. Proc. 91–50, 1991–2 C.B. 778.

[803] See, *e.g.*, secs. 247(f)(2), 267(d), 311, 332, 336(e)(2), 351, 354, 355, 361, 721, 731, and 1031 through 1045.

[804] For purposes of the provision, the term "applicable financial statement" means: (A) a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is (i) a 10–K (or successor form), or annual statement to shareholders, required to be filed by the taxpayer with the United States Securities and Exchange Commission ("SEC"), (ii) an audited financial statement of the taxpayer which is used for (I) credit purposes, (II) reporting to shareholders, partners, or other proprietors, or to beneficiaries, or (III) any other substantial nontax purpose, but only if there is no statement of the taxpayer described in clause (i), or (iii) filed by the taxpayer with any other Federal agency for purposes other than Federal tax purposes, but only if there is no statement of the taxpayer described in clause (i) or (ii); (B) a financial statement which is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government which is equivalent to the SEC and which has reporting standards not less stringent than the standards required by such Commission, but only if there is no statement of the taxpayer described in subparagraph (A); or (C) a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Secretary, but only if there is no statement of the taxpayer described in subparagraph (A) or (B). If the financial results of a taxpayer are reported on the applicable financial statement for a group of entities, such statement is treated as the applicable financial statement of the taxpayer. See sec. 451(b)(3) and (5), as modified by the Act.

[805] Accounting Standards Codification ("ASC") Topics 605, *Revenue Recognition,* and 606, *Revenue from Contracts with Customers,* provide the accounting rules for determining the amount of revenue to which a company expects to be entitled (*i.e.,* realization) and the timing of when such amount is included in revenue in the company's financial statements (*i.e.,* recognition). The timing of when costs incurred to fulfill a contract with a customer are included in the company's financial statements is determined separately from the inclusion timing of the associated revenue under various ASC topics, including ASC 330, *Inventory,* ASC 340–10–25–1 through 25–4, *Other Assets and Deferred Costs-Overall-Recognition-Preproduction Costs Related to Long-Term Supply Arrangements,* ASC 340–40, *Other Assets and Deferred Costs-Contracts with Customers,* ASC 350–40, *Intangibles—Goodwill and Other-Internal-Use Software,* ASC 360, *Property, Plant, and Equipment,* and ASC 985–20, *Software—Costs of Software to be Sold, Leased, or Marketed*. See ASC 340–40–15–3.

when due, paid, earned, or included in an applicable or other specified financial statement).

In the case of a contract which contains multiple performance obligations, the provision requires the taxpayer to allocate the transaction price to each performance obligation in accordance with the allocation made in the taxpayer's applicable financial statement.[806]

The provision does not apply to taxpayers without an applicable or other specified financial statement.[807]

Examples

Example 1.—A taxpayer enters into a one-year contract with a customer to provide cleaning services twice a month for $100 per cleaning service. The taxpayer invoices the customer and receives payment of $200 after the end of each month. The taxpayer provides cleaning services to the customer 10 times during the last five months of year one and 14 times during the first seven months of year two. The taxpayer receives payments from the customer of $800 in year one and $1,600 in year two. The taxpayer includes in revenue in its financial statements $1,000 in year one and $1,400 in year two.[808] Under prior law, the taxpayer would have included in gross income $1,000 in year one and $1,400 in year two.[809] Under the provision, the taxpayer includes in gross income $1,000 in year one and $1,400 in year two.

Example 2.—A taxpayer provides construction services to a customer to expand the customer's warehouse facility for $100,000. The taxpayer begins providing the construction services in year one and construction is completed during year two. Under the contract, the taxpayer bills the customer $50,000 in year one when construction begins and $50,000 in year two when construction is complete. In addition, the performance of the construction services is non-severable (*i.e.*, there are no milestones that have to be met before payment is due).[810] While the construction services are being provided, the customer retains control of the original warehouse facility and the expansion. The taxpayer includes in revenue in its financial statements $60,000 in year one and $40,000 in year two.[811] Under prior law, the taxpayer would have included in gross income $50,000 in year one and $50,000 in year two.[812] Under the provi-

[806] Congress expects that Treasury will provide guidance regarding whether and how to allocate the transaction price (i) to performance obligations that are not contractually based (e.g., the provision of free goods or services to a customer or the provision of a customary amount of training or support), (ii) for arrangements that include both income subject to section 451 and long-term contracts subject to section 460, and (iii) when the income realization event for Federal income tax purposes differs from the income realization event for financial statement purposes.

[807] See below for further discussion.

[808] Because the customer simultaneously receives and consumes the benefits provided by the taxpayer's performance as the taxpayer performs the cleaning services, the taxpayer recognizes revenue over time as it satisfies its performance obligation to provide cleaning services. See ASC 606–10–25–27(a) and 606–10–55–5.

[809] Under the all events test, the taxpayer includes amounts in gross income upon the earlier of when due (*i.e.,* after the end of each month), earned (*i.e.,* each time cleaning services are provided as such services are severable), or paid (*i.e.,* after the end of each month).

[810] See, *e.g.,* Tech. Adv. Mem. 200903079, October 8, 2008.

[811] Because the taxpayer's performance creates or enhances an asset that the customer controls as the asset is created or enhanced, the taxpayer recognizes revenue over time as it satisfies its performance obligation to provide construction services. See ASC 606–10–25–27(b) and 606–10–55–7.

[812] Under the all events test, the taxpayer includes $50,000 in gross income for year one upon the earlier of when due (*i.e.,* when construction begins), earned (*i.e.,* when performance of the nonseverable services is complete in year two), or paid (*i.e.,* upon receipt of payment in year

sion, the taxpayer includes in gross income $60,000 in year one and $40,000 in year two.

Example 3.—Assume the same facts as in Example 2 except that, under the contract, the taxpayer bills the customer, and the customer pays, $75,000 in year one when construction begins and $25,000 in year two when construction is complete. The taxpayer includes in revenue in its financial statements $60,000 in year one and $40,000 in year two.[813] Under prior law, the taxpayer would have included in gross income $75,000 in year one and $25,000 in year two.[814] Under the provision, the taxpayer includes in gross income $75,000 in year one and $25,000 in year two.

Example 4.—A taxpayer enters into a contract with a customer to build a customized piece of machinery for $50,000. Because of the customized nature of the machinery, the taxpayer is unable to sell the machinery to any of its other customers if the customer defaults or withdraws from the contract. Under the contract, taxpayer and the customer agree that the taxpayer will not invoice the customer until the item is delivered to the customer, the customer accepts the machinery, and title to the machinery has transferred to the customer. However, the contract also provides that, if the customer withdraws from the agreement, the taxpayer has an enforceable right to payment as the work is performed, even if the contract is not completed (for reasons other than a failure to perform by the taxpayer). The taxpayer begins producing the machinery in year one and the item is delivered to the customer in year two. The taxpayer invoices the customer for $50,000 and is paid such amount in year two. The taxpayer includes in revenue in its financial statements $30,000 in year one and $20,000 in year two.[815] Under prior law, the taxpayer would not have included any portion of the $50,000 in gross income in year one and would have included $50,000 in gross income in year two.[816] Under the provision, the

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one after construction begins). Under the all events test, the taxpayer includes $50,000 in gross income for year two (adjusted for amounts previously included in gross income during year one) upon the earlier of when due (*i.e.,* when construction is complete), earned (*i.e.,* when performance of the non-severable services is complete in year two), or paid (*i.e.,* upon receipt of payment in year two after construction is complete).

[813] Because the taxpayer's performance creates or enhances an asset that the customer controls as the asset is created or enhanced, the taxpayer recognizes revenue over time as it satisfies its performance obligation to provide construction services. See ASC 606–10–25–27(b) and 606–10–55–7.

[814] Under the all events test, the taxpayer includes $75,000 in gross income for year one upon the earlier of when due (*i.e.,* when construction begins), earned (*i.e.,* when performance of the non-severable services is complete in year two), or paid (*i.e.,* upon receipt of payment in year one after construction begins). Under the all events test, the taxpayer includes $25,000 in gross income for year two (adjusted for amounts previously included in gross income during year one) upon the earlier of when due (*i.e.,* when construction is complete), earned (*i.e.,* when performance of the non-severable services is complete in year two), or paid (*i.e.,* upon receipt of payment in year two after construction is complete). This example assumes that the taxpayer has not elected to defer advance payments under prior law or the provision. See below for further discussion of an election to defer advance payments under the provision.

[815] Because the taxpayer's performance does not create an asset with an alternative use to the taxpayer (*i.e.,* the machinery cannot be sold to other customers) and the taxpayer has an enforceable right to payment for performance completed to date, the taxpayer recognizes revenue over time as it satisfies its performance obligation to manufacture the item of machinery. See ASC 606–10–25–27(c) and 25–28 through 25–29, as well as ASC 606–10–55–8 through 55–15.

[816] Under the all events test, the taxpayer includes $50,000 in gross income for year two upon the earlier of when due (*i.e.,* when the taxpayer invoices the customer), earned (*i.e.,* when the machinery is delivered to and accepted by the customer), or paid (*i.e.,* when the taxpayer receives payment).

taxpayer incudes in gross income $30,000 in year one and $20,000 in year two.

Example 5.—A taxpayer enters into a contract with a customer to manufacture 500 widgets at a price of $10 each. The taxpayer receives a prepayment of $5,000 from the customer in year one. The taxpayer manufactures the widgets during year two and the widgets are delivered to the customer throughout year two as production of each widget is complete. The taxpayer does not include any portion of the prepayment in revenue in its financial statements in year one and, instead, includes the $5,000 in revenue in its financial statements in year two.[817] Under prior law, the taxpayer would have included in gross income $5,000 in year one and zero in year two.[818] Under the provision, the taxpayer includes in gross income $5,000 in year one and zero in year two.[819]

Prior law principles which are unchanged by the provision

Congress intends that the provision apply to items of gross income, such as sales, gross receipts, or other items of income, for which the timing of income recognition was determined using the all events test under prior law. Thus, the provision does not apply to items of gross income the timing of which is determined under a special method of accounting provided elsewhere in the Code, including special rules regarding items of gross income in connection with a mortgage servicing contract (contained in section 1286 of part V of subchapter P (special rules for bonds and other debt instruments)). However, the exception for special methods of accounting does not apply, and thus the provision is applicable, to any other income recognition timing rule contained in part V of subchapter P (special rules for bonds and other debt instruments).[820]

Consistent with prior law, the amount of cost of goods sold included as a subtraction from total sales is determined in accordance with the taxpayer's methods of accounting for items included in cost of goods sold.[821] An amount may not be taken into account in the computation of cost of goods sold, and thus reduce total sales, any earlier than the taxable year in which economic performance occurs with respect to such amount.[822] Once economic per-

[817] Because the customer simultaneously receives and consumes the benefits provided by the taxpayer's performance as the taxpayer delivers the widgets to the customer, the taxpayer recognizes revenue in year two as it satisfies its performance obligation to provide the widgets to the customer. See ASC 606–10–25–27(a) and 606–10–55–5.

[818] Under the all events test, the taxpayer includes $5,000 in gross income for year one upon the earlier of when due (*i.e.,* when the widgets are delivered to the customer), earned (*i.e.,* when the widgets are delivered to the customer), or paid (*i.e.,* when paid by the customer). This example assumes that the taxpayer accounts for sales of its product when the product is delivered (see Treas. Reg. sec. 1.446–1(c)(1)(ii)(C)), and has not elected to defer advance payments under prior law.

[819] This example assumes that the taxpayer has not elected to defer advance payments under the provision. See below for further discussion of an election to defer advance payments under the provision.

[820] See prior law discussion above regarding special methods of accounting. See also the discussion below regarding the interaction of the provision with the special rules for bonds and other debt instruments in part V of subchapter P.

[821] Treas. Reg. sec. 1.61–3(a). See, *e.g.,* sections 263A, 461(h), and 471. See also, *e.g.,* line 2 of Form 1120, Form 1120S, or Form 1065, or line 4 of Schedule C (Form 1040), as well as Form 1125–A. A taxpayer's gross profit is generally determined by subtracting returns and allowances and cost of goods sold from gross receipts or sales. See line 3 of Form 1120, Form 1120S, or Form 1065, or line 5 of Schedule C (Form 1040).

[822] Treas. Reg. secs. 1.61–3(a), 1.263A–1(c)(2)(ii), and 1.446–1(c)(1)(ii). For a liability that arises out of the provision of services or property to the taxpayer by another person, economic performance occurs as the other person provides such services, as the other person provides such

formance occurs, amounts may only be taken into account in the computation of cost of goods sold if they are not required to be capitalized and are not subject to any other provision of the Code that requires the deduction to be taken in a taxable year later than the year when economic performance occurs.[823] For example, generally taxpayers must maintain inventories whenever the production, purchase, or sale of merchandise is an income-producing factor.[824] In addition, such merchandise remains in inventory and is not included in cost of goods sold if title thereto is still vested in the taxpayer.[825] Section 263A and the regulations thereunder also require that direct costs and certain indirect costs incurred by the taxpayer (*i.e.,* costs for which economic performance has occurred) must be capitalized and included in the basis of property produced or acquired for resale by the taxpayer with the capitalized costs recovered by including such amounts in cost of goods sold when the underlying inventory or property is sold.[826]

Consistent with prior law, the provision does not apply to an item of gross income subject to the nonrecognition rules provided elsewhere in the Code.[827]

The provision does not revise the rules regarding when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred.[828] For example, the provision does not require the recognition of gain or loss from securities that are marked to market for financial reporting purposes if the gain or loss from such securities is not realized for Federal income tax purposes until such time that the taxpayer sells or otherwise disposes of the investment (because the taxpayer has not elected to apply, and is thus not subject to, the tax mark to market rules under section 475). In addition, the provision does not change any Federal income tax realization rule prescribed by the Code. For example, the provision does not apply to the Federal income tax treatment of amounts received upon the retirement, sale, or exchange of debt instruments which is governed by section 1271, or to the character of bond disposition gain where realization does

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property, or as the taxpayer uses such property. For a liability that requires the taxpayer to provide property to others, economic performance occurs as the taxpayer provides the property to the other person. Sec. 461(h)(2)(A) and (B). A liability includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. See Treas. Reg. secs. 1.446–1(c)(1)(ii)(B) and 1.461–4(c)(1) and T.D. 8408, 1992–1 C.B. 155.

[823] Conference Report to accompany H.R. 4170, Deficit Reduction Act of 1984, H.R. Rep. No. 98–861, June 23, 1984, p. 871.

[824] Sec. 471 and Treas. Reg. sec. 1.471–1.

[825] Sec. 471 and Treas. Reg. sec. 1.471–1. Whether the requirement that title be vested in the taxpayer has been met is generally determined based on whether the taxpayer has the benefits and burdens of ownership.

[826] Sec. 263A and Treas. Reg. sec. 1.263A–1(c)(4).

[827] See prior law discussion above regarding nonrecognition rules.

[828] For example, the provision does not require the recharacterization of a transaction from sale to lease, or vice versa, for Federal income tax purposes to conform to how the transaction is reported in the taxpayer's applicable financial statement. In addition, income from investments in corporations or partnerships that are accounted for under the equity method for financial reporting purposes will not result in the recognition of income for Federal income tax purposes until such time that the Federal income tax realization event has occurred (*e.g.,* when the taxpayer receives a dividend from the corporation in which it owns less than a controlling interest or when the taxpayer receives its allocable share of income, deductions, gains, and losses on its Schedule K–1 from the partnership).

not occur until the bond has been sold or otherwise disposed of by reason of section 1276.[829]

Examples

Example 6.—A taxpayer enters into a three-year contract to provide consulting services to a customer and receives payment as such services are provided. The contract also includes a performance bonus of $4,500 at the end of year three if certain material conditions and requirements are met. Because the taxpayer expects, at the time the contract is entered into, that all necessary conditions and requirements will be met at the end of the contract in year three, the taxpayer includes the $4,500 performance bonus in revenues in its financial statements ratably over the three-year contract, resulting in $1,500 included in revenue each year. At the end of the three-year contract, the taxpayer and the customer agree that the necessary conditions and requirements were met and the taxpayer receives the $4,500 performance bonus. For Federal income tax purposes, the performance bonus is not realized until year three when the necessary material conditions and requirements for receipt of the performance bonus have been met and the taxpayer has a fixed and definite right to receive the income. Accordingly, the taxpayer includes the $4,500 performance bonus in gross income in year three.

Example 7.—The taxpayer, an insurance agent, is engaged by an insurance carrier to sell insurance. For each policy sold to customers, the taxpayer receives a $50 commission from the insurance carrier at the time of purchase. The taxpayer also receives an additional $25 commission each time the policy is renewed. The taxpayer sells 1,000 one-year policies in year one, of which 800 are renewed in year two and 700 are renewed in year three. The taxpayer does not have any ongoing obligation to provide additional services to the insurance carrier or the customers after the initial sale of the policy. The taxpayer includes $86,000 in revenue in its financial statements for year one, which includes $50,000 of fixed consideration for policies sold in year one and $36,000 of variable consideration for the policies expected to be renewed in years two and three.[830] For Federal income tax purposes, the commissions related to policy renewals are not realized until year two and year three as the customers renew the policies. Accordingly, under the provision, the taxpayer includes in gross income commissions of $50,000 ($50 * 1,000) in year one, $20,000 ($25 * 800) in year two, and $17,500 ($25 * 700) in year three.

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[829] However, see further discussion below for taxpayers that elect under section 1278(b) to have deemed realization of market discount as it ratably accrues over the number of days the taxpayer holds the bond.

[830] Under ASC 606–10–32–2, a transaction price includes both fixed and variable consideration. ASC 606–10–32–5 provides that if consideration promised in a contract includes a variable amount, the transaction price includes an estimate of the amount of consideration expected to be received in exchange for transferring the promised goods or services to a customer. However, such variable consideration may only be included in the transaction price to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognition will not occur when uncertainty associated with the variable consideration is subsequently resolved. See ASC 606–10–32-11. For purposes of this example, at the time the contract is entered into in year one, the taxpayer estimates that the variable consideration to be received from policy renewals in year two and year three will be $36,000.

Interaction with special rules for bonds and other debt instruments

In addition, the provision directs accrual method taxpayers with an applicable or other specified financial statement to apply the income recognition rules under section 451 before applying any income recognition rules applicable under part V of subchapter P,[831] which include the OID rules contained in section 1272 (including the related provisions contained in sections 1273 through 1275), the election to include market discount in income as it ratably accrues,[832] and the stripped bond rules contained in section 1286 (including the related provisions in section 1288). Thus, for example, if a taxpayer has realized interchange fees on credit card loans that the OID rules would permit the taxpayer to recognize over time, but the taxpayer has included those fees in revenue for financial statement purposes when received (*e.g.,* late-payment fees, cash-advance fees, or interchange fees), this provision requires the taxpayer to apply the income recognition principles under section 451 before applying the OID rules.

However, the provision provides an exception for income in connection with a mortgage servicing contract.[833] Thus, under the provision, income from mortgage servicing rights continues to be recognized in accordance with the rules for such items of gross income (*i.e.,* "normal" mortgage servicing rights are included in income upon the earlier of when earned or received under the all events test of section 451 (*i.e.,* not averaged over the life of the mortgage),[834] and "excess"' mortgage servicing rights are treated as stripped coupons under section 1286 and therefore subject to the OID rules).[835]

Advance payments

The provision also codifies the one-year deferral method of accounting for advance payments for goods, services, and other specified items provided by the IRS under Revenue Procedure 2004–34.[836] That is, the provision allows accrual method taxpayers with an applicable or other specified financial statement to elect[837] to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes.[838] For purposes of the provision, an advance payment includes any payment received[839] during the taxable year (i) the full inclusion

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[831] Secs. 1271–1288. The provisions of part V of subchapter P provide special rules regarding the income realization and income recognition for bonds and other debt instruments, as well as the timing of certain related interest deductions.

[832] See sec. 1278(b).

[833] Sec. 451(b)(1)(B)(ii).

[834] See Rev. Rul. 70–142, 1970–2 C.B. 115.

[835] See Rev. Rul. 91–46, 1991–2 C.B. 358, and Rev. Proc. 91–50, 1991–2 C.B. 778.

[836] 2004–1 C.B. 991, as modified and clarified by Rev. Proc. 2011–18, 2011–5 I.R.B. 443, and Rev. Proc. 2013–29, 2013–33 I.R.B. 141.

[837] The election shall be made at such time, in such form and manner, and with respect to such categories of advance payments as the Secretary may provide. For these purposes, the recognition of income under such election is treated as a method of accounting. See sec. 451(c)(2).

[838] Consistent with prior law, an accrual method taxpayer with an applicable or other specified financial statement may instead include the amount of the advance payment in gross income in the year of receipt under the full inclusion method.

[839] For purposes of the provision, a payment is received by the taxpayer if it is actually or constructively received, or if it is due and payable to the taxpayer. See sec. 451(c)(4)(C).

of which in the gross income of the taxpayer for the taxable year of receipt is a permissible method of accounting under section 451 (determined without regard to the provision), (ii) any portion of which is included in revenue by the taxpayer in an applicable or other specified financial statement for a subsequent taxable year, and (iii) which is for any goods, services, or such other items as may be identified by the Secretary.[840] However, the provision excludes from eligible advance payments any payments that are received for certain items.[841] Thus, the provision is intended to override the two-year deferral and multiyear deferral methods of accounting for advance payments received for goods provided by Treasury Regulation section 1.451–5.

In the case of advance payments received for a combination of services, goods, or other specified items, the provision requires the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement.[842]

The provision requires the inclusion of a deferred advance payment in gross income if the taxpayer ceases to exist.[843]

Consistent with prior law and consistent with the methods of accounting previously followed by taxpayers applying the full inclusion method or the one-year deferral method in Revenue Procedure 2004–34, the amount of cost of goods sold included as a subtraction from total sales is determined in accordance with the taxpayer's methods of accounting for items included in cost of goods sold.[844] An amount may not be taken into account in the computation of cost of goods sold, and thus reduce total sales, any earlier than the taxable year in which economic performance occurs with respect to such amount.[845] Once economic performance occurs, amounts may only be taken into account in the computation of cost of goods sold if they are not required to be capitalized and are not subject to any

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[840] Sec. 451(c)(4). See sec. 4.01 of Rev. Proc. 2004–34, 2004–1 C.B. 991, as modified and clarified by Rev. Proc. 2011–18, 2011–5 I.R.B. 443, and Rev. Proc. 2013–29, 2013–33 I.R.B. 141.

[841] Sec. 451(c)(4)(B). Consistent with prior law, the following payments are excluded from advance payments: rent, insurance premiums governed by subchapter L, payments with respect to financial instruments, payments with respect to warranty or guarantee contracts under which a third party is the primary obligor, payments subject to section 871(a), 881, 1441, or 1442, payments in property to which section 83 applies, and any other payment identified by the Secretary. For prior law, see sec. 4.02 of Rev. Proc. 2004–34, 2004–1 C.B. 991, as modified and clarified by Rev. Proc. 2011–18, 2011–5 I.R.B. 443, and Rev. Proc. 2013–29, 2013–33 I.R.B. 141.

[842] Sec. 451(c)(4)(D). Congress expects that Treasury will provide guidance regarding whether and how to allocate the transaction price (i) to performance obligations that are not contractually based (*e.g.,* the provision of free goods or services to a customer or the provision of a customary amount of training or support), (ii) for arrangements that include both income subject to section 451 and long-term contracts subject to section 460, and (iii) when the income realization event for Federal income tax purposes differ from the income realization event for financial statement purposes.

[843] Sec. 451(c)(3).

[844] Treas. Reg. sec. 1.61–3(a). See, *e.g.,* sections 263A, 461(h), and 471. See also, *e.g.,* line 2 of Form 1120, Form 1120S, or Form 1065, or line 4 of Schedule C (Form 1040), as well as Form 1125–A. A taxpayer's gross profit is generally determined by subtracting returns and allowances and cost of goods sold from gross receipts or sales. See line 3 of Form 1120, Form 1120S, or Form 1065, or line 5 of Schedule C (Form 1040).

[845] Treas. Reg. secs. 1.61–3(a), 1.263A–1(c)(2)(ii), and 1.446–1(c)(1)(ii). For a liability that arises out of the provision of services or property to the taxpayer by another person, economic performance occurs as the other person provides such services, as the other person provides such property, or as the taxpayer uses such property. For a liability that requires the taxpayer to provide property to others, economic performance occurs as the taxpayer provides the property to the other person. Sec. 461(h)(2)(A) and (B). A liability includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. See Treas. Reg. secs. 1.446–1(c)(1)(ii)(B) and 1.461–4(c)(1) and T.D. 8408, 1992–1 C.B. 155.

other provision of the Code that requires the deduction to be taken in a taxable year later than the year when economic performance occurs.[846] For example, generally taxpayers must maintain inventories whenever the production, purchase, or sale of merchandise is an income-producing factor.[847] In addition, such merchandise remains in inventory, and is not included in cost of goods sold, if title thereto is still vested in the taxpayer.[848] Section 263A and the regulations thereunder also require that direct costs and certain indirect costs incurred by the taxpayer (*i.e.,* costs for which economic performance has occurred) must be capitalized and included in the basis of property produced or acquired for resale by the taxpayer with the capitalized costs recovered by including such amounts in cost of goods sold when the underlying inventory or property is sold.[849]

Examples

Example 8.—Assume the same facts as Example 3, except that the taxpayer elects to defer advance payments under section 451(c). Under the provision, the taxpayer includes in gross income $60,000 in year one and $40,000 in year two.

Example 9.—Assume the same facts as Example 5, except that the taxpayer elects to defer advance payments under section 451(c). Under the provision, the taxpayer does not include any portion of the advance payment in gross income in year one and, instead, includes $5,000 in gross income in year two.

Example 10.—A taxpayer enters into a contract with a customer to build a customized piece of machinery for $50,000. The taxpayer receives an advance payment of $35,000 in year one for which it elected to apply a two-year deferral under prior law. In addition, the taxpayer elects to defer advance payments under section 451(c). Due to the customized nature of the machinery, the taxpayer is unable to sell the good to any of its other customers if the customer defaults or withdraws from the contract. Under the contract, the taxpayer and the customer agree that the taxpayer will not invoice the customer for the remaining $15,000 until the machinery is delivered to the customer, the customer accepts the machinery, and title to the machinery has transferred to the customer. However, if the customer withdraws from the agreement, the contract also provides that the taxpayer has an enforceable right to payment as the work is performed, even if the contract is not completed (for reasons other than a failure to perform by the taxpayer). The taxpayer begins producing the machinery in year two and the machinery is delivered to the customer in year three. The taxpayer invoices the customer and receives payment for the remaining $15,000 in year three. The taxpayer includes in revenue in its financial statements $30,000 in year two and $20,000 in year

[846] Conference Report to accompany H.R. 4170, Deficit Reduction Act of 1984, H.R. Rep. No. 98–861, June 23, 1984, p. 871.

[847] Sec. 471 and Treas. Reg. sec. 1.471–1.

[848] Sec. 471 and Treas. Reg. sec. 1.471–1. Whether the requirement that title be vested in the taxpayer has been met is generally determined based on whether the taxpayer has the benefits and burdens of ownership.

[849] Sec. 263A and Treas. Reg. sec. 1.263A–1(c)(4).

three.[850] Under prior law, the taxpayer would have not included any portion of the $50,000 in gross income in year one or year two and would have included $50,000 in gross income in year three.[851] Under the provision, the taxpayer defers including the $35,000 advance payment in gross income from year one to year two. Accordingly, under the provision, the taxpayer incudes in gross income $35,000 in year two and $15,000 in year three.

Example 11.—A taxpayer enters into a contract with a customer to manufacture 500 widgets at a price of $10 each. Taxpayer receives a prepayment of $5,000 from the customer in year one for which it elected to apply a two-year deferral under prior law. In addition, the taxpayer elects to defer advance payments under section 451(c). Taxpayer manufactures the widgets during year two and year three and the widgets are delivered to the customer during year three. The taxpayer does not include any portion of the advance payment in revenue in its financial statements in year one or year two and, instead, includes the $5,000 in revenue in its financial statements in year three.[852] Under prior law, the taxpayer would have not have included any portion of the advance payment in gross income for year one or year two and, instead, would have included the entire amount in gross income in year three.[853] Under the provision, the taxpayer defers including the $5,000 advance payment in gross income from year one to year two. Accordingly, under the provision, the taxpayer includes the $5,000 advance payment in gross income in year two.

Taxpayers without an applicable financial statement

These provisions do not apply to taxpayers that do not have an applicable or other specified financial statement. Accrual method taxpayers without an applicable or other specified financial statement continue to determine the timing for when sales, gross receipts, and other income are included in gross income under the all events test (*i.e.,* upon the earlier of when (i) payment is earned through performance, (ii) payment is due to the taxpayer, or (iii) payment is received by the taxpayer),[854] unless an exception per-

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[850] Because the taxpayer's performance does not create an asset with an alternative use to the taxpayer (*i.e.,* the machinery cannot be sold to other customers) and the taxpayer has an enforceable right to payment for performance completed to date, the taxpayer recognizes revenue over time as it satisfies its performance obligation to manufacture the item of machinery. See ASC 606–10–25–27(c) and 25–28 through 25–29, as well as ASC 606–10–55–8 through 55–15.

[851] The $50,000 included in gross income for year three includes (i) the remaining $15,000 included in gross income under the all events test in year three upon the earlier of when due (*i.e.,* when the taxpayer invoices the customer), earned (*i.e.,* when the machinery is delivered to and accepted by the customer), or paid (*i.e.,* when taxpayer receives payment) plus (ii) the $35,000 advance payment deferred from year one and included in gross income for year three under the two-year deferral method of Treas. Reg. sec. 1.451–5. At the time prior law was in effect, ASC 606, *Revenue from Contracts with Customers*, was not yet applicable to financial statements. Under the accounting standards previously in effect, the taxpayer would have included the $50,000 in revenue in its financial statements entirely in year three; thus, allowing the taxpayer to defer the $35,000 advance payment to year three under the two-year deferral method of Treas. Reg. sec. 1.451–5.

[852] Because the taxpayer's performance obligation is satisfied at a point in time (*i.e.,* at the time control of the widgets is transferred to the customer), the taxpayer recognizes revenue at such point in time. See ASC 606–10–25–23 and 25–30.

[853] At the time prior law was in effect, ASC 606, *Revenue from Contracts with Customers,* was not yet applicable to financial statements. Under the accounting standards previously in effect, the taxpayer would have included the $5,000 in revenue in its financial statements entirely in year three, which allowed the taxpayer to defer the $5,000 advance payment to year three under the two-year deferral method of Treas. Reg. sec. 1.451–5.

[854] See Rev. Rul. 2003–10, 2003–1 C.B. 288.

mits deferral or a special method of accounting applies. In addition, such taxpayers generally may continue to defer advance payments for goods, services, and other items using a permissible method of deferral.[855]

The Treasury Department has issued published guidance addressing this provision.[856]

Effective Date

The provision generally applies to taxable years beginning after December 31, 2017, and the application of these rules is a change in the taxpayer's method of accounting for purposes of section 481. In the case of any taxpayer required by this provision to change its method of accounting for its first taxable year beginning after December 31, 2017, such change is treated as initiated by the taxpayer and made with the consent of the Secretary.

In the case of income from a debt instrument having OID, the provision applies to taxable years beginning after December 31, 2018, and the related section 481(a) adjustment is taken into account over six taxable years.

[855] As of the date of enactment, taxpayers without an applicable or other specified financial statement could continue to defer advance payments using either the one-year, two-year, or multiyear deferral methods (if the taxpayer is otherwise eligible to use such methods and to the extent that such methods are consistent with the Code and subsequent published guidance issued by the Treasury Department). Consistent with prior law, the related liabilities to provide goods, services, or other items to customers in exchange for the advance payments received by the taxpayer are included as an item of gross income (*i.e.,* as a cost of goods sold adjustment) or as a deduction taken into account in determining the taxpayer's taxable income in accordance with the taxpayer's methods of accounting for such items. See, *e.g.,* secs. 263A, 461(h), and 471. See also Treas. Reg. secs. 1.61–3(a) and 1.446–1(c)(1)(ii)(A).

[856] REG–104872–18, 83 Fed. Reg. 51904, October 15, 2018; Notice 2018–35, 2018–18 I.R.B. 520, April 30, 2018; Notice 2018–80, 2018–42 I.R.B. 609, October 15, 2018; and Rev. Proc. 2018–60, available at https://www.irs.gov/pub/irs-drop/rp-18-60.pdf.

PART IV—BUSINESS-RELATED EXCLUSIONS AND DEDUCTIONS

A. Limitation on Deduction for Interest (sec. 13301 of the Act and sec. 163(j) of the Code)

Prior Law

Interest deduction

Interest paid or accrued by a business generally is deductible in the computation of taxable income subject to a number of limitations.[857]

Interest is generally deducted by a taxpayer as it is paid or accrued, depending on the taxpayer's method of accounting. For all taxpayers, if an obligation is issued with original issue discount ("OID"), a deduction for interest is allowable over the life of the obligation on a yield to maturity basis.[858] Generally, OID arises where interest on a debt instrument is not calculated based on a qualified rate and required to be paid at least annually.

Investment interest expense

In the case of a taxpayer other than a corporation, the deduction for interest on indebtedness that is allocable to property held for investment ("investment interest") is limited to the taxpayer's net investment income for the taxable year.[859] Disallowed investment interest is carried forward to the next taxable year.

Net investment income is investment income net of investment expenses. Investment income generally consists of gross income from property held for investment, and investment expense includes all deductions directly connected with the production of investment income (*e.g.*, deductions for investment management fees) other than deductions for interest.

The two-percent floor on miscellaneous itemized deductions allows taxpayers to deduct investment expenses connected with investment income only to the extent such deductions exceed two percent of the taxpayer's adjusted gross income.[860] Miscellaneous

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[857] Sec. 163(a). In addition to the limitations discussed herein, other limitations include: denial of the deduction for the disqualified portion of the original issue discount on an applicable high yield discount obligation (sec. 163(e)(5)), denial of deduction for interest on certain obligations not in registered form (sec. 163(f)), reduction of the deduction for interest on indebtedness with respect to which a mortgage credit certificate has been issued under section 25 (sec. 163(g)), disallowance of deduction for personal interest (sec. 163(h)), disallowance of deduction for interest on debt with respect to certain life insurance contracts (sec. 264), and disallowance of deduction for interest relating to tax-exempt income (sec. 265). Interest may also be subject to capitalization. See, *e.g.*, sections 263A(f) and 461(g).

[858] Sec. 163(e). But see section 267 (dealing in part with interest paid to a related or foreign party).

[859] Sec. 163(d).

[860] Sec. 67(a). For a discussion of changes made to the deduction of miscellaneous itemized deductions by the Act, see the description of section 11045 of the Act (Suspension of Miscellaneous Itemized Deductions).

itemized deductions[861] that are not investment expenses are disallowed first before any investment expenses are disallowed.[862]

Earnings stripping

Section 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests are satisfied: (1) the payor's debt-to-equity ratio exceeds 1.5 to 1.0, and (2) the payor's net interest expense exceeds the sum of 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion) plus any excess limitation carryforward (defined below).[863] Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest;[864] (2) unrelated parties in certain instances in which a related party guarantees the debt; and (3) a real estate investment trust ("REIT") by a taxable REIT subsidiary of that trust.[865] The amount disallowed may not exceed the amount by which the corporation's net interest expense exceeds 50 percent of the corporation's adjusted taxable income.[866] Interest amounts disallowed under these rules can be carried forward indefinitely.[867] In addition, any excess limitation (*i.e.*, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years (the "excess limitation carryforward").[868]

Explanation of Provision

In general

In the case of any taxpayer for any taxable year, the deduction for business interest is limited to the sum of (1) business interest income of the taxpayer for the taxable year, (2) 30 percent of the adjusted taxable income of the taxpayer for the taxable year (not less than zero), and (3) the floor plan financing interest of the taxpayer for the taxable year. The amount of any business interest not allowed as a deduction for any taxable year may be carried forward indefinitely. The limitation applies at the taxpayer level (but see a special carryforward rule for partnerships, described below). In the case of a group of affiliated corporations that file a consolidated re-

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[861] Miscellaneous itemized deductions include itemized deductions of individuals other than certain specific itemized deductions. Sec. 67(b). Miscellaneous itemized deductions generally include, for example, investment management fees and certain employee business expenses, but specifically do not include, for example, interest, taxes, casualty and theft losses, charitable contributions, medical expenses, or other listed itemized deductions.

[862] H.R. Rep. No. 841, 99th Cong., 2d Sess., p. II–154, Sept. 18, 1986 (Conf. Rep.) ("In computing the amount of expenses that exceed the 2-percent floor, expenses that are not investment expenses are intended to be disallowed before any investment expenses are disallowed.").

[863] Secs. 163(j)(2)(A), (2)(B) and (6)(A). For a brief description of the legislative background of section 163(j), see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCS–41–11), July 11, 2011, pp. 21–23.

[864] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed by the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

[865] Sec. 163(j)(3).

[866] Sec. 163(j)(1)(A).

[867] Sec. 163(j)(1)(B).

[868] Sec. 163(j)(2)(B)(ii).

turn, the limitation applies at the consolidated tax return filing level.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for purposes of the Code is interest for purposes of the provision. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Business interest does not include investment interest, and business interest income does not include investment income, within the meaning of section 163(d).[869]

Adjusted taxable income means the taxable income of the taxpayer computed without regard to: (1) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any net operating loss deduction; and (4) the amount of any deduction allowed under section 199A.[870] Additionally, for taxable years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to any deduction allowable for depreciation, amortization, or depletion.[871] For taxable years beginning after December 31, 2021, adjusted taxable income is computed with regard to deductions allowable for depreciation, amortization, or depletion. The Secretary may provide for other adjustments to the computation of adjusted taxable income.

Floor plan financing interest means interest paid or accrued on floor plan financing indebtedness. Floor plan financing indebtedness means indebtedness used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory so acquired.[872] A motor vehicle means a motor vehicle that is: (1) any self-propelled vehicle designed for transporting person or property on a public street, highway, or road; (2) a boat; or (3) farm machinery or equipment.

By including business interest income and floor plan financing interest in the limitation, the rule operates to allow (1) business interest up to the amount of business interest income and (2) floor plan financing interest to be fully deductible. That is, a deduction for business interest is permitted to the full extent of business interest income and any floor plan financing interest.[873] The deduc-

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[869] Section 163(d) applies in the case of a taxpayer other than a corporation; a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision. For example, in the case of an insurance company that for regulatory (*i.e.*, statutory accounting) purposes has both underwriting income and expense and investment interest income and expense, any interest income is business interest income and any interest expense is business interest for purposes of section 163(j).

[870] For a discussion of section 199A, see the description of section 11011 of the Act (Deduction for Qualified Business Income) and the Appendix.

[871] Any deduction allowable for depreciation, amortization, or depletion includes any deduction allowable for any amount treated as depreciation, amortization, or depletion.

[872] Property that is held exclusively for lease is not inventory, but rather property used in a trade or business under section 1221(a)(2). Property simultaneously held for sale or lease is treated as inventory until such time as it first becomes leased, at which point it is no longer treated as inventory. See, *e.g.*, Notice 2013–13, 2013–12 I.R.B. 659, March 18, 2013.

[873] Note, however, that if the taxpayer takes floor plan financing interest into account to increase the taxpayer's interest limitation under section 163(j) for a taxable year, property placed in service by the taxpayer during such year and subsequent taxable years is not eligible for the additional first-year depreciation deduction under section 168(k), as modified by the Act. For a

tion for any remaining business interest is limited to 30 percent of adjusted taxable income.

It is generally intended that, similar to prior law, section 163(j) apply after the application of provisions that subject interest to deferral, capitalization, or other limitation. Thus, as with prior-law section 163(j), the provision applies to interest deductions that are deferred, for example under section 163(e) or section 267(a)(3)(B), in the taxable year to which such deductions are deferred.[874] Also as with prior-law section 163(j), the provision applies after section 263A is applied to capitalize interest[875] and after, for example, section 265 or section 279 is applied to disallow any interest deduction.[876] However, the provision applies before the application of sections 465 and 469 (again, similar to prior-law section 163(j)(7)).

Carryforward of disallowed business interest

The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Business interest may be carried forward indefinitely. The provision contains rules (described below) intended to prevent trafficking in carryforwards, and it is intended that the provision be administered consistent with that intent.

With respect to corporations, any carryforward of disallowed business interest of the corporation is an item taken into account in the case of certain corporate acquisitions described in section 381 and is subject to limitation under section 382.

Application to passthrough entities[877]

In general

In the case of any partnership, the limitation is applied at the partnership level. To prevent double counting, there are special rules for the determination of the business interest income and adjusted taxable income of each partner of the partnership. Similarly, to allow for additional interest deduction by a partner in the case of an excess amount of either business interest income of the partnership or adjusted taxable income of the partnership, special rules apply. Similar rules apply with respect to any S corporation and its shareholders. Additionally, there is a special rule for carryforward of disallowed partnership interest that applies only to partnerships.

Double counting rule

The business interest income and adjusted taxable income of each partner (or shareholder, as the case may be) is determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of the partnership. In the absence of such rules, items of business interest income or adjusted taxable income of a partnership might be viewed as generating additional

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discussion of changes made to section 168(k) by the Act, including an example of the interaction of sections 168(k) and 163(j) with regard to taxpayers with floor plan financing interest, see the description of section 13201 of the Act (Temporary 100-Percent Expensing for Certain Business Assets).

[874] See, *e.g.*, Prop. Treas. Reg. sec. 1.163(j)–7(b)(2) under prior section 163(j).

[875] See, *e.g.*, Treas. Reg. sec. 1.263A–9(g)(1)(i).

[876] See, *e.g.*, Prop. Treas. Reg. sec. 1.163(j)–7(b)(1) under prior section 163(j).

[877] Technical corrections may be necessary to achieve the provision's application to passthrough entities as described herein.

interest deductions as the items are passed through to the partners.

Example 1.—ABC is a partnership owned 50–50 by XYZ Corporation and an individual. ABC generates $200 of noninterest income. Its only expense is $60 of business interest. Under the provision the deduction for business interest is limited to 30 percent of adjusted taxable income, that is, 30 percent * $200 = $60. ABC deducts $60 of business interest and reports ordinary business income of $140. XYZ Corporation's distributive share of the ordinary business income of ABC is $70. XYZ Corporation has net taxable income of zero from its other operations, none of which is attributable to business interest income, and without regard to its business interest. XYZ Corporation has business interest of $25. In the absence of any special rule, the $70 of taxable income from its interest in ABC might permit the deduction of up to an additional $21 of interest (30 percent * $70 = $21), resulting in a deduction disallowance of $4. That is, XYZ Corporation's $100 share of ABC's adjusted taxable income would generate $51 of interest deductions (*i.e.*, XYZ Corporation's $30 share of ABC's interest deduction plus XYZ Corporation's interest deduction of $21). If XYZ Corporation were instead a passthrough entity, additional deductions might be available at each tier.

The double counting rule provides that XYZ Corporation has adjusted taxable income computed without regard to the $70 distributive share of the income of ABC. As a result, XYZ Corporation has adjusted taxable income of $0. XYZ Corporation's deduction for business interest is limited to 30 percent * $0 = $0, resulting in a deduction disallowance of $25.

Additional deduction limit

For purposes of determining the allowable interest deduction of a partner in a partnership, the partner's business interest deduction limitation calculated under the provision is increased to reflect the partner's distributive share of any business interest income or adjusted taxable income of the partnership that was not used to generate a business interest deduction at the partnership level. Specifically, in the absence of disallowed business interest attributable to the partnership (see discussion of the partnership carryforward rule, below), the partner's business interest deduction limitation is increased by the sum of the partner's distributive share of the partnership's excess business interest income and 30 percent of the partnership's excess taxable income. Excess business interest income with respect to any partnership is the excess of the business interest income of the partnership over the business interest, reduced by floor plan financing interest,[878] of the partnership. Excess taxable income with respect to any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as (1) the excess (if any) of (a) 30 percent of the adjusted taxable income of the partnership over (b) the amount (if any) by which the business interest of the partnership, reduced by

[878] To the extent the partnership takes floor plan financing interest into account to increase the amount of interest permitted to be deducted under section 163(j)(1).

floor plan financing interest,[879] exceeds the business interest income of the partnership bears to (2) 30 percent of the adjusted taxable income of the partnership. These rules allow a partner of a partnership to deduct additional business interest that the partner may have paid or incurred to the extent the partnership could have deducted more business interest.

Example 2.—The facts are the same as in Example 1 except ABC has only $40 of business interest. As in Example 1, ABC has a limit on its business interest deduction of $60. The excess taxable income for ABC is $66.67 ($20/$60 * $200). XYZ Corporation's distributive share of the excess taxable income from ABC is $33.33. XYZ Corporation's deduction for business interest is limited to 30 percent of its adjusted taxable income plus its distributive share of the excess taxable income from ABC (30 percent * ($0 + $33.33) = $10). As a result of the excess taxable income, XYZ Corporation may deduct $10 of business interest and has a business interest deduction disallowance of $15 ($25 – $10).

Carryforward rule

In the case of a partnership, the general entity-level carryforward rule does not apply. Instead, any business interest that is not allowed as a deduction to the partnership for the taxable year (referred to as "disallowed business interest") is allocated to the partners. Each partner may deduct its share of the partnership's disallowed business interest in any future year, but only to the extent of the partner's distributive share of excess business interest income and 30 percent of the partner's distributive share of excess taxable income of the partnership the activities of which gave rise to the disallowed business interest carryforward. Any amount that is not allowed as a deduction is carried forward. For example, if a partner's disallowed business interest from a prior year of Partnership X is $100, and in the current year the partner is allocated $100 of excess taxable income and $10 of excess business interest income from X and has $200 of adjusted taxable income from other sources, the partner may only deduct $40 of the disallowed business interest in the current year ($10 excess business interest income + (30 percent * $100 excess taxable income)). The remaining $60 of disallowed business interest is carried forward to the subsequent year. To prevent double counting, any deduction by the partner of disallowed business interest requires a corresponding reduction in the partner's distributive share of current-year excess business interest income and excess taxable income used to determine the partner's current-year interest limitation.

Additionally, when disallowed business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a subsequent year for disallowed business interest does not reduce the partner's basis in its partnership interest. In the event the

[879] Again, to the extent the partnership takes floor plan financing interest into account to increase the amount of interest permitted to be deducted under section 163(j)(1).

partner disposes of a partnership interest the basis of which has been so reduced, the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of disallowed business interest that has been deducted by the partner against excess business interest income or excess taxable income of the same partnership.[880]

This special carryforward rule does not apply to S corporations and their shareholders.

Exceptions

The limitation does not apply to any taxpayer (other than a tax shelter prohibited from using the cash method under section 448(a)(3)) that meets the $25 million gross receipts test of section 448(c) (*i.e.,* if the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $25 million).[881] Aggregation rules apply to determine the amount of a taxpayer's gross receipts under the $25 million gross receipts test.

The trade or business of performing services as an employee is not treated as a trade or business for purposes of the limitation.[882] As a result, for example, the wages of an employee are not counted in the adjusted taxable income of the taxpayer for purposes of determining the limitation.

At the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (*i.e.,* any electing real property trade or business) is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.[883] Similarly, at the taxpayer's election, any farming business[884] or

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[880] The special rule for dispositions also applies to transfers of a partnership interest (including by reason of death) in transactions in which gain is not recognized in whole or in part. No deduction is allowed to the transferor or transferee for any disallowed business interest resulting in a basis increase under this rule.

[881] In the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership. For a discussion of changes made to section 448 by the Act, see the description of section 13102 of the Act (Small Business Accounting Method Reform and Simplification).

[882] The trade or business of performing services as an employee is also mentioned in section 62(a)(1), among other places, and has the same meaning here as there.

[883] Congress intends that any such real property trade or business, including such a trade or business conducted by a corporation or REIT, be included. Because this description of a real property trade or business refers only to the section 469(c)(7)(C) description, and not to other rules of section 469 (such as the rule of section 469(c)(2) that passive activities include rental activities or the rule of section 469(a) that a passive activity loss is limited under section 469), the other rules of section 469 are not made applicable by this reference. It is further intended that a real property operation or a real property management trade or business includes the operation or management of a lodging facility, including a lodging facility that provides some supplemental services, such as an assisted living facility. In addition, an electing real property trade or business is required to use the alternative depreciation system ("ADS") to depreciate any of its nonresidential real property, residential rental property, qualified improvement property, qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant property. See the description of section 13204 of the Act (Applicable Recovery Period for Real Property).

[884] As defined in section 263A(e)(4) (*i.e.,* farming business means the trade or business of farming and includes the trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots)). Treas. Reg. sec. 1.263A–4(a)(4) further defines a farming business as a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples of a farming business include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising

any business engaged in the trade or business of a specified agricultural or horticultural cooperative,[885] is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to any such trade or business.[886]

The limitation does not apply to certain regulated public utilities. Specifically, the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State[887] or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative is not treated as a trade or business for purposes of the limitation, and thus any interest paid or accrued on indebtedness properly allocable to such trades or businesses is not business interest.[888]

The Treasury Department and IRS have issued published guidance addressing this provision.[889]

Effective Date

The provision applies to taxable years beginning after December 31, 2017. Congress intends that taxpayers with disqualified interest disallowed under prior-law section 163(j)(1)(A) for the last taxable year beginning before January 1, 2018, may carry such interest forward as business interest to the taxpayer's first taxable year beginning after December 31, 2017, and that such business interest carried forward will be subject to potential disallowance under the provision in the same manner as any other business interest otherwise paid or accrued in a taxable year beginning after December 31, 2017.

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of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. A farming business also includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products. See Treas. Reg. sec. 1.263A–4(a)(4)(i) and (ii). A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer. See Treas. Reg. sec. 1.263A–4(a)(4)(i).

[885] As defined in section 199A(g)(4).

[886] An electing farming business is required to use ADS to depreciate any property with a recovery period of 10 years or more. See the description of section 13205 of the Act (Use of Alternative Depreciation System for Electing Farming Businesses).

[887] The term "State" includes the District of Columbia. See sec. 7701(a)(10) ("The term 'State' shall be construed to include the District of Columbia where such construction is necessary to carry out provisions of this title").

[888] Note, however, that any property primarily used by a regulated public utility trade or business with a depreciable interest in the property is not eligible for the additional first-year depreciation deduction by such utility business under section 168(k), as modified by the Act. For a discussion of changes made to section 168(k) by the Act, see the description of section 13201 of the Act (Temporary 100-Percent Expensing for Certain Business Assets).

[889] REG–106089–18, November 26, 2018, available at https://www.irs.gov/pub/irs-drop/REG-106089-18-NPRM.pdf; Rev. Proc. 2018–59, 2018–50 I.R.B. (Nov. 26, 2018); Notice 2018–28, 2018–16 IRB 492 (Apr. 2, 2018).

B. Modification of Net Operating Loss Deduction (sec. 13302 of the Act and sec. 172 of the Code)

Prior Law

A net operating loss ("NOL") generally means the amount by which a taxpayer's business deductions exceed its gross income.[890] In general, an NOL may be carried back two taxable years and carried over 20 taxable years to offset taxable income in such years (referred to as the "NOL deduction").[891] NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.[892]

Different carryback periods apply with respect to NOLs arising in different circumstances. Extended carryback periods are allowed for NOLs attributable to specified liability losses, certain casualty and disaster losses, and farming losses.[893] The carryback of excess interest losses attributable to corporate equity reduction transactions is limited.[894] Special rules prohibit carrybacks to or from any taxable year in which a taxpayer is a real estate investment trust (a "REIT").[895]

For purposes of the alternative minimum tax, a taxpayer's NOL deduction generally is limited to 90 percent of alternative minimum taxable income (determined without regard to the NOL deduction).[896]

Explanation of Provision

The provision makes a number of changes with respect to losses arising in taxable years beginning after December 31, 2017.[897] First, the provision limits the NOL deduction to 80 percent of taxable income (determined without regard to the NOL deduction).[898] Carryovers of such NOLs to other years are adjusted to take account of this limitation, and may be carried over indefinitely.

In addition, the provision[899] repeals the two-year carryback[900] and the special carryback provisions for specified liability losses, individual casualty losses, and small business and farming disaster losses.[901] In the case of certain farming losses, the provision short-

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[890] Sec. 172(c).

[891] Sec. 172(b)(1)(A).

[892] Sec. 172(b)(2). The amount of the NOL which may be carried to a taxable year is reduced by the taxable income for prior taxable years to which the NOL may be carried.

[893] Sec. 172(b)(1)(C) (10-year carryback for specified liability losses), (E) (three-year carryback for individual casualty losses, small business disaster losses, and farming disaster losses), and (F) (five-year carryback for farming losses).

[894] Sec. 172(b)(1)(D).

[895] Sec. 172(b)(1)(B).

[896] Secs. 55 and 56(a)(4) and (d). For a description of the alternative minimum tax, see the description of sections 12001–12003 of the Act (Alternative Minimum Tax).

[897] In calculating the amount of the NOL arising in a taxable year, certain deductions are excluded. For example, deductions under sections 199A and 250 are not allowed. For a description of section 199A, see the description of section 11011 of the Act (Deduction for Qualified Business Income). For a description of section 250, see the description of section 14202 of the Act (Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income).

[898] For this purpose, a REIT is subject to a limit based on 80 percent of its real estate investment trust taxable income (as defined in section 857(b)(2) but without regard to the deduction for dividends paid (as defined in section 561). See sec. 172(d)(6)(C).

[899] A technical correction may be necessary to reflect that the changes to carryovers and carrybacks apply to losses arising in taxable years beginning after December 31, 2017.

[900] In light of the general repeal of the two-year carryback, the special rules limiting carrybacks for REITs are repealed.

[901] Thus, specified liability losses are no longer eligible for a 10-year carryback, and certain individual casualty losses, as well as small business and farming disaster losses, are no longer

ens the carryback period from five years to two years.[902] Finally, a special rule provides a two-year carryback and 20-year carryover for NOLs of a property and casualty insurance company (*i.e.*, an insurance company (as defined in section 816(a)) other than a life insurance company). Further, the 80-percent limitation does not apply to the NOLs of such insurance companies.

NOLs arising in taxable years beginning before January 1, 2018, remain subject to prior law. Accordingly, such NOLs are not subject to the 80-percent limitation, and remain subject to the 20-year carryover limitation and to the prior-law carryback rules.

A taxpayer with NOL carryovers to a taxable year from both taxable years beginning before 2018 ("pre-2018 NOL carryovers") and taxable years beginning after 2017 ("post-2017 NOL carryovers") computes its tax liability as follows. First, the taxpayer is entitled to an NOL deduction in the amount of its pre-2018 NOL carryovers without limitation. Second, the taxpayer is entitled to an additional NOL deduction equal to the lesser of (1) its post-2017 NOL carryovers, or (2) 80 percent of the excess (if any) of the taxpayer's taxable income (before any NOL deduction attributable to post-2017 NOL carryovers) over the NOL deduction attributable to pre-2018 NOL carryovers.[903]

Examples

Example 1.—The following example illustrates the rules for carryovers of pre-2018 NOLs and post-2017 NOLs.

Suppose a taxpayer (a calendar-year corporation) has $120 of pre-2018 NOL carryovers and $70 of post-2017 NOL carryovers to 2019. In 2019, the taxpayer has $100 of taxable income (before any NOL deduction). The taxpayer is entitled to an NOL deduction equal to the sum of (i) its pre-2018 NOL carryovers and (ii) the lesser of its post-2017 carryovers or 80 percent of its taxable income in 2019 (determined without regard to the NOL deduction attributable to post-2017 NOL carryovers). In this case, the taxpayer's pre-2018 NOL carryovers ($120) exceed its pre-NOL taxable income ($100), so the taxpayer is entitled to an NOL deduction fully offsetting its taxable income. The taxpayer will have $20[904] of pre-2018 NOL carryovers and $70 of post-2017 NOL carryovers to 2020.

Suppose, in 2020, the taxpayer again has $100 of taxable income (before any NOL deduction). The taxpayer is entitled to an NOL deduction equal to the sum of (i) its pre-2018 NOL carryovers and (ii) the lesser of its post-2017 carryovers or 80 percent of its taxable income in 2020 (determined without regard to the NOL deduction attributable to post-2017 NOL carryovers). In this case, the tax-

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eligible for a three-year carryback under section 172. Under section 165(i), however, a taxpayer may elect to take certain disaster losses into account for the taxable year immediately preceding the taxable year in which the disaster occurred.

[902] For this purpose, the term "farming loss" means the lesser of (1) the amount which would be the NOL for the taxable year if only income and deductions attributable to farming businesses (as defined in section 263A(e)(4)) are taken into account, or (2) the amount of the NOL for such taxable year. For any loss year, a farming business may irrevocably elect out of the two-year carryback. Such election must be made in the manner as prescribed by the Secretary by the due date (including extensions) of the taxpayer's return for the taxable year of the NOL.

[903] A technical correction may be necessary to reflect this intent.

[904] $20 is the excess of the $120 of pre-2018 NOL carryovers to 2019 over $100 taxable income for 2019 as computed under section 172(b)(2).

payer's NOL deduction is $20 plus the lesser of $70 or 80 percent of the taxpayer's taxable income (before any NOL deduction attributable to post-2017 NOL carryovers). In this case, 80 percent of taxable income computed without regard to post-2017 NOL carryovers is $64 (80 percent of $80 ($100 taxable income less the NOL deduction of $20 attributable to pre-2018 NOL carryovers)). Thus, for 2020, the taxpayer is entitled to an NOL deduction of $84 ($20 plus $64). The taxpayer will have $6 ($70 less $64) of post-2017 NOL carryovers to 2021.

Example 2.—The following example illustrates the interaction of the 80-percent limitation and the two-year carryback of certain farming losses.

Suppose, in 2018, a calendar-year taxpayer has a $300 farming loss. The taxpayer has no other NOLs and is not limited by section 461(l).[905] Because the provision allows a special two-year carryback in the case of certain farming losses, the taxpayer may carry back the farming loss to 2016 or 2017. However, the NOL deduction for such carryback year will be limited to 80 percent of taxable income (determined without regard to the NOL deduction) for such taxable year. If the taxpayer had $100 of taxable income in 2016 and $200 of taxable income in 2017 (both without regard to any NOL deduction), the taxpayer is entitled to an $80 NOL deduction in 2016 (80 percent of $100) and a $160 NOL deduction in 2017 (80 percent of $200). The taxpayer will have $60 of post-2017 NOL carryovers to 2019 (*i.e.*, the $300 2018 NOL less (1) the $80 2016 NOL carryback and (2) the $160 2017 NOL carryback).

Effective Date

The provision limiting the NOL deduction applies to losses arising in taxable years beginning after December 31, 2017.

The provision allowing indefinite carryovers and modifying carrybacks applies to losses arising in taxable years beginning[906] after December 31, 2017.

C. Like-Kind Exchanges of Real Property (sec. 13303 of the Act and sec. 1031 of the Code)

Prior Law

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" which is to be held for productive use in a trade or business or for investment.[907] In general, section 1031 does not apply to any exchange of stock in trade (*i.e.*, inventory) or other property held primarily for sale; stocks, bonds, or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in

[905] For a discussion of section 461(l), see the description of section 11012 of the Act (Limitation on Losses for Taxpayers Other Than Corporations).

[906] A technical correction may be necessary to reflect this intent.

[907] Sec. 1031(a)(1).

action.[908] Section 1031 also does not apply to certain exchanges involving livestock[909] or foreign property.[910]

For purposes of section 1031, the determination of whether property is of a "like kind" relates to the nature or character of the property and not its grade or quality, *i.e.*, the nonrecognition rules do not apply to an exchange of one class or kind of property for property of a different class or kind (*e.g.*, section 1031 does not apply to an exchange of real property for personal property).[911] The different classes of property are: (1) depreciable tangible personal property;[912] (2) intangible or nondepreciable personal property;[913] and (3) real property.[914] However, the rules with respect to whether real estate is "like kind" are applied more liberally than the rules governing like-kind exchanges of depreciable, intangible, or nondepreciable personal property. For example, improved real estate and unimproved real estate generally are considered to be property of a "like kind" as this distinction relates to the grade or quality of the real estate,[915] while depreciable tangible personal properties must be either within the same General Asset Class[916] or within the same Product Class.[917]

The nonrecognition of gain in a like-kind exchange applies only to the extent that like-kind property is received in the exchange. Thus, if an exchange of property would meet the requirements of section 1031, but for the fact that the property received in the transaction consists not only of the property that would be permitted to be exchanged on a tax-free basis, but also other nonqualifying property or money ("additional consideration"), then the

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[908] Sec. 1031(a)(2). A chose in action is a right that can be enforced by legal action.

[909] Sec. 1031(e).

[910] Sec. 1031(h).

[911] Treas. Reg. sec. 1.1031(a)–1(b).

[912] For example, an exchange of a personal computer classified under asset class 00.12 of Rev. Proc. 87–56, 1987–2 C.B. 674, for a printer classified under the same asset class of Rev. Proc. 87–56 would be treated as property of a like kind. However, an exchange of an airplane classified under asset class 00.21 of Rev. Proc. 87–56 for a heavy general purpose truck classified under asset class 00.242 of Rev. Proc. 87–56 would not be treated as property of a like kind. See Treas. Reg. sec. 1.1031(a)–2(b)(7).

[913] For example, an exchange of a copyright on a novel for a copyright on a different novel would be treated as property of a like kind. See Treas. Reg. sec. 1.1031(a)–2(c)(3). However, the goodwill or going concern value of one business is not of a like kind to the goodwill or going concern value of a different business. See Treas. Reg. sec. 1.1031(a)–2(c)(2). The IRS has ruled that intangible assets such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill qualify as property of a like kind under section 1031. See Chief Counsel Advice 200911006, February 12, 2009.

[914] Treas. Reg. sec. 1.1031(a)–1(b) and (c).

[915] Treas. Reg. sec. 1.1031(a)–1(b).

[916] Treasury Regulation section 1.1031(a)–2(b)(2) provides the following list of General Asset Classes, based on asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87–56, 1987–2 C.B. 674: (i) Office furniture, fixtures, and equipment (asset class 00.11), (ii) Information systems (computers and peripheral equipment) (asset class 00.12), (iii) Data handling equipment, except computers (asset class 00.13), (iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21), (v) Automobiles, taxis (asset class 00.22), (vi) Buses (asset class 00.23), (vii) Light general purpose trucks (asset class 00.241), (viii) Heavy general purpose trucks (asset class 00.242), (ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25), (x) Tractor units for use over-the-road (asset class 00.26), (xi) Trailers and trailer-mounted containers (asset class 00.27), (xii) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and (xiii) Industrial steam and electric generation and/or distribution systems (asset class 00.4).

[917] Property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System ("NAICS"), set forth in Executive Office of the President, Office of Management and Budget, *North American Industry Classification System,* United States, 2002 (NAICS Manual), as periodically updated. Treas. Reg. sec. 1.1031(a)–2(b)(3).

gain to the recipient of the other property or money is required to be recognized, but not in an amount exceeding the fair market value of such other property or money.[918] Additionally, any such gain realized on a section 1031 exchange as a result of additional consideration being involved constitutes ordinary income to the extent that the gain is subject to the recapture provisions of sections 1245 and 1250.[919] No losses may be recognized from a like-kind exchange.[920]

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred. This basis is increased to the extent of any gain recognized as a result of the receipt of other property or money in the like-kind exchange, and decreased to the extent of any money received by the taxpayer.[921] The holding period of qualifying property received includes the holding period of the qualifying property transferred, but the nonqualifying property received is required to begin a new holding period.[922]

A like-kind exchange also does not require that the properties be exchanged simultaneously. Rather, the property to be received in the exchange must be received not more than 180 days after the date on which the taxpayer relinquishes the original property (but in no event later than the due date (including extensions) of the taxpayer's income tax return for the taxable year in which the transfer of the relinquished property occurs). In addition, the taxpayer must identify the property to be received within 45 days after the date on which the taxpayer transfers the property relinquished in the exchange.[923]

The Treasury Department has issued regulations[924] and revenue procedures[925] providing guidance and safe harbors for taxpayers engaging in deferred like-kind exchanges.

Explanation of Provision

The provision limits the provision providing for nonrecognition of gain or loss in the case of like-kind exchanges to exchanges of real property not held primarily for sale.[926]

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[918] Sec. 1031(b). For example, if a taxpayer holding land A having a basis of $40,000 and a fair market value of $100,000 exchanges the property for land B worth $90,000 plus $10,000 in cash, the taxpayer would recognize $10,000 of gain on the transaction, which would be includable in income. The remaining $50,000 of gain would be deferred until the taxpayer disposes of land B in a taxable sale or exchange.

[919] Secs. 1245(b)(4) and 1250(d)(4). For example, if a taxpayer holding section 1245 property A with an original cost basis of $11,000, an adjusted basis of $10,000, and a fair market value of $15,000 exchanges the property for section 1245 property B with a fair market value of $14,000 plus $1,000 in cash, the taxpayer would recognize $1,000 of ordinary income on the transaction. The remaining $4,000 of gain would be deferred until the taxpayer disposes of section 1245 property B in a taxable sale or exchange.

[920] Sec. 1031(c).

[921] Sec. 1031(d). Thus, in the example noted above, the taxpayer's basis in B would be $40,000 (the taxpayer's transferred basis of $40,000, increased by $10,000 in gain recognized, and decreased by $10,000 in money received).

[922] Sec. 1223(1).

[923] Sec. 1031(a)(3).

[924] Treas. Reg. sec. 1.1031(k)–1(a) through (o).

[925] See Rev. Proc. 2000–37, 2000–40 I.R.B. 308, as modified by Rev. Proc. 2004–51, 2004–33 I.R.B. 294.

[926] It is intended that real property eligible for like-kind exchange treatment under prior law will continue to be eligible for like-kind exchange treatment under the provision. For example, a like-kind exchange of real property includes an exchange of shares in a mutual ditch, reservoir, or irrigation company described in section 501(c)(12)(A) if at the time of the exchange

Effective Date

The provision generally applies to exchanges completed after December 31, 2017. However, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or the property received by the taxpayer in the exchange is received on or before such date.

D. Limitation on Deduction by Employers of Expenses for Fringe Benefits (sec. 13304 of the Act and sec. 274 of the Code)

Prior Law

Limitations on employer deductions

No deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement, or recreation ("entertainment"), unless the taxpayer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business, or (2) a facility (*e.g.*, an airplane) used in connection with such activity.[927] If the taxpayer establishes that entertainment expenses are directly related to (or associated with) the active conduct of its trade or business, the deduction generally is limited to 50 percent of the amount otherwise deductible.[928] Similarly, a deduction for any expense for food or beverages generally is limited to 50 percent of the amount otherwise deductible.[929] In addition, no deduction is allowed for membership dues with respect to any club organized for business, pleasure, recreation, or other social purpose.[930]

There are a number of exceptions to the general rule disallowing the deduction of entertainment expenses and the rules limiting deductions to 50 percent of the otherwise deductible amount. One such exception applies to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and as wages to an employee.[931] Another exception applies to expenses for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee (*e.g.*, a nonemployee director) as compensation for services rendered or as a prize or award.[932] The exceptions apply only to the extent that amounts are properly reported by the company as compensation and wages or otherwise includible in income. In no event can the amount of the deduction exceed the

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such shares have been recognized by the highest court or statute of the State in which the company is organized as constituting or representing real property or an interest in real property. Similarly, improved real estate and unimproved real estate are generally considered to be property of a like kind. See Treas. Reg. sec. 1.1031(a)–1(b).

[927] Sec. 274(a)(1).

[928] Sec. 274(n)(1)(B).

[929] Sec. 274(n)(1)(A). This includes expenses for food or beverages (and facilities used in connection therewith) furnished on the business premises of the taxpayer primarily for the taxpayer's employees under section 274(e)(1).

[930] Sec. 274(a)(3).

[931] Sec. 274(e)(2)(A). See below for a discussion of the modification of this rule for certain individuals.

[932] Sec. 274(e)(9).

amount of the taxpayer's actual cost, even if a greater amount (*i.e.*, fair market value) is includible in income.[933]

Other exceptions to the deduction disallowance rules include the following: expenses paid or incurred by the taxpayer, in connection with the performance of services for another person (other than an employer), under a reimbursement or other expense allowance arrangement if the taxpayer accounts for the expenses to such person;[934] expenses for recreational, social, or similar activities primarily for the benefit of employees other than certain owners and highly compensated employees;[935] entertainment expenses directly related to business meetings of a taxpayer's employees, stockholders, agents or directors,[936] or directly related and necessary to attendance at business meetings or conventions of organizations described in section 501(c)(6) and exempt from taxation under section 501(a);[937] expenses for goods, services, and facilities made available by the taxpayer to the general public;[938] and expenses for goods or services (including the use of facilities) which are sold by the taxpayer in a *bona fide* transaction for an adequate and full consideration in money or money's worth.[939] Other exceptions from the 50-percent deduction limit include exceptions for food or beverage expenses excludable from the gross income of the recipient under section 132(e) (relating to *de minimis* fringes) and for food or beverages provided to crew members of certain commercial vessels and certain oil or gas platform or drilling rig workers.[940]

Employee compensation

Expenses treated as compensation

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.[941] In general, an employee (or other service provider) must include in gross income the amount by which the fair market value of a fringe benefit exceeds the sum of the amount (if any) paid by the individual and the amount (if any) specifically excluded from gross income.[942] Treasury regulations provide detailed rules regarding the valuation of certain fringe benefits, including flights on an employer-provided aircraft. In general, the value of a noncommercial flight generally is determined under the base aircraft valuation formula, also known as the Standard Industry Fare Level formula ("SIFL").[943] If the SIFL valuation rules do not apply, the

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[933] Treas. Reg. sec. 1.162–25T(a).
[934] Sec. 274(e)(3).
[935] Sec. 274(e)(4).
[936] Sec. 274(e)(5).
[937] Sec. 274(e)(6).
[938] Sec. 274(e)(7).
[939] Sec. 274(e)(8).
[940] Secs. 274(n)(2)(B) and (E). The legislative history to the Tax Reform Act of 1986 (Pub. L. No. 99–514) further provides that a restaurant or catering firm may deduct 100 percent (rather than the 80-percent limitation that would otherwise have applied under the Tax Reform Act of 1986) of its costs for food and beverage items, purchased in connection with preparing and providing meals to its paying customers, that are consumed at the worksite by employees of the restaurant or caterer. Conference Report to accompany H.R. 3838, Tax Reform Act of 1986, H.R. Rep. No. 99–841, September 18, 1986, p. II–25. See also Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS–10–87), May 1987, p. 68, clarifying that this exception only applies to employees who work in the employer's restaurant or catering business.
[941] Sec. 61(a)(1).
[942] Treas. Reg. sec. 1.61–21(b)(1).
[943] Treas. Reg. sec. 1.61–21(g)(5).

value of a flight on an employer-provided aircraft generally is equal to the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.[944]

In the context of an employer providing an aircraft to employees for nonbusiness (*e.g.*, vacation) flights, the exception for expenses treated as compensation has been interpreted as not limiting the company's deduction for expenses attributable to the operation of the aircraft to the amount of compensation reportable to its employees.[945] The result of that interpretation is often a deduction several times larger than the amount required to be included in income. Further, in many cases, the individual including amounts attributable to personal travel in income directly benefits from the enhanced deduction, resulting in a net deduction for the personal use of the company aircraft.

Subsequent to the *Sutherland Lumber-Southwest* decision, the exceptions for expenses treated as compensation or otherwise includible income were modified by the American Jobs Creation Act[946] for specified individuals such that the exceptions apply only to the extent of the amount of expenses treated as compensation or includible in income of the specified individual.[947] Specified individuals are individuals who, with respect to an employer or other service recipient (or a related party), are subject to the requirements of section 16(a) of the Securities Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient (or related party) were an issuer of equity securities referred to in section 16(a).[948]

As a result, in the case of specified individuals, no deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment, amusement or recreation, or (2) a facility (*e.g.*, an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income to the specified individual. For example, a company's deduction attributable to aircraft operating costs and other expenses for a specified individual's vacation use of a company aircraft is limited to the amount reported as compensation to the specified individual. However, in the case of other employees or service providers, the company's deduction is not limited to the amount treated as compensation or includible in income.[949]

Excludable fringe benefits

Certain employer-provided fringe benefits are excluded from an employee's gross income and wages for employment tax purposes, including, but not limited to, *de minimis* fringes, qualified trans-

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[944] Treas. Reg. sec. 1.61–21(b)(6).

[945] *Sutherland Lumber-Southwest, Inc. v. Commissioner,* 114 T.C. 197 (2000), aff'd 255 F.3d 495 (8th Cir. 2001) (the "*Sutherland Lumber-Southwest* decision").

[946] Pub. L. No. 108–357. See also Conference Report to accompany H.R. 4520, American Jobs Creation Act of 2004, H.R. Rep. No. 108–755, October 7, 2004, pp. 797–798.

[947] Sec. 274(e)(2)(B)(i). See also Treas. Reg. sec. 1.274–9(a).

[948] Sec. 274(e)(2)(B)(ii). See also Treas. Reg. sec. 1.274–9(b).

[949] See Treas. Reg. sec. 1.274–10(a)(2).

portation fringes, on-premises athletic facilities, and meals provided for the "convenience of the employer."[950]

A *de minimis* fringe generally means any property or service the value of which is (taking into account the frequency with which similar fringes are provided by the employer) so small as to make accounting for it unreasonable or administratively impracticable,[951] and also includes food or beverages provided to employees through an eating facility operated by the employer that is located on or near the employer's business premises and meets certain requirements.[952]

Qualified transportation fringes provided by an employer include qualified parking (parking on or near the employer's business premises or parking on or near a location from which the employee commutes to work by transit pass, vanpool, or carpool), transit passes, vanpool benefits (commuter highway vehicles for travel between the employee's residence and place of employment), and qualified bicycle commuting reimbursements.[953]

On-premises athletic facilities are gyms or other athletic facilities located on the employer's premises, operated by the employer, and substantially all the use of which is by employees of the employer, their spouses, and their dependent children.[954]

The value of meals furnished to an employee or the employee's spouse or dependents by or on behalf of an employer for the convenience of the employer is excludible from the employee's gross income, but only if such meals are provided on the employer's business premises.[955]

Explanation of Provision

In general

The provision eliminates the deduction permitted under prior law with respect to entertainment, amusement, or recreation. It also eliminates the deduction permitted to an employer under prior law for items with respect to qualified transportation fringes and employer-provided commuting. In addition, as described below, the provision impacts the deduction for expenses of an employer associated with providing food or beverages to employees through an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer.[956]

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[950] Secs. 132(a), 119(a), 3121(a)(19) and (20), 3231(e)(5) and (9), 3306(b)(14) and (16), and 3401(a)(19).

[951] Sec. 132(e)(1). Examples include occasional personal use of an employer's copying machine, occasional parties or meals for employees and their guests, local telephone calls, and coffee, doughnuts and soft drinks. Treas. Reg. sec. 1.132–6(e)(1).

[952] Sec. 132(e)(2). Revenue derived from such a facility must normally equal or exceed the direct operating costs of the facility. Employees who are entitled, under section 119, to exclude the value of a meal provided at such a facility are treated as having paid an amount for the meal equal to the direct operating costs of the facility attributable to such meal.

[953] Secs. 132(f)(1) and (5). The qualified transportation fringe exclusions are subject to monthly limits. Sec. 132(f)(2).

[954] Sec. 132(j)(4).

[955] Sec. 119(a).

[956] The provision generally does not impact the other exceptions to the 50-percent limitation on deductions for food or beverage expenses, as described *infra* under prior law. For example, a restaurant or catering business may continue to deduct 100 percent of its costs for food or beverage items, purchased in connection with preparing and providing meals to its paying customers, which are consumed at the worksite by employees who work in the employer's restaurant or catering business.

Entertainment, amusement, or recreation expenses

The provision provides that no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement, or recreation, (2) membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes, or (3) a facility or portion thereof used in connection with any of the above items. Thus, the provision repeals the prior-law exception to the deduction disallowance for entertainment, amusement, or recreation (collectively, "entertainment") that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50-percent limit to such deductions).[957]

Notwithstanding these limitations, taxpayers may still deduct 50 percent of certain business-related food and beverage expenses. A taxpayer may still generally deduct 50 percent of the food or beverage expenses associated with operating its trade or business (*e.g.*, meals consumed by employees on work travel). A taxpayer may also continue to deduct 50 percent of the properly substantiated food or beverage expenses associated with a meal that is considered a business meal with a client, provided the business meal is not lavish or extravagant.[958] When a meal is included in an activity or event with a client that primarily constitutes entertainment, the provision disallows the deduction for the entire activity or event including the meal.[959] For example, food or beverages consumed during a theatre or sporting event would be nondeductible under this rule because the activity or event is primarily entertainment. However, a meal between the taxpayer (or an employee of the taxpayer) and a client at a restaurant to primarily discuss business is a business meal that may be 50-percent deductible, provided other applicable requirements are satisfied, including substantiation.[960]

Qualified transportation fringes and employer-provided commuting

The provision disallows a deduction for items with respect to providing any qualified transportation fringe to employees of the taxpayer. Such items include amounts elected by an employee to be used on a pretax salary basis towards any qualified transportation fringe benefit. The term "qualified transportation fringe" is defined[961] to include qualified parking, and therefore encompasses costs associated with providing qualified parking, including any parking facility maintained by the employer or parking on any por-

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[957] As discussed above under prior law, section 274(e)(5) provides an exception from the deduction disallowance rules for entertainment expenses directly related to business meetings of a taxpayer's employees, stockholders, agents, or directors, and section 274(e)(6) provides such an exception for such expenses directly related and necessary to attendance at business meetings or conventions of organizations described in section 501(c)(6) and exempt from taxation under section 501(a). A technical correction may be necessary to clarify that such exceptions do not apply to expenses of entertainment, amusement, or recreation (including any facility or portion thereof used in connection with entertainment, amusement, or recreation) for which no deduction is allowed under the provision. However, such exceptions continue to apply to 50 percent of food or beverage expenses that otherwise satisfy applicable requirements.

[958] See section 274(k), which was not amended by Pub. L. No. 115–97.

[959] An objective test like that under Treas. Reg. sec. 1.274–2(b)(1)(ii) (which under prior law applies to determine whether an activity is of a type generally considered to constitute entertainment) should apply to determine whether an event or activity primarily constitutes entertainment.

[960] See sec. 274(d) and (k).

[961] Sec. 132(f).

tion of the employer's business premises used in connection with qualified parking. This includes appropriate allocations of depreciation and other costs with respect to facilities used for parking (*e.g.*, allocable salaries for security and maintenance personnel, property taxes, repairs and maintenance, etc.). The amount of the deduction disallowance is equal to the amount of direct and other properly allocable costs of the taxpayer to provide the qualified transportation fringe. Accordingly, the deduction disallowance is not determined by reference to the value of the transportation fringe benefit calculated for purposes of applying section 132(f) and instead, the employer must take into account the direct and other properly allocable costs that it incurs to maintain and provide the qualified parking to its employees.[962]

The provision also disallows a deduction for any expense incurred for providing any transportation, or any payment or reimbursement, for commuting between the employee's residence and place of employment, except as necessary for ensuring the safety of an employee.

The provision is intended to include qualified transportation fringe expenses in the exception to the deduction disallowance for expenses that are treated as compensation.[963] Any expenses incurred for providing any form of transportation which are not qualified transportation fringes (or any payment or reimbursement) for commuting between the employee's residence and place of employment, even if included in compensation, are not eligible for this exception.

Meals that are a de minimis fringe or for the convenience of the employer

For amounts incurred and paid after December 31, 2017, and before January 1, 2026, the provision reduces the deduction to 50 percent for expenses of the employer associated with providing food or beverages to employees through an eating facility that meets the requirements for *de minimis* fringes and for the convenience of the employer. Such amounts incurred and paid after December 31, 2025, are not deductible.

The Treasury Department has issued published guidance addressing this provision.[964]

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[962] The determination of costs associated with providing qualified transportation fringes that are subject to a deduction disallowance is consistent with the determination of such costs required to be included in unrelated business taxable income under section 512(a)(7) (as added by section 13703 of the Act (Unrelated Business Taxable Income Increased by Amount of Certain Fringe Benefit Expenses for which Deduction is Disallowed)). Therefore, this determination includes pretax salary amounts attributable to any qualified transportation fringe benefit, costs for parking facilities used in connection with qualified parking (as defined in section 132(f)(5)(C)), and appropriate allocations of depreciation and other costs for such facilities. See description of section 13703 of the Act. A technical correction may be necessary to reflect this intent.

[963] See section 274(e). A technical correction may be necessary to reflect this intent. Note that this would apply to qualified bicycle commuting reimbursements during the suspension period (taxable years beginning after December 31, 2017, and ending before January 1, 2026) of the exclusion from gross income for such benefits.

[964] Notice 2018–76, 2018–42 I.R.B. 599; IRS Publication 15–B, *Employer's Tax Guide to Fringe Benefits* (revised Feb. 22, 2018), p. 21.

Effective Date

The provision generally applies to amounts paid or incurred after December 31, 2017. However, for expenses of the employer associated with providing food or beverages to employees through an eating facility that meets the requirements for *de minimis* fringes and for the convenience of the employer, amounts paid or incurred after December 31, 2025, are not deductible.

E. Repeal of Deduction for Income Attributable to Domestic Production Activities (sec. 13305 of the Act and former sec. 199 of the Code)

Prior Law

In general

Section 199 provides a deduction from taxable income (or, in the case of an individual, adjusted gross income[965]) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income (determined without regard to the section 199 deduction) for the taxable year.[966] For corporations subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to slightly less than 32 percent on qualified production activities income.[967] A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; and (2) other expenses, losses, or deductions which are properly allocable to those receipts.[968]

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property[969] that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States;[970] (2) any sale, exchange, or other disposition, or any lease,

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[965] For this purpose, adjusted gross income is determined after application of sections 86, 135, 137, 219, 221, 222, and 469, without regard to the section 199 deduction. Sec. 199(d)(2).

[966] Sec. 199(a). In the case of oil related qualified production activities income, the deduction is reduced by three percent of the least of the taxpayer's oil related qualified production activities income, qualified production activities income, or taxable income (determined without regard to the section 199 deduction) for the taxable year. Sec. 199(d)(9). For this purpose, oil related qualified production activities income for any taxable year is the portion of qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (within the meaning of section 927(a)(2)(C) as in effect before its repeal) during the taxable year. Sec. 199(d)(9).

[967] This example assumes the deduction does not exceed the wage limitation discussed below.

[968] Sec. 199(c)(1). In computing qualified production activities income, the domestic production activities deduction itself is not an allocable deduction. Sec. 199(c)(1)(B)(ii). See Treas. Reg. secs. 1.199–1 through 1.199–9 where the Secretary has prescribed rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining qualified production activities income.

[969] Qualifying production property generally includes any tangible personal property, computer software, and sound recordings. Sec. 199(c)(5).

[970] When used in the Code in a geographical sense, the term "United States" generally includes only the States and the District of Columbia. Sec. 7701(a)(9). A special rule for determining domestic production gross receipts, however, provides that for taxable years beginning

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rental, or license, of qualified film[971] produced by the taxpayer; (3) any sale, exchange, or other disposition, or any lease, rental, or license, of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.[972]

The amount of the deduction for a taxable year is limited to 50 percent of the W–2 wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.[973]

Agricultural and horticultural cooperatives

With regard to member-owned agricultural and horticultural cooperatives formed under Subchapter T of the Code, section 199 provides the same treatment of qualified production activities income derived from agricultural or horticultural products that are manufactured, produced, grown, or extracted by cooperatives,[974] or that are marketed through cooperatives, as it provides for qualified production activities income of other taxpayers (*i.e.*, the cooperative may claim a deduction from qualified production activities income).

In addition, section 199(d)(3)(A) provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative (to which Part I of Subchapter T applies), which is allocable to the portion of qualified production activities income of the cooperative that is deductible under the provision, is deductible from the gross income of the member. In order to qualify, such amount must be designated by the organization as allocable to the deductible portion of qualified production activities income in a written notice mailed to its patrons not later than the payment period described in section 1382(d). In addition, section 199(d)(3)(B) provides that the coopera-

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after December 31, 2005, and before January 1, 2017, in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term "United States" includes the Commonwealth of Puerto Rico, but only if all of the taxpayer's Puerto Rico-sourced gross receipts are taxable under the Federal income tax for individuals or corporations for such taxable year. See sections 199(d)(8)(A) and (C). Such special rule was extended to taxable years beginning before January 1, 2018, by the Bipartisan Budget Act of 2018, Pub. L. No. 115–123, February 9, 2018. In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico. Sec. 199(d)(8)(B).

[971] Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers. Sec. 199(c)(6).

[972] Sec. 199(c)(4)(A).

[973] Sec. 199(b)(1). For purposes of the provision, "W–2 wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and designated Roth contributions as defined in section 402A. See sec. 199(b)(2)(A). The wage limitation for qualified films includes any compensation for services performed in the United States by actors, production personnel, directors, and producers and is not restricted to W–2 wages. Sec. 199(b)(2)(D).

[974] For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative.

tive cannot reduce its income under section 1382 (*e.g.*, cannot claim a dividends-paid deduction) for such amounts.

Explanation of Provision

The provision repeals the deduction for income attributable to domestic production activities.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

As the enactment of section 199A is also effective for taxable years beginning after December 31, 2017,[975] any item taken into account in determining the qualified production activities income of the taxpayer under former section 199 cannot be taken into account in determining the combined qualified business income amount of the taxpayer under section 199A. For example, assume that an individual holds an interest in a fiscal-year partnership or S corporation, the taxable year of which began before January 1, 2018, and ends within or with the individual's first taxable year beginning after December 31, 2017 (*e.g.*, the individual's 2018 calendar taxable year). The individual's share of any item from the partnership or S corporation that constitutes qualified business income, qualified REIT dividends, qualified cooperative dividends,[976] and qualified publicly traded partnership income and that is taken into account in determining taxable income for the individual's 2018 taxable year is eligible for the section 199A deduction. However, the individual's share of any item from the partnership or S corporation that would otherwise be taken into account in determining qualified production activities income for the individual's 2018 taxable year is not eligible for the former section 199 deduction, as former section 199 is repealed for taxable years beginning after December 31, 2017.

F. Denial of Deduction for Certain Fines, Penalties, and Other Amounts (sec. 13306 of the Act and sec. 162 of the Code)

Prior Law

In general

The Code denies a deduction for fines or penalties paid to a government for the violation of any law.[977]

Explanation of Provision

The provision denies deductibility for any otherwise deductible amount paid or incurred (whether by suit, agreement, or otherwise) to or at the direction of a government or specified nongovernmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation

[975] For a discussion of the effective date of the enactment of section 199A, see the description of section 11011 of the Act (Deduction for Qualified Business Income).

[976] As originally enacted. Modifications enacted March 23, 2018, are described in the Appendix.

[977] Sec. 162(f).

of any law. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property) or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement as restitution, remediation, or required to come into compliance. In the case of any amount of restitution for failure to pay any tax and assessed as restitution under the Code, such restitution is deductible only to the extent it would have been allowed as a deduction if it had been timely paid. The IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made. Restitution or included remediation of property does not include reimbursement of government investigative or litigation costs.

An exception also applies to any amount paid or incurred as taxes due.[978]

The provision applies only where a government (or other entity treated in a manner similar to a government under the provision) is a complainant or investigator with respect to the violation or potential violation of any law.[979] The provision requires government agencies (or entities treated as such agencies under the provision) to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least $600 (or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure the efficient administration of the internal revenue laws). The report must separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The report must be made at the time the agreement is entered into, as determined by the Secretary of the Treasury.

Effective Date

The provision denying the deduction and the reporting provision are effective for amounts paid or incurred on or after the date of enactment (*i.e.,* December 22, 2017), except that they do not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Such exception does not apply to an order or agreement requiring court approval unless the approval was obtained before such date.

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[978] Thus, amounts paid or incurred as taxes due are not affected by the provision (*e.g.,* State taxes that are otherwise deductible). The reference to taxes due is also intended to include interest with respect to such taxes (but not interest, if any, with respect to any penalties imposed with respect to such taxes).

[979] Thus, for example, the provision does not apply to payments made by one private party to another in a lawsuit between private parties, merely because a judge or jury acting in the capacity as a court directs the payment to be made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause the payment to be made "at the direction of a government" for purposes of the provision.

G. Denial of Deduction for Settlements Subject to Nondisclosure Agreements Paid in Connection with Sexual Harassment or Sexual Abuse (sec. 13307 of the Act and sec. 162 of the Code)

Prior Law

In general

A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[980] However, certain exceptions apply. No deduction is allowed for: (1) any charitable contribution or gift that exceeds the amount allowable as a deduction under section 170; (2) any illegal bribe, illegal kickback, or other illegal payment; (3) certain lobbying and political expenditures; (4) any fine or similar penalty paid to a government for the violation of any law; (5) two-thirds of treble damage payments under the antitrust laws; (6) certain foreign advertising expenses; (7) certain amounts paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person; or (8) certain applicable employee remuneration.

Explanation of Provision

Under the provision, no deduction is allowed for any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement. In addition, in the case of the taxpayer for whom a deduction is disallowed, no deduction is allowed for attorney's fees related to such settlement or payment. Any attorney's fees incurred by the beneficiary of the settlement or recipient of the payment are not subject to this rule.[981]

Effective Date

The provision is effective for amounts paid or incurred after the date of enactment (*i.e.,* December 22, 2017).

H. Repeal of Deduction for Local Lobbying Expenses (sec. 13308 of the Act and sec. 162 of the Code)

Prior Law

In general

A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[982] However, section 162(e) denies a deduction for amounts paid or incurred in connection with (1) influencing legislation,[983]

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[980] Sec. 162(a).

[981] A technical correction may be necessary to reflect this intent.

[982] Sec. 162(a).

[983] The term "influencing legislation" means any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of legislation. The term "legislation" includes actions with respect to Acts, bills, resolutions, or similar items by the Congress, any

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(2) participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office, (3) any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums, or (4) any direct communication with a covered executive branch official[984] in an attempt to influence the official actions or positions of such official. Expenses paid or incurred in connection with lobbying and political activities (such as research for, or preparation, planning, or coordination of, any previously described activity) also are not deductible.[985]

Exceptions

Local legislation

Notwithstanding the above, a deduction is allowed for ordinary and necessary expenses incurred in connection with any legislation of any local council or similar governing body ("local legislation").[986] With respect to local legislation, the exception permits a deduction for amounts paid or incurred in carrying on any trade or business (1) in direct connection with appearances before, submission of statements to, or sending communications to the committees or individual members of such council or body with respect to legislation or proposed legislation of direct interest to the taxpayer, or (2) in direct connection with communication of information between the taxpayer and an organization of which the taxpayer is a member with respect to any such legislation or proposed legislation which is of direct interest to the taxpayer and such organization, and (3) that portion of the dues paid or incurred with respect to any organization of which the taxpayer is a member which is attributable to the expenses of the activities described in (1) or (2) carried on by such organization.[987]

For purposes of this exception, legislation of an Indian tribal government is treated in the same manner as local legislation.[988]

De minimis

For taxpayers with $2,000 or less of in-house expenditures related to lobbying and political activities, a *de minimis* exception is provided that permits a deduction.[989]

Explanation of Provision

The provision repeals the exception for amounts paid or incurred related to lobbying local councils or similar governing bodies, including Indian tribal governments. Thus, the general disallowance

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State legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure. Secs. 162(e)(4) and 4911(e)(2).

[984] The term "covered executive branch official" means (1) the President, (2) the Vice President, (3) any officer or employee of the White House Office of the Executive Office of the President, and the two most senior level officers of each of the other agencies in such Executive Office, (4) any individual servicing in a position in level I of the Executive Schedule under section 5312 of title 5, United States Code, (5) any other individual designated by the President as having Cabinet-level status, and (6) any immediate deputy of an individual described in (4) or (5). Sec. 162(e)(6).

[985] Sec. 162(e)(5)(C).

[986] Sec. 162(e)(2)(A).

[987] Sec. 162(e)(2)(B).

[988] Sec. 162(e)(7).

[989] Sec. 162(e)(5)(B).

rules applicable to lobbying and political expenditures will apply to costs incurred related to such local legislation.

Effective Date

The provision applies to amounts paid or incurred on or after the date of enactment (*i.e.,* December 22, 2017).

I. Recharacterization of Certain Gains in the Case of Partnership Profits Interests Held in Connection with Performance of Investment Services (sec. 13309 of the Act and sec. 1061 of the Code)

Prior Law

Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxed upon the receipt of the partnership interest.[990]

In 1993, the IRS, referring to the litigation of the tax treatment of receiving a partnership profits interest and the results in the cases, issued administrative guidance that the IRS generally would treat the receipt of a partnership profits interest for services as not a taxable event for the partnership or the partner.[991] Under this guidance, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. More recent administrative guidance[992] clarifies that this treatment applies with respect to a substantially unvested profits interest provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.[993]

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating to the receipt of property for the performance of serv-

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[990] Only a handful of cases have addressed this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner,* 56 T.C. 530 (1971), aff'd 492 F.2d 286 (7th Cir. 1974)), a more recent case concluded that partnership profits interests were not includable on receipt, because the profits interests were speculative and without fair market value (*Campbell v. Commissioner,* 943 F. 2d 815 (8th Cir. 1991)).

[991] Rev. Proc. 93–27, 1993–2 C.B. 343, citing the *Diamond* and *Campbell* cases, *supra.*

[992] Rev. Proc. 2001–43, 2001–2 C.B. 191. This result applies under the guidance even if the interest is substantially nonvested on the date of grant.

[993] A similar result would occur under the "safe harbor" election under proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG–105346–03, 70 Fed. Reg. 29675, May 24, 2005.

ices.[994] A partnership capital interest for this purpose is an interest that would entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.[995]

Property received for services under section 83

In general

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the "service provider") generally must recognize income for the taxable year in which the property is first substantially vested (*i.e.,* transferable or not subject to a substantial risk of forfeiture).[996] The amount includible in the service provider's income is the excess of the fair market value of the property when it is substantially vested over the amount (if any) paid for the property. A deduction generally is allowed to the person for whom such services are performed (the "service recipient") equal to the amount included in gross income by the service provider. The deduction generally is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which the amount is included in the service provider's income.[997]

Property that is subject to a substantial risk of forfeiture and that is not transferable is generally referred to as "substantially nonvested." Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance (or refraining from performance) of substantial services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.

Section 83(b) election

Under section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may neverthe-

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[994] Secs. 61 and 83; Treas. Reg. sec. 1.721–1(b)(1); see *U.S. v. Frazell,* 335 F.2d 487 (5th Cir. 1964), *cert. denied,* 380 U.S. 961 (1965).

[995] Rev. Proc. 93–27, 1993–2 C.B. 343.

[996] The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. 70 Fed. Reg. 29675, May 24, 2005. The proposed regulations provide that a partnership interest is "property" for purposes of section 83. Thus, a compensatory transfer of a partnership interest is includible in the service provider's gross income at the time that it first becomes substantially vested (or, in the case of a substantially nonvested partnership interest, at the time of grant if a section 83(b) election is made). However, because the fair market value of a compensatory partnership interest is often difficult to determine, the proposed regulations also permit a partnership and a partner to elect a safe harbor under which the fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, in the case of a true profits interest in a partnership (one under which the partner would be entitled to nothing if the partnership were liquidated immediately following the grant), under the proposed regulations, the grant of a substantially vested profits interest (or, if a section 83(b) election is made, the grant of a substantially nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

[997] Sec. 83(h).

less elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a "section 83(b) election." The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

Passthrough tax treatment of partnerships

The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[998] Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower tax rates. A partner's basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership's tax status as a passthrough entity. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

Net long-term capital gain

In general, gain is not recognized and loss is not deductible for income tax purposes until a taxpayer disposes of an asset. The amount of gain recognized generally is included in income and the amount of loss sustained in a business or for profit transaction is generally deductible.

Special rules apply in the case of the sale or exchange of capital assets. In the case of an individual, estate, or trust, any adjusted net capital gain that otherwise would be taxed at the 10- or 15-percent rate is not taxed. Any adjusted net capital gain that otherwise would be taxed at rates over 15 percent and below 39.6 percent is taxed at a 15-percent rate. Any adjusted net capital gain that otherwise would be taxed at a 39.6-percent rate is taxed at a 20-percent rate.[999]

The adjusted net capital gain of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation.[1000]

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[998] Sec. 702.

[999] Sec. 1. Other rates apply to certain types of gain. The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate. In addition, a tax is imposed on net investment income in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income, which includes gains and dividends, or the excess of modified adjusted gross income over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in the case of any other individual.

[1000] Sec. 163(d).

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.

Net long term capital gain means the excess (if any) of gain from the sale or exchange of capital assets held more than one year over the loss from the sale or capital assets held more than one year (to the extent taken into account in computing income).

Net short term capital loss means the excess (if any) of loss from the sale or exchange of capital assets held for not more than one year over the gain from the sale or capital assets held for not more than one year (to the extent taken into account in computing income).

Explanation of Provision

In general

The provision provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer.

Interaction with section 83

The provision provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer, notwithstanding the rules of section 83 or any election in effect under section 83(b). The Congress wishes to clarify the interaction of section 83 with the provision's three-year holding requirement, which applies notwithstanding the rules of section 83 or any election in effect under section 83(b). Under the provision, the fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest. Thus, the provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (rather than one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

Short-term capital gain

The provision treats as short-term capital gain taxed at ordinary income tax rates the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies.[1001] In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

[1001] Sec. 1061(a). A net long-term capital gain is defined in section 1222(7) to mean the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.

A special rule provides that, as provided in regulations or other guidance issued by the Secretary, this rule does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third party investors. A third party investor means a person (1) who holds an interest in the partnership that is not property held in connection with an applicable trade or business (defined below) with respect to that person, and (2) who is not and has not been actively engaged in directly or indirectly providing substantial services for the partnership or any applicable trade or business (and is (or was) not related to a person so engaged). A related person for this purpose is a family member (within the meaning of attribution rules [1002]) or colleague that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

Applicable partnership interest

An applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business. The services may be performed by the taxpayer or by any other related person or persons [1003] in any applicable trade or business. It is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership, and the Treasury Department is directed to provide guidance implementing this intent. An applicable partnership interest does not include an interest held by a person who is employed by another entity that is conducting a trade or business (which is not an applicable trade or business) and who provides services only to the other entity.

An applicable partnership interest does not include an interest in a partnership directly or indirectly held by a corporation. For example, if two corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not applicable partnership interests. The term "corporation" for purposes of section 1061(c)(4)(A) does not include an S corporation, so a partnership interest held by an S corporation is not excluded from the term "applicable partnership interest."

An applicable partnership interest does not include any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed (as of the time the partnership interest was received), or commensurate with the value of the partnership interest that is taxed under section 83 on receipt or vesting of the partnership interest. For example, in the case of a partner who holds a capital interest in the partnership with respect to capital he or she contributed to the partnership, if the partnership agreement provides

[1002] Sec. 318(a)(1).

[1003] Although the provision does not supply a definition of a related person for purposes of the rule defining an applicable partnership interest in section 1061(c)(1), it is intended that for this purpose a related person means a related person within the meaning of section 267(b) or 707(b). A technical correction may be needed to carry out this intent.

that the partner's share of partnership capital is commensurate with the amount of capital he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent.

Applicable trade or business

An applicable trade or business means any activity (regardless of whether the activity is conducted in one or more entities) that consists in whole or in part of the following: (1) raising or returning capital, and either (2) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition), or (3) developing specified assets.

Developing specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider. Services performed as an employee of an applicable trade or business are treated as performed in an applicable trade or business for purposes of this rule. Merely voting shares owned or exercising the right to vote with respect to shares owned does not amount to development; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development.

Specified assets

Under the provision, specified assets means securities (generally as defined under rules for mark-to-market accounting for securities dealers), commodities (as defined under rules for mark-to-market accounting for commodities dealers), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means any (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified. For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm.

A partnership interest, for purposes of determining the proportionate interest of a partnership in any specified asset, includes

any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a hedge fund acquires an interest in a partnership that is neither publicly traded nor widely held and whose assets consist of stocks, bonds, positions that are clearly identified hedges with respect to securities, and commodities; the partnership interest is a specified asset for purposes of the provision.

Transfer of applicable partnership interest to related person

If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, then the taxpayer includes in gross income as short-term capital gain so much of the taxpayer's net long-term capital gain attributable to the sale or exchange of an asset held for not more than three years as is allowable to the interest. The amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of the provision (that is, amounts are not double-counted). A related person for this purpose is a family member (within the meaning of attribution rules [1004]) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

Reporting requirement

The Secretary is directed to require reporting (at the time in the manner determined by the Secretary) necessary to carry out the purposes of the provision. The penalties otherwise applicable to a failure to report to partners under section 6031(b) apply to failure to report under this requirement.

Regulatory authority

The Treasury Department is directed to issue regulations or other guidance necessary to carry out the purposes of the provision. Such guidance is to address prevention of the abuse of the purposes of the provision, including through the allocation of income to tax-indifferent parties. Guidance is also to provide for the application of the provision in the case of tiered structures of entities.

The Treasury Department and IRS have issued published guidance addressing this provision.[1005]

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

[1004] Sec. 318(a)(1).
[1005] Notice 2018–18, 2018–12 I.R.B. 443, March 19, 2018.

J. Prohibition on Cash, Gift Cards, and Other Nontangible Personal Property as Employee Achievement Awards (sec. 13310 of the Act and secs. 74(c) and 274(j) of the Code)

Prior Law

An employer's deduction for the cost of an employee achievement award is limited to a certain amount.[1006] Employee achievement awards that are deductible by an employer (or would be deductible but for the fact that the employer is a tax-exempt organization) are excludible from an employee's gross income.[1007] Amounts attributable to employee achievement awards that are excludible from gross income under section 74(c) for income tax purposes are also excluded from wages for employment tax purposes.

Generally, an employee achievement award is an item of tangible personal property given to an employee in recognition of either length of service or safety achievement and presented as part of a meaningful presentation.[1008]

Explanation of Provision

The provision adds a definition of "tangible personal property" that may be considered a deductible employee achievement award. It provides that tangible personal property shall not include cash, cash equivalents, gift cards, gift coupons or gift certificates (other than arrangements conferring only the right to select and receive tangible personal property from a limited array of such items preselected or preapproved by the employer), or vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items. No inference is intended that this is a change from prior law and guidance.

Effective Date

The provision applies to amounts paid or incurred after December 31, 2017.

K. Elimination of Deduction for Living Expenses Incurred by Members of Congress (sec. 13311 of the Act and sec. 162 of the Code)

Prior Law

Section 162 generally permits a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Such expenses include certain traveling expenses while temporarily (within a one-year period) away from home in the pursuit of a trade or business. For this purpose, the place of residence of a Member of Congress within the State, congressional district, or possession that he or she represents is considered the Member's home, but amounts expended for living expenses in excess of $3,000 within a taxable year are not deductible.

[1006] Secs. 274(j)(1) and (2).
[1007] Sec. 74(c).
[1008] Sec. 274(j)(3).

Explanation of Provision

The provision repeals the deduction for living expenses of Members of Congress.

Effective Date

The provision is effective for taxable years beginning after the date of enactment of the Act (*i.e.*, December 22, 2017).

L. Certain Contributions by Governmental Entities Not Treated as Contributions to Capital (sec. 13312 of the Act and sec. 118 of the Code)

Prior Law

The gross income of a corporation does not include any contribution to its capital.[1009] For purposes of this rule, a contribution to the capital of a corporation does not include any contribution in aid of construction or any other contribution from a customer or potential customer.[1010] A special rule allows certain contributions in aid of construction received by a regulated public utility that provides water or sewerage disposal services to be treated as a tax-free contribution to the capital of the utility.[1011] No deduction or credit is allowed for, or by reason of, any expenditure that constitutes a contribution that is treated as a tax-free contribution to the capital of the utility.[1012] Section 118 applies only to corporations.

If property is acquired by a corporation as a contribution to capital and is not contributed by a shareholder as such, the adjusted basis of the property is zero.[1013] If the contribution consists of money, the corporation must first reduce the basis of any property acquired with the contributed money within the following 12-month period, and then reduce the basis of other property held by the corporation.[1014] Similarly, the adjusted basis of any property acquired by a utility with a contribution in aid of construction is zero.[1015]

Explanation of Provision

The provision provides that the term "contribution to the capital of the taxpayer" does not include (1) any contribution in aid of construction (without exception)[1016] or any other contribution as a customer or potential customer, and (2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such). Thus, for example, a municipal tax abatement for locating a business in a particular municipality is not considered a contribution to capital of the corporation. The provision instructs the Secretary to issue such regulations or other guidance as may be necessary or appropriate to carry out this section, including regulations or other guidance for determining

[1009] Sec. 118(a).
[1010] Sec. 118(b).
[1011] Sec. 118(c)(1).
[1012] Sec. 118(c)(4).
[1013] Sec. 362(c)(1).
[1014] Sec. 362(c)(2). See also Treas. Reg. sec. 1.362–2.
[1015] Sec. 118(c)(4).
[1016] The special rules for water and sewerage disposal utilities are repealed.

whether any contribution constitutes a contribution in aid of construction.

Effective Date

In general, the provision applies to contributions made after the date of enactment (*i.e.*, December 22, 2017). The provision does not apply to any contribution made after December 22, 2017, by a governmental entity which is made pursuant to a master development plan that has been approved prior to such date by a governmental entity.

M. Repeal of Rollover of Publicly Traded Securities Gain into Specialized Small Business Investment Companies (sec. 13313 of the Act and former sec. 1044 of the Code)

Prior Law

A corporation or individual may elect to roll over tax-free any capital gain realized on the sale of publicly-traded securities to the extent of the taxpayer's cost of purchasing common stock or a partnership interest in a specialized small business investment company within 60 days of the sale.[1017] The amount of gain that an individual may elect to roll over for a taxable year is limited to (1) $50,000 or (2) $500,000 reduced by the gain previously excluded.[1018] For corporations, these limits are $250,000 and $1 million, respectively.[1019]

Explanation of Provision

The provision repeals the election to roll over tax-free capital gain realized on the sale of publicly-traded securities.

Effective Date

The provision applies to sales after December 31, 2017.

N. Certain Self-Created Property Not Treated as a Capital Asset (sec. 13314 of the Act and sec. 1221(a)(3) of the Code)

Prior Law

In general, property held by a taxpayer (whether or not connected with his trade or business) is considered a capital asset.[1020] Certain assets, however, are specifically excluded from the definition of capital asset. Such excluded assets are: inventory property, property of a character subject to depreciation (including real property),[1021] certain self-created intangibles, accounts or notes receivable acquired in the ordinary course of business (*e.g.*, for providing services or selling property), publications of the U.S. Government

[1017] Sec. 1044(a).
[1018] Sec. 1044(b)(1).
[1019] Sec. 1044(b)(2).
[1020] Sec. 1221(a).
[1021] The net gain from the sale, exchange, or involuntary conversion of certain property used in the taxpayer's trade or business (in excess of depreciation recapture) is treated as long-term capital gain. Sec. 1231. However, net gain from such property is treated as ordinary income to the extent that losses from such property in the previous five years were treated as ordinary losses. Sec. 1231(c).

received by a taxpayer other than by purchase at the price offered to the public, commodities derivative financial instruments held by a commodities derivatives dealer unless established to the satisfaction of the Secretary that any such instrument has no connection to the activities of such dealer as a dealer and clearly identified as such before the close of the day on which it was acquired, originated, or entered into, hedging transactions clearly identified as such, and supplies regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.[1022]

Self-created intangibles subject to the exception are copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property which is held either by the taxpayer whose personal efforts created the property, or (in the case of a letter, memorandum, or similar property) a taxpayer for whom the property was produced.[1023] For the purpose of determining gain, a taxpayer with a transferred basis from the taxpayer whose personal efforts created the property, or for whom the property was created, also is subject to the exception.[1024] However, a taxpayer may elect to treat musical compositions and copyrights in musical works as capital assets.[1025]

Since the intent of Congress is that profits and losses arising from everyday business operations be characterized as ordinary income and loss, the general definition of capital asset is narrowly applied and the categories of exclusions are broadly interpreted.[1026]

Explanation of Provision

This provision amends section 1221(a)(3), resulting in the exclusion of a patent, invention, model or design (whether or not patented), and a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) from the definition of a "capital asset." Thus, gains or losses from the sale or exchange of a patent, invention, model or design (whether or not patented), or a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) will not receive capital gain treatment under section 1221.[1027]

[1022] Sec. 1221(a)(1)–(8).

[1023] Sec. 1221(a)(3)(A) and (B).

[1024] Sec. 1221(a)(3)(C).

[1025] Sec. 1221(b)(3). Thus, if a taxpayer who owns musical compositions or copyrights in musical works that the taxpayer created (or if a taxpayer to which the musical compositions or copyrights have been transferred by the works' creator in a substituted basis transaction) elects the application of this provision, gain from a sale of the compositions or copyrights is treated as capital gain, not ordinary income.

[1026] *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 52 (1955).

[1027] However, consistent with prior law, the transfer (other than by gift, inheritance, or devise) of a patent by an individual that created the patent, or any other individual who acquired an interest in the patent in an exchange for consideration in money (*i.e.*, an exchange that did not result in a substituted or transferred basis in the patent) prior to the actual reduction to practice of the invention covered by the patent (where such other individual is not the employer of the creator or related to the creator), is treated as a sale or exchange of a capital asset held for more than one year. See section 1235.

Effective Date

The provision applies to dispositions after December 31, 2017.

PART V—BUSINESS CREDITS

A. Modification of Orphan Drug Credit (sec. 13401 of the Act and secs. 45C and 280C of the Code)

Prior Law

Section 45C provides a 50-percent business tax credit for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as "orphan drugs." Qualified clinical testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration ("FDA") but before the drug has been approved for sale by the FDA.[1028] A rare disease or condition is defined as one that (1) affects fewer than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from sales in the United States of the drug.[1029]

Amounts included in computing the credit under this section are excluded from the computation of the research credit under section 41.[1030]

No deduction is allowed for the portion of otherwise allowable qualified clinical testing expenses equal to the amount of the orphan drug credit allowed for the taxable year.[1031]

Explanation of Provision

The provision reduces the credit rate to 25 percent of qualified clinical testing expenses. The provision also allows taxpayers to elect a reduced orphan drug credit rather than having their otherwise allowable deduction for qualified clinical testing expenses reduced by that amount. If an election is made, the orphan drug credit is reduced by an amount equal to that credit multiplied by the highest corporate tax rate.

Effective Date

The provision applies to amounts paid or incurred in taxable years beginning after December 31, 2017.

[1028] Sec. 45C(b).
[1029] Sec. 45C(d).
[1030] Sec. 45C(c).
[1031] Sec. 280C(b).

B. Rehabilitation Credit Limited to Certified Historic Structures (sec. 13402 of the Act and sec. 47 of the Code)

Prior Law

Section 47 provides a two-tier tax credit for rehabilitation expenditures.

A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. A pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

Explanation of Provision

The provision repeals the 10-percent credit for pre-1936 buildings.

The provision retains the 20-percent credit for qualified rehabilitation expenditures with respect to a certified historic structure, with a modification. Under the provision, the credit allowable for a taxable year during the five-year period beginning in the taxable year in which the qualified rehabilitated building is placed in service is an amount equal to the ratable share. The ratable share for a taxable year during the five-year period is amount equal to 20 percent of the qualified rehabilitation expenditures for the building, as allocated ratably to each taxable year during the five-year period. Congress intended that the sum of the ratable shares for the taxable years during the five-year period does not exceed 100 percent of the credit for qualified rehabilitation expenditures for the qualified rehabilitated building.

Effective Date

The provision applies to amounts paid or incurred after December 31, 2017.

A transition rule provides that in the case of qualified rehabilitation expenditures (for either a certified historic structure or a pre-1936 building), with respect to any building owned or leased (as provided under prior law) by the taxpayer at all times on and after

January 1, 2018, the 24-month period selected by the taxpayer (section 47(c)(1)(C)(i)), or the 60-month period selected by the taxpayer under the rule for phased rehabilitation (section 47(c)(1)(C)(ii)), is to begin not later than the end of the 180-day period beginning on the date of the enactment of the Act, and the amendments made by the provision apply to such expenditures paid or incurred after the end of the taxable year in which such 24-month or 60-month period ends.

C. Employer Credit for Paid Family and Medical Leave (sec. 13403 of the Act and new sec. 45S of the Code)

Prior Law

The Family and Medical Leave Act of 1993, as amended (the "FMLA"), generally requires employers to provide employees with up to 26 weeks of leave under certain circumstances.[1032] The FMLA does not require that the employer continue to pay employees during such leave, although employers may choose to pay for all or a portion of such leave. State and local governments may provide, or State and local laws may require employers to provide, employees with up to a certain amount of paid leave for types of leave that may or may not fall under the FMLA.

Compensation paid to employees during FMLA leave is generally deductible as an ordinary and necessary business expense. Such compensation constitutes wages taxable to the employee for income and employment tax purposes. Although the wages may be taken into account in the computation of the general business credit[1033] as part of the computation of those credits that are computed with respect to qualified wages paid,[1034] prior law does not otherwise provide a credit to employers for compensation paid to employees while on leave.

Explanation of Provision

The provision temporarily allows "eligible employers" to claim a general business credit equal to 12.5 percent of the amount of eligible wages (based on the normal hourly wage rate)[1035] paid to "qualifying employees" during any period in which such employees are on "family and medical leave" if the rate of payment under the program is 50 percent of the wages normally paid to an employee for actual services performed for the employer. The credit is increased by 0.25 percentage points (but not above 25 percent) for each percentage point by which the rate of payment exceeds 50 percent. The maximum amount of family and medical leave that may be taken into account with respect to any qualifying employee for any taxable year is 12 weeks.

[1032] Pub. L. No. 103–3 (Feb. 5, 1993); 29 U.S.C. sec. 2601, *et seq.*

[1033] Under section 38 and applicable rules.

[1034] See, *e.g.*, sec. 45A (Indian employment credit) and sec. 51 (work opportunity tax credit).

[1035] Wages for this purpose are Federal Unemployment Tax Act wages defined in section 3306(b), without regard to the dollar limitation, but do not include amounts taken into account for purposes of determining any other credit under subpart D of the Code. A technical correction may be necessary to reflect that the wages with respect to the credit are limited to the employee's normal hourly wage rate and do not include additional amounts, such as a bonus, that could be paid during the leave period.

An "eligible employer" is one which has in place a written policy that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and which allows all less-than-full-time qualifying employees a commensurate amount of leave (on a *pro rata* basis) compared to the leave provided to full-time employees. The policy must also provide that the rate of payment under the program is not less than 50 percent of the wages normally paid to any such employee for services performed for the employer.

In addition, in order to be an eligible employer, the employer is prohibited from certain practices or acts which are also prohibited under the FMLA, regardless of whether the employer is subject to the FMLA. Specifically, the employer must provide paid family and medical leave in compliance with a written policy that ensures that the employer will not interfere with, restrain, or deny the exercise of or the attempt to exercise, any right provided under the policy and will not discharge or in any other manner discriminate against any individual for opposing any practice prohibited by the policy.

The provision treats all members of an aggregated group [1036] as a single employer, other than for purposes of the requirement for an employer to have in place a written policy with certain terms.[1037] In other words, the aggregation rule does not prevent an employer within an aggregated group from qualifying for the credit notwithstanding that other employers within the same aggregated group do not have the required written policy. However, the terms (the offer, the actual benefit, etc.) of the employer's paid leave cannot be discriminatory based on taking into account all employees of all employers otherwise treated as a single employer under the provision. For example, if employees who earn below a certain threshold (such as $20,000 annually) are employed by one or more employers within the aggregated group that do not have the required written policy in place, while employees earning above $20,000 are employed by another employer in the group having the required written policy (Employer A), Employer A is not an eligible employer. Similarly, if employees are separately employed by category or position (such as part-time employees, or administrative employees) on a discriminatory basis for purposes of providing paid family and medical leave, this results in failure to be an eligible employer.

A "qualifying employee" means any individual who is an employee under tax rules and principles and is defined in section 3(e) of the Fair Labor Standards Act of 1938,[1038] as amended, who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60 percent of the compensation threshold for highly compensated employees.[1039] For 2018, this 60 percent amount is $72,000.

"Family and medical leave" for purposes of new section 45S is generally defined as leave described under sections 102(a)(1)(A)–(E) or 102(a)(3) of the FMLA.[1040] If an employer provides paid leave

[1036] Under subsections (a) and (b) of section 52.
[1037] A technical correction may be necessary to reflect this intent.
[1038] Pub. L. No. 75–718 (June 25, 1938); 29 U.S.C. sec. 201, *et seq.*
[1039] Sec. 414(q)(1)(B) ($120,000 for 2018).
[1040] FMLA section 102(a)(1) provides leave for FMLA purposes due to (A) the birth of a son or daughter of the employee and in order to care for such son or daughter; (B) the placement

as vacation leave, personal leave, or other medical or sick leave[1041] (unless the medical or sick leave is specifically for one or more of the "family and medical leave" purposes defined above), such paid leave would not be considered to be family and medical leave. In addition, leave paid for by a State or local government or required by State or local law (including such leave required to be paid by the employer) is not taken into account in determining the amount of paid family and medical leave provided by the employer that is eligible for the credit.

The Secretary will make determinations as to whether an employer or an employee satisfies the applicable requirements for an eligible employer or qualifying employee, based on information provided by the employer that the Secretary determines to be necessary or appropriate.

The following examples illustrate the operation of the interaction between State or local government mandated paid leave and the credit. Assume that in each of the examples 1 through 3 below, a State mandates that an employer provide two weeks of family and medical leave at a rate of 50 percent of its employees' normal hourly wage rate. For purposes of the examples, assume that all other applicable requirements of section 45S are met (including that employees are qualifying employees) unless otherwise indicated:

Example 1.—Assume that the employer provides its employees with four weeks of paid leave, at 50 percent of the employees' normal hourly wage rate. Under this fact pattern, the employer would be eligible for a credit of 12.5 percent of the eligible wages paid with respect to weeks three and four of paid leave, as those payments constitute two weeks of non-mandated paid leave at 50 percent of the employees' normal hourly wage rate.

Example 2.—Assume that the employer provides its employees with three weeks of paid leave, at 50 percent of the employees' normal hourly wage rate. Under this fact pattern, the employer would not be eligible for the credit under section 45S. Although the employer pays its employees a total of three weeks' compensation at 50 percent of the employees' normal hourly wage rate, because the compensation for two of those weeks are mandated by State law, under 45S(c)(4), that compensation is disregarded for purposes of the credit. Thus, the employer provides only one week of non-mandated paid leave at 50 percent of its employees' normal hourly wage rate, and fails to qualify as an eligible employer under 45S(c)(1)(A).

Example 3.—Assume that the employer provides its employees with two weeks of paid leave, at 100 percent of the employees' normal hourly wage rate. Under this fact pattern, the employer would be eligible for a credit of 12.5 percent of the eligible wages paid with respect to the two weeks of paid leave. The employer has pro-

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of a son or daughter with the employee for adoption or foster care; (C) caring for the spouse, or a son, daughter, or parent, of the employee, if such spouse, son, daughter, or parent has a serious health condition; (D) a serious health condition that makes the employee unable to perform the functions of the employee's position; (E) any qualifying exigency (as the Secretary of Labor shall, by regulation, determine) arising out of the fact that the spouse, or a son, daughter, or parent of the employee is on covered active duty (or has been notified of an impending call or order to covered active duty) in the Armed Forces. In addition, FMLA section 102(a)(3) provides leave for FMLA purposes due to the need of an employee who is a spouse, son, daughter, parent, or next-of-kin of an eligible service member to care for such service member.

[1041] These terms mean these types of leave within the meaning of FMLA section 102(d)(2).

vided non-mandated paid leave at 50 percent of the employees' normal hourly wage rate for two weeks, and thus qualifies for the credit under section 45S. The employer may not receive a credit at a rate in excess of 12.5 percent, notwithstanding that the total compensation paid to its employees on family and medical leave was 100 percent of the normal hourly wage rate, because 50 percent of the paid leave provided by the employer was mandated by State law.[1042]

Example 4.—Assume instead that the State requires only that an employer offer four weeks of unpaid family and medical leave. If the employer were to provide its employees with two weeks of paid leave at 50 percent of its employees' normal hourly wage rate, the employer would be eligible for a credit of 12.5 percent of the wages paid with respect to those two weeks of paid leave, as those payments constitute two weeks of non-mandated paid leave at 50 percent of the employees' normal hourly wage rate.

The Treasury Department has issued published guidance addressing this provision.[1043]

Effective Date

The provision is generally effective for wages paid in taxable years beginning after December 31, 2017, and before January 1, 2020.

D. Repeal of Tax Credit Bonds (sec. 13404 of the Act and former secs. 54A, 54B, 54C, 54D, 54E, 54F and 6431 of the Code)

Prior Law

In general

Tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost. The borrowing subsidy generally is measured by reference to the credit rate set by the Treasury Department. Current tax-credit bonds include qualified tax credit bonds, which have certain common general requirements, and include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds, and qualified school construction bonds.[1044]

[1042] If this example instead assumed that the State required an employer to provide paid leave at a rate of only 40 percent of its employees' normal hourly wage rate, then the employer would be eligible for a credit based on 15 percent of the employees' wages (as the employer would have paid non-State mandated compensation of 60 percent of the employees' normal hourly wage rate under this fact pattern). Alternatively, if the example instead assumed that the State required an employer to pay 60 percent of its employees' normal hourly wage rate, the employer could not qualify for the section 45S credit if the employer paid its employees 100 percent of their normal hourly wage rate (because the amount of non-State mandated paid leave from the employer does not equal or exceed 50 percent of the employee's normal hourly wage rate).

[1043] Notice 2018–71, 2018–41 I.R.B.548.

[1044] The authority to issue two other types of tax-credit bonds, recovery zone economic development bonds and Build America Bonds, expired on January 1, 2011.

Qualified tax-credit bonds

General rules applicable to qualified tax-credit bonds[1045]

Unlike tax-exempt bonds, qualified tax-credit bonds generally are not interest-bearing obligations. Rather, the taxpayer holding a qualified tax-credit bond on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit rate for an issue of qualified tax credit bonds is determined by the Secretary and is estimated to be a rate that permits issuance of the qualified tax-credit bonds without discount and interest cost to the qualified issuer.[1046] The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

New clean renewable energy bonds

New clean renewable energy bonds ("New CREBs"') may be issued by qualified issuers to finance qualified renewable energy facilities.[1047] Qualified renewable energy facilities are facilities that: (1) qualify for the tax credit under section 45 (other than Indian coal and refined coal production facilities), without regard to the placed-in-service date requirements of that section; and (2) are owned by a public power provider, governmental body, or cooperative electric company.

The term "qualified issuers" includes: (1) public power providers; (2) a governmental body; (3) cooperative electric companies; (4) a not-for-profit electric utility that has received a loan or guarantee under the Rural Electrification Act; and (5) clean renewable energy bond lenders. There was originally a national limitation for New CREBs of $800 million. The national limitation was then increased by an additional $1.6 billion in 2009. As with other tax credit bonds, a taxpayer holding New CREBs on a credit allowance date is entitled to a tax credit. However, the credit rate on New CREBs is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.[1048]

Qualified energy conservation bonds

Qualified energy conservation bonds may be used to finance qualified conservation purposes.

The term "qualified conservation purpose" means:

[1045] Certain other rules apply to qualified tax credit bonds, such as maturity limitations, reporting requirements, spending rules, and rules relating to arbitrage. Separate rules apply in the case of tax-credit bonds which are not qualified tax-credit bonds (*i.e.*, "recovery zone economic development bonds," and "Build America Bonds").

[1046] However, for new clean renewable energy bonds and qualified energy conservation bonds, the applicable credit rate is 70 percent of the otherwise applicable rate.

[1047] Sec. 54C.

[1048] Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

- Capital expenditures incurred for purposes of: (a) reducing energy consumption in publicly owned buildings by at least 20 percent; (b) implementing green community programs;[1049] (c) rural development involving the production of electricity from renewable energy resources; or (d) any facility eligible for the production tax credit under section 45 (other than Indian coal and refined coal production facilities);
- Expenditures with respect to facilities or grants that support research in: (a) development of cellulosic ethanol or other nonfossil fuels; (b) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; (c) increasing the efficiency of existing technologies for producing nonfossil fuels; (d) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; and (e) technologies to reduce energy use in buildings;
- Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;
- Demonstration projects designed to promote the commercialization of: (a) green building technology; (b) conversion of agricultural waste for use in the production of fuel or otherwise; (c) advanced battery manufacturing technologies; (d) technologies to reduce peak-use of electricity; and (e) technologies for the capture and sequestration of carbon dioxide emitted from combusting fossil fuels in order to produce electricity; and
- Public education campaigns to promote energy efficiency (other than movies, concerts, and other events held primarily for entertainment purposes).

There was originally a national limitation on qualified energy conservation bonds of $800 million. The national limitation was then increased by an additional $2.4 billion in 2009. As with other qualified tax credit bonds, the taxpayer holding qualified energy conservation bonds on a credit allowance date is entitled to a tax credit. The credit rate on the bonds is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.[1050]

Qualified zone academy bonds

A qualified zone academy bond ("QZABs") is defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy," and (2) private entities have promised to contribute to

[1049] Capital expenditures to implement green community programs include grants, loans, and other repayment mechanisms to implement such programs. For example, States may issue these tax credit bonds to finance retrofits of existing private buildings through loans and/or grants to individual homeowners or businesses, or through other repayment mechanisms. Other repayment mechanisms can include periodic fees assessed on a government bill or utility bill that approximates the energy savings of energy efficiency or conservation retrofits. Retrofits can include heating, cooling, lighting, water-saving, storm water-reducing, or other efficiency measures.

[1050] Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A total of $400 million of QZABs has been authorized to be issued annually in calendar years 1998 through 2008. The authorization was increased to $1.4 billion for calendar year 2009, and also for calendar year 2010. For each of the calendar years 2011 through 2016, the authorization was set at $400 million.

Qualified school construction bonds

Qualified school construction bonds must meet three requirements: (1) 100 percent of the available project proceeds of the bond issue is used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a bond-financed facility is to be constructed; (2) the bonds are issued by a State or local government within which such school is located; and (3) the issuer designates such bonds as qualified school construction bonds.

There is a national limitation on qualified school construction bonds of $11 billion for calendar years 2009 and 2010, and zero after 2010. If an amount allocated is unused for a calendar year, it may be carried forward to the following and subsequent calendar years. Under a separate special rule, the Secretary of the Interior may allocate $200 million of school construction bond authority for Indian schools.

Direct-pay bonds and expired tax-credit bond provisions

The Code provides that an issuer may elect to issue certain tax-credit bonds as "direct-pay bonds." Instead of a credit to the holder, with a "direct-pay bond" the Federal government pays the issuer a percentage of the interest on the bonds. The following tax-credit bonds may be issued as direct-pay bonds: new clean renewable energy bonds, qualified energy conservation bonds, and qualified school construction bonds. Qualified zone academy bonds may not be issued as direct-pay using any national zone academy bond allocation for calendar years after 2011 or any carryforward of such allocations. The ability to issue Build America Bonds and Recovery Zone bonds, which have direct-pay features, expired January 1, 2011.

Explanation of Provision

The provision prospectively repeals authority to issue tax-credit bonds and direct-pay bonds.

Effective Date

The provision applies to bonds issued after December 31, 2017.

PART VI—PROVISIONS RELATED TO SPECIFIC ENTITES AND INDUSTRIES

SUBPART A—PARTNERSHIPS PROVISIONS

A. Treatment of Gain or Loss of Foreign Persons from Sale or Exchange of Interests in Partnerships Engaged in Trade or Business Within the United States (sec. 13501 of the Act and secs. 864(c) and 1446 of the Code)

Prior Law

In general

A partnership generally is not treated as a taxable entity, but rather, income of the partnership is taken into account on the tax returns of the partners. The character (as capital or ordinary) of partnership items passes through to the partners as if the items were realized directly by the partners.[1051] A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower tax rates, and deducts its distributive share of partnership items of deduction and loss. A partner's basis in the partnership interest is increased by any amount of gain and decreased by any amount of losses thus included. These basis adjustments prevent double taxation of partnership income to the partner. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

Gain or loss from the sale or exchange of a partnership interest generally is treated as gain or loss from the sale or exchange of a capital asset.[1052] However, the amount of money and the fair market value of property received in the exchange that represent the partner's share of certain ordinary income-producing assets of the partnership give rise to ordinary income rather than capital gain.[1053] In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election to do so,[1054] or the partnership has a substantial built-in loss immediately after the transfer.[1055] If an election is in effect or the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner. These adjustments are to account for the difference between the transferee partner's proportionate share of the adjusted basis of the

[1051] Sec. 702.
[1052] Sec. 741; *Pollack v. Commissioner*, 69 T.C. 142 (1977).
[1053] Sec. 751(a). These ordinary income-producing assets are unrealized receivables of the partnership or inventory items of the partnership ("751 assets").
[1054] Sec. 754.
[1055] Sec. 743(a).

partnership property and the transferee partner's basis in its partnership interest.[1056] The effect of the adjustments on the basis of partnership property is to approximate the result of a direct purchase of the property by the transferee partner.

Source of gain or loss on transfer of a partnership interest

A foreign person that is engaged in a trade or business in the United States is taxed on income that is effectively connected with the conduct of that trade or business ("effectively connected gain or loss").[1057] Partners in a partnership are treated as engaged in the conduct of a trade or business within the United States if the partnership is so engaged.[1058] Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from the business.[1059]

Among the factors taken into account in determining whether income, gain, or loss is effectively connected gain or loss are the extent to which the income, gain, or loss is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the income, gain, or loss (the "asset-use" and "business-activities" tests).[1060] In determining whether the asset-use or business-activities tests are met, due regard is given to whether such assets or such income, gain, or loss were accounted for through such trade or business. Thus, notwithstanding the general rule that source of gain or loss from the sale or exchange of personal property is generally determined by the residence of the seller,[1061] a foreign partner may have effectively connected income by reason of the asset use or business activities of the partnership in which he is an investor.

Special rules apply to treat gain or loss from disposition of U.S. real property interests as effectively connected with the conduct of a U.S. trade or business.[1062] To the extent that consideration received by the nonresident alien or foreign corporation for all or part of its interest in a partnership is attributable to a U.S. real property interest, that consideration is considered to be received from the sale or exchange in the United States of such property.[1063] In certain circumstances, gain attributable to sales of U.S. real property interests may be subject to withholding tax of ten percent of the amount realized on the transfer.[1064]

Under a 1991 revenue ruling, the IRS ruled that the asset-use test and business-activities test should be applied to partnership assets to determine the extent to which income derived from the sale or exchange of a partnership interest is effectively connected

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[1056] Sec. 743(b).
[1057] Secs. 871(b), 864(c), and 882.
[1058] Sec. 875.
[1059] Secs. 871(b)(2) and 882(a)(2). Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, and is collected by withholding at the source of the payment. The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30 percent is fixed or determinable annual or periodical income that is not effectively connected with the conduct of a U.S. trade or business.
[1060] Sec. 864(c)(2).
[1061] Sec. 865(a).
[1062] Sec. 897(a) and (g).
[1063] Sec. 897(g).
[1064] Sec. 1445(e)(5). Temp. Treas. Reg. sec. 1.1445–11T(b) and (d).

with the partnership's U.S. business.[1065] Under the ruling, unrealized gain or loss in partnership assets that would be treated as effectively connected with the conduct of a U.S. trade or business if those assets were sold by the partnership is treated as effectively connected with the conduct of a U.S. trade or business. The ruling thus takes an aggregate approach to taxation of the sale of a partnership interest, treating such sale as a sale of the separate assets of the partnership rather than as a sale of an interest in the entity as a whole.

However, a 2017 Tax Court case, *Grecian Magnesite Mining v. Commissioner*, rejected the aggregate approach adopted by the ruling and instead held that the rules of subchapter K required that sale of a partnership interest be treated as sale of an interest in the entity as a whole rather than the sale or exchange of the underlying partnership property. Having reached that conclusion, the court then concluded that the gain from the taxpayer's sale of its partnership interest was income from sources outside the United States, did not satisfy any exception to the general rule that foreign-source income is not ECI, and thus was not effectively connected with the conduct of the partnership's trade or business in the United States.[1066]

Explanation of Provision

The provision overturns the result in *Grecian Magnesite* by treating gain or loss from the sale or exchange of a partnership interest as effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange.[1067] The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as non-separately stated income and loss.[1068]

The provision also requires the transferee of a partnership interest to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation.[1069] Congress intends that, under regulatory authority provided to carry out withholding requirements of the provision, the Secretary may provide guidance permitting a broker, as agent of the transferee, to deduct and withhold the tax equal to 10 percent of the amount realized on the disposition of a partnership interest to which the provision applies. If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.[1070]

[1065] Rev. Rul. 91–32, 1991–1 C.B. 107.

[1066] *See Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017). The IRS filed a notice of appeal with the U.S. Circuit Court of Appeals for the District of Columbia on December 18, 2017. *Grecian Magnesite Mining v. Commissioner*, No. 17–1269 (D.C. Cir. Filed Dec. 18, 2017). The IRS filed its opening brief in that appeal on June 8, 2018, Grecian Magnesite filed its brief on July 3, 2018, and the IRS filed a reply brief on August 6, 2018. Oral argument in the appeal was held on October 9, 2018.

[1067] Sec. 864(c)(8)(B).

[1068] *Ibid.*

[1069] Sec. 1446(f)(1).

[1070] Sec. 1446(f)(4).

The provision provides the Secretary of the Treasury with specific regulatory authority to issue such regulations as the Secretary determines appropriate for the application of the provision.[1071] Such guidance may identify other exchanges to which tax-free exchange treatment may otherwise apply, such as those described in sections 332, 351, 354, 355, 356, or 361, under comparable provisions of subchapter K, or under such other provisions that the Secretary determines appropriate.[1072]

The Treasury Department and IRS have issued published guidance addressing this provision.[1073]

Effective Date

The portion of the provision treating gain or loss on sale of a partnership interest as effectively connected income is effective for sales and exchanges on or after November 27, 2017. The portion of the provision requiring withholding on sales or exchanges of partnership interests is effective for sales and exchanges after December 31, 2017.

B. Modify Definition of Substantial Built-in Loss in the Case of Transfer of Partnership Interest (sec. 13502 of the Act and sec. 743(d) of the Code)

Prior Law

In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election under section 754 to make basis adjustments, or the partnership has a substantial built-in loss immediately after the transfer.[1074]

If an election is in effect, or if the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner. These adjustments are to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[1075] The adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner.

A substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.[1076] Certain securitization partnerships and electing investment partnerships are not treated as having a substantial built-in loss in certain instances, and thus are not required to make basis adjustments to partnership prop-

[1071] Secs. 864(c)(8)(E) and 1446(f)(6).
[1072] Sec. 864(c)(8)(E).
[1073] Notice 2018–8, 2018–7 I.R.B. 352 (Jan. 2, 2018); Notice 2018–29, 2018–16 I.R.B. 495 (Apr. 2, 2018).
[1074] Sec. 743(a).
[1075] Sec. 743(b).
[1076] Sec. 743(d).

erty.[1077] For electing investment partnerships, in lieu of the partnership basis adjustments, a partner-level loss limitation rule applies.[1078]

Explanation of Provision

The provision modifies the definition of a substantial built-in loss for purposes of section 743(d), affecting transfers of partnership interests. Under the provision, in addition to the prior- and present-law definition, a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

For example, a partnership of three taxable partners (partners A, B, and C) has not made an election pursuant to section 754. The partnership has two assets, one of which, Asset X, has a built-in gain of $1 million, while the other asset, Asset Y, has a built-in loss of $900,000. Pursuant to the partnership agreement, any gain on sale or exchange of Asset X is specially allocated to partner A. The three partners share equally in all other partnership items, including in the built-in loss in Asset Y. In this case, each of partner B and partner C has a net built-in loss of $300,000 (one third of the loss attributable to asset Y) allocable to his partnership interest. Nevertheless, the partnership does not have an overall built-in loss, but a net built-in gain of $100,000 ($1 million minus $900,000). Partner C sells his partnership interest to another person, D, for $33,333. Under the provision, the test for a substantial built-in loss applies both at the partnership level and at the transferee partner level. If the partnership were to sell all its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of $300,000 (one third of the built-in loss of $900,000 in Asset Y). A substantial built-in loss exists under the partner-level test added by the provision, and the partnership adjusts the basis of its assets accordingly with respect to D.

Effective Date

The provision applies to transfers of partnership interests after December 31, 2017.

C. Charitable Contributions and Foreign Taxes Taken into Account in Determining Limitation on Allowance of Partner's Share of Loss (sec. 13503 of the Act and sec. 704 of the Code)

Prior Law

A partner's distributive share of partnership loss (including capital loss) is allowed only to the extent of the adjusted basis (before reduction by current year's losses) of the partner's interest in the

[1077] See sec. 743(e) (alternative rules for electing investment partnerships) and sec. 743(f) (exception for securitization partnerships).

[1078] Unlike in the case of an electing investment partnership, the partner-level loss limitation rule does not apply for a securitization partnership.

partnership at the end of the partnership taxable year in which the loss occurred. Any disallowed loss is allowable as a deduction at the end of the first succeeding partnership taxable year, and subsequent taxable years, to the extent that the partner's adjusted basis for its partnership interest at the end of any such year exceeds zero (before reduction by the loss for the year).[1079]

A partner's basis in its partnership interest is increased by its distributive share of income (including tax exempt income). A partner's basis in its partnership interest is decreased (but not below zero) by distributions by the partnership and its distributive share of partnership losses and expenditures of the partnership not deductible in computing partnership taxable income and not properly chargeable to capital account.[1080] In the case of a charitable contribution, a partner's basis is reduced by the partner's distributive share of the adjusted basis of the contributed property.[1081]

A partnership computes its taxable income in the same manner as an individual with certain exceptions. The exceptions provide, in part, that the deductions for foreign taxes and charitable contributions are not allowed to the partnership.[1082] Instead, a partner takes into account its distributive share of the foreign taxes paid by the partnership and the charitable contributions made by the partnership for the taxable year.[1083]

However, in applying the basis limitation on partner losses, Treasury regulations do not take into account the partner's share of partnership charitable contributions and foreign taxes paid or accrued.[1084] The IRS has taken the position in a private letter ruling that the basis limitation on partner losses does not apply to limit the partner's deduction for its share of the partnership's charitable contributions.[1085] While the regulations relating to the loss limitation do not mention the foreign tax credit, a taxpayer may choose the foreign tax credit in lieu of deducting foreign taxes.[1086]

By contrast, under S corporation rules limiting the losses and deductions which may be taken into account by a shareholder of an S corporation to the shareholder's basis in stock and debt of the corporation, the shareholder's pro rata share of charitable contribu-

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[1079] Sec. 704(d) and Treas. Reg. sec. 1.704–1(d)(1).

[1080] Sec. 705(a).

[1081] Rev. Rul. 96–11, 1996–1 C. B. 140.

[1082] Sec. 703(a)(2)(B) and (C). In addition, section 703(a)(2) provides that other deductions are not allowed to the partnership, notwithstanding that the partnership's taxable income is computed in the same manner as an individual's taxable income, specifically: personal exemptions, net operating loss deductions, certain itemized deductions for individuals, or depletion.

[1083] Sec. 702.

[1084] The regulation provides that "[i]f the partner's distributive share of the aggregate of items of loss specified in section 702(a)(1), (2), (3), (8) [now (7)], and (9) [now (8)] exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss." The regulation does not refer to section 702(a)(4) (charitable contributions) and (6) (foreign taxes paid or accrued). Treas. Reg. sec. 1.704–1(d)(2).

[1085] Priv. Ltr. Rul. 8405084. See also William S. McKee, William F. Nelson and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, WG&L, 4th Edition (2011), paragraph 11.05[1][b], p. 11–214 (noting that the "failure to include charitable contributions in the section 704(d) limitation is an apparent technical flaw in the statute. Because of it, a zero-basis partner may reap the benefits of a partnership charitable contribution without an offsetting decrease in the basis of his interest, whereas a fellow partner who happens to have a positive basis may do so only at the cost of a basis decrease").

[1086] Sec. 901.

tions and foreign taxes are taken into account.[1087] In the case of charitable contributions, a special rule is provided prorating the amount of appreciation not subject to the limitation in the case of charitable contributions of appreciated property by the S corporation.[1088]

Explanation of Provision

The provision modifies the basis limitation on partner losses to provide that the limitation takes into account a partner's distributive share of partnership charitable contributions (as defined in section 170(c)) and taxes (described in section 901) paid or accrued to foreign countries and to possessions of the United States. Thus, the amount of the basis limitation on partner losses is decreased to reflect these items. In the case of a charitable contribution by the partnership, the amount of the basis limitation on partner losses is decreased by the partner's distributive share of the adjusted basis of the contributed property. In the case of a charitable contribution by the partnership of property whose fair market value exceeds its adjusted basis, a special rule provides that the basis limitation on partner losses does not apply to the extent of the partner's distributive share of the excess.

Effective Date

The provision applies to partnership taxable years beginning after December 31, 2017.

D. Repeal of Technical Termination of Partnerships (sec. 13504 of the Act and sec. 708(b) of the Code)

Prior Law

A partnership is considered as terminated under specified circumstances.[1089] Special rules apply in the case of the merger, consolidation, or division of a partnership.[1090]

A partnership is treated as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.[1091]

A partnership is also treated as terminated if within any 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.[1092] This is sometimes referred to as a technical termination. Under regulations, the technical termination gives rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners.[1093]

[1087] Sec. 1366(d) and (a)(1). Under a related rule, the shareholder's basis in his interest is decreased by the basis (rather than the fair market value) of appreciated property by reason of a charitable contribution of the property by the S corporation (sec. 1367(a)(2)).

[1088] Sec. 1366(d)(4).

[1089] Sec. 708(b)(1).

[1090] Sec. 708(b)(2). Mergers, consolidations, and divisions of partnerships take either an assets-over form or an assets-up form pursuant to Treas. Reg. sec. 1.708–1(c).

[1091] Sec. 708(b)(1)(A).

[1092] Sec. 708(b)(1)(B).

[1093] Treas. Reg. sec. 1.708–1(b)(4).

The effect of a technical termination is not necessarily the end of the partnership's existence, but rather the termination of some tax attributes. Upon a technical termination, the partnership's taxable year closes, potentially resulting in short taxable years.[1094] Partnership-level elections generally cease to apply following a technical termination.[1095] A technical termination generally results in the restart of partnership depreciation recovery periods.

Explanation of Provision

The provision repeals the section 708(b)(1)(B) rule providing for technical terminations of partnerships. The provision does not change the prior- and present-law rule of section 708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Effective Date

The provision applies to partnership taxable years beginning after December 31, 2017.

SUBPART B—INSURANCE REFORMS

A. Net Operating Losses of Life Insurance Companies (sec. 13511 of the Act and sec. 805 of the Code)

Prior 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.[1096]

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.[1097]

In the case of a life insurance company, a deduction is allowed in the taxable year for operations loss carryovers and carrybacks, in lieu of the deduction for net operating losses allowed to other corporations.[1098] 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 tax-

[1094] Sec. 706(c)(1); Treas. Reg. sec. 1.708–1(b)(3).

[1095] Partnership level elections include, for example, the section 754 election to adjust basis on a transfer or distribution, as well as other elections that determine the partnership's tax treatment of partnership items. A list of elections can be found at William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, 4th edition, para. 9.01[7], pp. 9-42–9-44.

[1096] Sec. 172(b)(2).

[1097] Sec. 56(d).

[1098] Secs. 810, 805(a)(5).

able years preceding the loss year and an operations loss carryover to each of the 15 taxable years following the loss year.[1099]

Explanation of Provision

The provision repeals the operations loss deduction for life insurance companies and allows the NOL deduction under section 172, effective for losses arising in taxable years beginning after December 31, 2017. Thus, an NOL of a life insurance company arising in a taxable year beginning after December 31, 2017, is carried over (and not carried back) and is subject to a limitation on deductibility based on 80 percent of taxable income (determined without regard to certain deductions) under the NOL rules.[1100] Because the provision applies to losses arising in taxable years beginning after December 31, 2017, operations loss carryovers from taxable years beginning on or before December 31, 2017, are allowed as deductions in taxable years beginning after December 31, 2017, in accordance with section 810 as in effect before its repeal by the Act. For example, in the case of an operations loss of a life insurance company arising in a taxable year beginning in 2017, the 15-year carryforward limitation under the law in effect for the year in which the loss arose continues to apply to the loss. Such losses may expire if not used within the 15-year carryforward period.

Effective Date

The provision applies to losses arising in taxable years beginning after December 31, 2017.

B. Repeal of Small Life Insurance Company Deduction (sec. 13512 of the Act and former sec. 806 of the Code)

Prior Law

The small life insurance company deduction for any taxable year is 60 percent of so much of the tentative life insurance company taxable income ("LICTI") for such taxable year as does not exceed $3 million, reduced (but not below zero) by 15 percent of the excess of tentative LICTI over $3 million. The maximum deduction that can be claimed by a small company is $1.8 million, and a company with a tentative LICTI of $15 million or more is not entitled to any small company deduction. A small life insurance company for this purpose is one with less than $500 million of assets.

Explanation of Provision

The provision repeals the small life insurance company deduction.

The provision makes a conforming amendment, moving to section 453B(e)(3) (relating to installment sales) the prior- and present-law rule regarding the treatment of a real estate activity that constitutes the active conduct of a trade or business and of performance of administrative services in connection with certain plans.

[1099] Sec. 810(b)(1). Special rules apply with respect to a new company as defined in section 810(e).

[1100] See sec. 172. For a discussion of the changes made by the Act to section 172, see the description of section 13302 of the Act (Modification of Net Operating Loss Deduction).

The repeal of section 806(b)(3)(C) as part of the repeal of section 806 does not alter the applicability of limitations under section 1503(c) relating to the use of certain losses against income of life insurance companies. Thus, limitations under section 1503(c) continue to apply.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

C. Adjustment for Change in Computing Reserves (sec. 13513 of the Act and sec. 807(f) of the Code)

Prior Law

Change in method of accounting

In general, a taxpayer may change its method of accounting under section 446 with the consent of the Secretary (or may be required to change its method of accounting by the Secretary). In such instances, a taxpayer generally is required to make an adjustment (a "section 481(a) adjustment") to prevent amounts from being duplicated in, or omitted from, the calculation of the taxpayer's income. Pursuant to IRS procedures, negative section 481(a) adjustments generally are deducted from income in the year of the change whereas positive section 481(a) adjustments generally are required to be included in income ratably over four taxable years.[1101]

However, section 807(f) explicitly provides that changes in the basis for determining life insurance company reserves are to be taken into account ratably over 10 years.

10-year spread for change in computing life insurance company reserves

For Federal income tax purposes, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[1102] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

Income or loss resulting from a change in the method of computing reserves is taken into account ratably over a 10-year period.[1103] The rule for a change in basis in computing reserves applies only if there is a change in basis in computing the Federally prescribed reserve (as distinguished from the net surrender value). Although life insurance tax reserves require the use of a Federally prescribed method, interest rate, and mortality or morbidity table, changes in other assumptions for computing statutory reserves (*e.g.*, when premiums are collected and claims are paid) may cause increases or decreases in a company's life insurance reserves that must be spread over a 10-year period. Changes in the net sur-

[1101] See, *e.g.*, Rev. Proc. 2015–13, 2015–5 I.R.B. 419, and Rev. Proc. 2017–30, 2017–18 I.R.B. 1131.
[1102] Sec. 807.
[1103] Sec. 807(f).

render value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve but a current liability.

If for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments to reserves is taken into account for the preceding taxable year.

Explanation of Provision

A change in the basis for computing life insurance reserves or any other item referred to in section 807(c) in a taxable year is taken into account under section 481 as an adjustment attributable to a change in method of accounting initiated by the taxpayer and made with the consent of the Secretary. The prior-law 10-year spread rule to account for such a change is repealed. Thus, income or loss resulting from a change in method of computing life insurance company reserves is taken into account consistent with IRS procedures, generally ratably over a four-year period, instead of over a 10-year period.

Consistent with IRS procedures, a company that makes a change in method of computing life insurance company reserves is required to comply with procedures for automatic method changes[1104] and is required to report and file such statements and other information as the Secretary requires[1105] under those procedures.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

D. Repeal of Special Rule for Distributions to Shareholders from Pre-1984 Policyholders Surplus Account (sec. 13514 of the Act and former sec. 815 of the Code)

Prior Law

Under the Federal tax law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation. A company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). For stock insurance companies, Federal income tax on the other 50 percent of the gain from operations was deferred, and was accounted for as part of a policyholder's surplus account and, subject to certain limitations, taxed only when distributed to stockholders or upon corporate dissolution (Phase III). To determine whether amounts had been distributed, a company maintained a shareholders surplus account, which generally included the company's previously taxed income that would be available for distribution to shareholders. Distributions to shareholders were treated as being first out of the shareholders surplus

[1104] Because the change is treated as initiated by the taxpayer and made with the consent of the Secretary, the procedures for automatic method changes apply. Procedures for automatic method changes are set forth in Rev. Proc. 2018–31, 2018–22 I.R.B. 637.

[1105] Thus, the company is required to file Form 3115, for example.

account, then out of the policyholders surplus account, and finally out of other accounts.[1106]

The Deficit Reduction Act of 1984[1107] included provisions that, for 1984 and later years, eliminated further deferral of tax on amounts (described above) that previously would have been deferred under the three-phase system. Although for taxable years after 1983, life insurance companies may not enlarge their policyholders surplus account, the companies are not taxed on previously deferred amounts unless the amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account.[1108]

Any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company is subject to tax at the corporate rate in the taxable year of the distribution. Prior law for 1984 and later years (like pre-1984 law) provides that any distribution to shareholders is treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.

For taxable years beginning after December 31, 2004, and before January 1, 2007, the application of the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a life insurance company were suspended.[1109] Distributions in those years were treated as first made out of the policyholders surplus account, to the extent thereof, and then out of the shareholders surplus account, and lastly out of other accounts.

Explanation of Provision

The provision repeals section 815, the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a stock life insurance company.

In the case of any stock life insurance company with an existing policyholders surplus account (as defined in section 815 before its repeal), tax is imposed on the balance of the account as of the close of the company's last taxable year beginning before January 1, 2018. A life insurance company is required to pay tax on the balance of the account ratably over the first eight taxable years beginning after December 31, 2017. Specifically, the tax imposed on a life insurance company is the tax on the sum of life insurance company taxable income for the taxable year (but not less than zero) plus 1/8 of the balance of the existing policyholders surplus account as of December 31, 2017. Thus, life insurance company losses are not allowed to offset the amount of the policyholders surplus account balance subject to tax.

For example, assume a company has a policyholders surplus account balance of $64 as of December 31, 2017 (the end of its taxable year). For its 2018 taxable year, the company has a loss of $4.

[1106] Former sec. 815. The policyholders surplus account was also reduced by the amount of tax paid on distributions from the account. The additional reduction in the account was subject to tax. A distribution from a policyholders surplus account was subject to tax regardless of whether life insurance company taxable income was positive or negative, so that the taxable amount was not offset by a current operations loss. Former sec. 815(d) and (f).

[1107] Pub. L. No. 98–369.

[1108] Sec. 815.

[1109] Former sec. 815(g).

Under the provision, the company has an income inclusion for 2018 of $8 (that is, 1/8 of its $64 balance) and a $4 net operating loss carryforward to its next taxable year. For its 2019 taxable year, the company has a loss of $2 (after taking into account the loss carryforward under the rules of section 172) and also has a tax credit of $1. Under the provision, the company has an income inclusion for 2019 of $8 (that is, 1/8 of $64), a $2 net operating loss carryforward to its next taxable year, and a $1 general business credit carryforward.[1110]

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

E. Modification of Proration Rules for Property and Casualty Insurance Companies (sec. 13515 of the Act and sec. 832(b) of the Code)

Prior Law

The taxable income of a property and casualty insurance company is determined as the sum of its gross income from underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions.[1111] Underwriting income means the premiums earned on insurance contracts during the taxable year reduced by losses incurred and expenses incurred. The amount of losses incurred takes into account the change during the taxable year in unpaid losses on life insurance contracts (if any) plus discounted unpaid losses of the property and casualty insurance company.

A proration rule applies to property and casualty insurance companies. A property and casualty insurance company must reduce the amount of its deduction for losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns.[1112] This proration rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from deductible dividends, and from other untaxed amounts.[1113]

Explanation of Provision

The provision replaces the 15-percent reduction under prior law[1114] with a reduction equal to 5.25 percent divided by the top corporate tax rate. The top corporate tax rate is 21 percent for 2018

[1110] A technical correction may be needed to clarify that the income inclusion under the provision may not be offset by a credit.

[1111] Sec. 832.

[1112] Sec. 832(b)(5).

[1113] See H.R. Rep. 99–426, Tax Reform Act of 1985, Report of the Committee on Ways and Means, House of Representatives, on H.R. 3838, December 7, 1985, page 670 (Reasons for Change). The Conference Agreement adopted the House bill provision with modifications. See H.R. Rep. 99–841, Tax Reform Act of 1986, Conference Report to Accompany H.R. 3838, September 18, 1986, pp. 356–7.

[1114] The product of the prior-law 15-percent proration percentage and the prior-law highest corporate tax rate of 35 percent equals 5.25 percent.

and thereafter,[1115] so the percentage reduction is 25 percent under the proration rule for property and casualty insurance companies. The proration percentage will be automatically adjusted in the future if the highest corporate tax rate is changed, so that the product of the proration percentage and the highest corporate tax rate always equals 5.25 percent.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

F. Repeal of Special Estimated Tax Payments (sec. 13516 of the Act and former sec. 847 of the Code)

Prior Law

Allowance of additional deduction and establishment of special loss discount account

Prior law allows an insurance company required to discount its unpaid loss reserves an additional deduction that is not to exceed the excess of (1) the amount of the undiscounted unpaid losses over (2) the amount of the related discounted unpaid losses, to the extent the amount was not deducted in a preceding taxable year.[1116] The provision imposes the requirement that a special loss discount account be established and maintained, and that special estimated tax payments be made. Unused amounts of special estimated tax payments are treated as a section 6655 estimated tax payment for the 16th year after the year for which the special estimated tax payment was made.

The total payments by a taxpayer, including section 6655 estimated tax payments and other tax payments, together with special estimated tax payments made under this provision, are generally the same as the total tax payments that the taxpayer would make if the taxpayer did not elect to have this provision apply, except to the extent amounts can be refunded under the provision in the 16th year.

Calculation of special estimated tax payments based on tax benefit attributable to deduction

More specifically, prior law imposes a requirement that the taxpayer make special estimated tax payments in an amount equal to the tax benefit attributable to the additional deduction allowed under the provision. If amounts are included in gross income as a result of a reduction in the taxpayer's special loss discount account or the liquidation or termination of the taxpayer's insurance business, and an additional tax is due for any year as a result of the inclusion, then an amount of the special estimated tax payments equal to such additional tax is applied against such additional tax. If there is an adjustment reducing the amount of additional tax against which the special estimated tax payment was applied, then in lieu of any credit or refund for the reduction, a special estimated

[1115] See the description of section 13001 of the Act (21-Percent Corporate Tax Rate).
[1116] Sec. 847.

tax payment is treated as made in an amount equal to the amount that would otherwise be allowable as a credit or refund.

The amount of the tax benefit attributable to the deduction is to be determined (under Treasury regulations (which have not been promulgated)) by taking into account tax benefits that would arise from the carryback of any net operating loss for the year as well as current year benefits. In addition, tax benefits for the current and carryback years are to take into account the benefit of filing a consolidated return with another insurance company without regard to the consolidation limitations imposed by section 1503(c).

The taxpayer's estimated tax payments under section 6655 are to be determined without regard to the additional deduction allowed under this provision and the special estimated tax payments. Legislative history [1117] indicates that it is intended that the taxpayer may apply the amount of an overpayment of any section 6655 estimated tax payments for the taxable year against the amount of the special estimated tax payment required under this provision. The special estimated tax payments under this provision are not treated as estimated tax payments for purposes of section 6655 (*e.g.*, for purposes of calculating penalties or interest on underpayments of estimated tax) when such special estimated tax payments are made.

Refundable amount

To the extent that a special estimated tax payment is not used to offset additional tax due for any of the first 15 taxable years beginning after the year for which the payment was made, such special estimated tax payment is treated as an estimated tax payment made under section 6655 for the 16th year after the year for which the special estimated tax payment was made. If the amount of such deemed section 6655 payment, together with the taxpayer's other payments credited against tax liability for such 16th year, exceeds the tax liability for such year, then the excess (up to the amount of the deemed section 6655 payment) may be refunded to the taxpayer to the same extent provided under prior law with respect to overpayments of tax.

Regulatory authority

In addition to the regulatory authority to adjust the amount of special estimated tax payments in the event of a change in the corporate tax rate, authority is provided to Treasury to prescribe regulations necessary or appropriate to carry out the purposes of the provision.

Regulations have not been promulgated under section 847.

Explanation of Provision

The provision repeals section 847. Thus, the election to apply section 847, the additional deduction, special loss discount account, special estimated tax payment, and refundable amount rules of prior law are eliminated.

[1117] See H.R. Rep. No. 100–1104, Conference Report to accompany H.R. 4333, the Technical and Miscellaneous Revenue Act of 1988, October 21, 1988, p. 174.

The entire balance of an existing account is included in income of the taxpayer for the first taxable year beginning after 2017, and the entire amount of existing special estimated tax payments are applied against the amount of additional tax attributable to this inclusion. Any special estimated tax payments in excess of this amount are treated as estimated tax payments under section 6655.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

G. Computation of Life Insurance Tax Reserves (sec. 13517 of the Act and sec. 807 of the Code)

Prior Law and Background

In general

In determining life insurance company taxable income, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[1118] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners ("NAIC") for purposes of financial reporting under State laws and State insurance regulatory rules (known as annual statements).

For Federal income tax purposes, in computing the net increase or net decrease in reserves, six items are taken into account. These are: (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations under insurance and annuity contracts that do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (5) premiums received in advance and liabilities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance that are held for retired lives, premium stabilization, or a combination of both. No deduction for asset adequacy reserves or deficiency reserves is allowed.

Life insurance reserves are amounts set aside to mature or liquidate future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies.[1119] Additional requirements also apply to life insurance reserves.[1120]

The amount of life insurance reserves for any contract is the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules, but may not exceed the statutory reserve with respect to the contract (for regulatory reporting). In computing the Federally prescribed reserve for any type of contract, the taxpayer must use the tax reserve method applicable to the contract, an interest rate for discounting of reserves

[1118] Sec. 807.
[1119] Sec. 816(b)(1)(B).
[1120] See secs. 816(b)(1)(A), 816(b)(2), and 816(h).

to take account of the time value of money, and the prevailing commissioners' standard tables for mortality or morbidity.

Interest rate

The assumed interest rate to be used in computing the Federally prescribed reserve is the greater of the applicable Federal interest rate or the prevailing State assumed interest rate. The applicable Federal interest rate is the annual rate determined by the Secretary under the discounting rules for property and casualty reserves for the calendar year in which the contract is issued. The prevailing State assumed interest rate is generally the highest assumed interest rate permitted to be used in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning the calendar year in which the contract is issued. In determining the highest assumed rates permitted in at least 26 States, each State is treated as permitting the use of every rate below its highest rate.

A one-time election is permitted (revocable only with the consent of the Secretary) to apply an updated applicable Federal interest rate every five years in calculating life insurance reserves. The election is provided to take account of the fluctuations in market rates of return that companies experience with respect to life insurance contracts of long duration. The use of the updated applicable Federal interest rate under the election does not cause the recalculation of life insurance reserves for any prior year. Under the election no change is made to the interest rate used in determining life insurance reserves if the updated applicable Federal interest rate is less than one-half of one percentage point different from the rate used by the company in calculating life insurance reserves during the preceding five years.

Development of principle-based reserving for insurance regulatory purposes

In 2012, the NAIC established a task force to develop State regulatory insurance reserving methodology that takes into account a wide range of future economic conditions (a stochastic approach referred to as principle-based reserving or "PBR"). The PBR approach would supplement or replace static formulas and assumptions for determining reserves as prescribed by then-existing State laws (a deterministic or a formulaic approach). Starting in 2017, a Valuation Manual that includes PBR requirements became operative.[1121] By October, 2017, legislatures of 47 States had enacted legislation relating to PBR insurance reserves for State regulatory purposes. The NAIC has adopted revised insurance company accreditation standards to become effective Jan. 1, 2020; until then, generally, PBR methodology for State insurance regulatory pur-

[1121] The Valuation Manual sets forth requirements for insurance regulatory reserves. National Association of Insurance Commissioners, Valuation Manual, January 1, 2018 Edition, *VM–20, Requirements for Principle-Based Reserves for Life Products, and VM–21, Requirements for Principle-Based Reserves for Variable Annuities*, https://www.naic.org/documents/prod_serv_2018_valuation_manual.pdf.

poses is optional for many types of insurance contracts issued by life insurers.[1122]

Explanation of Provision

For purposes of determining the deduction for increases in certain reserves of a life insurance company, the amount of the life insurance reserves for any contract (other than certain variable contracts) is the greater of (1) the net surrender value of the contract (if any), or (2) 92.81 percent of the amount determined using the tax reserve method applicable to the contract as of the date the reserve is determined.[1123]

In the case of a variable contract, the amount of life insurance reserves for the contract is the sum of (1) the greater of (a) the net surrender value of the contract, or (b) the separate-account reserve amount under section 817 for the contract, plus (2) 92.81 percent of the excess (if any) of the amount determined using the tax reserve method applicable to the contract as of the date the reserve is determined over the amount determined in (1).[1124]

In no event shall the amount of life insurance reserve exceed the amount of the annual statement reserve.[1125] As under prior law, no deduction for asset adequacy reserves or deficiency reserves is allowed.[1126]

Consistent with the purpose of the provision to accommodate the NAIC-prescribed principle-based reserve methodology and to provide for a tax reserve amount that is simpler, more transparent, and easier to compute than under prior law, the provision provides for a percentage reduction to address the inconsistency of insurance regulatory accounting with accurate measurement of income for Federal income tax purposes. Under NAIC-prescribed principle-based reserve methodology in effect at the time of the enactment of the provision, principle-base reserves for any contract do not include any asset adequacy reserve component.[1127] Therefore, no asset adequacy reserve-related reduction to the NAIC-prescribed PBR reserves as then in effect is necessary or required before applying the percentage reduction in computing tax reserves.

[1122] National Association of Insurance Commissioners Center for Insurance Policy and Research, *The National System of State Regulation and Principle-Based Reserving*, July 12, 2018, https://www.naic.org/cipr_topics/principle_based_reserving_pbr.htm.

[1123] Sec. 807(d)(1)(A).

[1124] Sec. 807(d)(1)(B).

[1125] Sec. 807(d)(1)(C).

[1126] See sec. 816(h). As under prior law, life insurance reserves are amounts set aside to mature or liquidate future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies. Sec. 816(b)(1)(B).

[1127] National Association of Insurance Commissioners Statutory Issue Paper No. 154, *Implementation of Principle-Based Reserving*, finalized December 10, 2016, https://www.naic.org/sap_app_updates/documents/154_a.pdf (IP No. 154). IP No. 154 states at page IP154–4, "Asset adequacy testing is an existing requirement which functions as an additional check of reserve adequacy by reviewing to ensure that assets will be sufficient and available to meet reserving obligations as claims become due. No changes were recommended . . . because asset adequacy testing *under the Actuarial Opinion and Memorandum Regulation (Model #822)* have [sic] not changed." The *Actuarial Opinion and Memorandum Regulation (Model #822)* indicates or implies that asset adequacy reserves are to be separately stated and held as an additional reserve for insurance regulatory reporting purposes, stating at page 822–3 (section 5.E.2), "If the appointed actuary determines as the result of asset adequacy analysis that a reserve should be held in addition to the aggregate reserve held by the company and calculated in accordance with methods set forth in the Standard Valuation Law, the company shall establish the additional reserve."

For example, an insurance company issues life insurance contracts in 2018. The annual statement reserve for the contracts can be determined under an NAIC-prescribed PBR method in effect in 2018.[1128] Because the principle-based reserve for the contracts includes no asset adequacy reserve component, no asset adequacy reserve-related reduction is necessary before applying 92.81 percent to determine the tax reserve for the contracts. However, as under prior law, asset adequacy reserves or deficiency reserves remain nondeductible for Federal income tax purposes. If a tax reserve method currently or in the future (whether prescribed by the NAIC,[1129] or consistent with the section 807 tax reserve method [1130]) includes an amount, such as an asset adequacy reserve, deficiency reserve, or other reserve or amount that is not deductible for Federal income tax purposes, the reserve amount is reduced by the nondeductible amount before applying the percentage reduction under section 807.

A no-double-counting rule provides that no amount or item is taken into account more than once in determining any reserve under subchapter L of the Code.[1131] For example, an amount taken into account in determining a loss reserve under section 807 may not be taken into account again in determining a loss reserve under section 832. Similarly, a loss reserve determined under the tax reserve method (whether the Commissioners Reserve Valuation Method, the Commissioner's Annuity Reserve Valuation Method, a principle-based reserve method, or another method developed in the future, that is prescribed for a type of contract by the National Association of Insurance Commissioners) may not again be taken into account in determining the portion of the reserve that is separately accounted for under section 817 or be included also in determining the net surrender value of a contract. The provision provides reserve rules for supplemental benefits and retains prior-law rules regarding certain contracts issued by foreign branches of domestic life insurance companies.

The provision requires the Secretary to provide for reporting (at such time and in such manner as the Secretary shall prescribe) with respect to the opening balance and closing balance or reserves and with respect to the method of computing reserves for purposes of determining income.[1132] For this purpose, the Secretary may require that a life insurance company (including an affiliated group filing a consolidated return that includes a life insurance company) is required to report each of the line item elements of each separate account by combining them with each such item from all other separate accounts and the general account, and to report the combined amounts on a line-by-line basis on the taxpayer's return. Similarly, the Secretary may in such guidance provide that reporting on a separate account by separate account basis is generally not permitted. Under existing regulatory authority, if the Secretary determines it is necessary in order to carry out and enforce this provision, the Secretary may require e-filing or comparable filing of the

[1128] Use of the PBR methodology is optional in some cases until 2020.
[1129] Sec. 807(d)(3)(A)(iv)(I).
[1130] Sec. 807(d)(3)(A)(iv)(II).
[1131] Sec. 807(d)(1)(D).
[1132] Sec. 807(e)(6).

return on magnetic media or other machine readable form, and may require that the taxpayer provide its annual statement via a link, electronic copy, or other similar means.

Effective Date

The provision applies to taxable years beginning after December 31, 2017. For the first taxable year beginning after December 31, 2017, the difference in the amount of the reserve with respect to any contract at the end of the preceding taxable year and the amount of such reserve determined as if the proposal had applied for that year is taken into account in determining income for each of the eight taxable years following that preceding year, one-eighth per year.

H. Modification of Rules for Life Insurance Proration for Purposes of Determining the Dividends Received Deduction (sec. 13518 of the Act and sec. 812 of the Code)

Prior 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 (for purposes of computing life insurance company taxable income) are adjusted by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest and by the policyholders' share of the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts.[1133]

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,[1134] 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 distribu-

[1133] Secs. 807(a)(2)(B) and (b)(1)(B).

[1134] Secs. 805(a)(4) and 812. Under pre-1984 law, described 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. 572–573, "a life insurance company was taxed on the lesser of its table investment income or its gain from operations. If a company's gain from operations exceeded its taxable investment income, the company was taxed on 50 percent of such excess. . . . The computation of gain from operations began with the company's total income, including the company's share of investment yield, net capital gain, premiums, and other considerations, decreases in insurance reserves and all other amounts." Thus, under the law prior to 1984, a life insurance company preferred to have a low company's share for purposes of determining its taxable income, and a high company's share for purposes of the proration rules. After 1983, no such tension remained.

tions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer.

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.[1135] 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.[1136]

Gross investment income includes specified items.[1137] The specified items include interest (including tax-exempt interest), dividends, rents, royalties and other related specified items, the amount by which net short-term capital gain exceeds net long-term capital loss, and trade or business income. Gross investment income generally does not include gain (other than the amount by which net short-term capital gain 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.[1138] 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). In any case where neither the prevailing State assumed interest rate nor the applicable Federal rate is used, "another appropriate rate" is used for this calculation. No statutory definition of "another appropriate rate" is provided; the law is unclear as to what rate or rates are appropriate for this purpose.[1139]

In 2007, the IRS issued Rev. Rul. 2007–54,[1140] 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

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[1135] Sec. 812(a).

[1136] Sec. 812(c).

[1137] Sec. 812(d).

[1138] Sec. 812(b)(1). This portion is defined as gross investment income's share of policyholder dividends.

[1139] 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.

[1140] 2007–38 I.R.B. 604.

more appropriately be addressed by regulation.[1141] 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.[1142] 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.[1143] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

In the case of variable contracts, however, a special rule eliminates the effect of gains and losses for purposes of determining the inclusion or deduction relating to a change in the amount of the tax reserves.[1144] Under this rule, realized and unrealized gains are subtracted from, and realized and unrealized losses are added to, the amount of tax reserves taken into account for variable contracts, 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, so as to take account of the subtracted or added amounts.

Dividends received deduction

A corporate taxpayer may partially or fully deduct dividends received.[1145] 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.[1146]

[1141] 2007–42 I.R.B. 799.

[1142] Section 817(d) provides a more detailed definition of a variable contract.

[1143] Sec. 807.

[1144] Sec. 817. The rule also applies in the case of certain other deductions for benefits paid and assumption reinsurance costs incurred with respect to variable contracts (sec. 817(a) flush language).

[1145] Sec. 243 *et seq.* Conceptually, dividends received by a corporation are retained in corporate solution; these amounts are taxed when distributed to noncorporate shareholders.

[1146] Sec. 246(c).

The taxpayer's holding period is reduced for periods during which its risk of loss is reduced.[1147]

Explanation of Provision

The provision modifies and simplifies the life insurance company proration rules[1148] for reducing dividends received deductions[1149] and reserve deductions[1150] with respect to untaxed income. For purposes of these life insurance proration rules, the company's share is 70 percent. The policyholder's share is 30 percent.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

I. Capitalization of Certain Policy Acquisition Expenses (sec. 13519 of the Act and sec. 848 of the Code)

Prior Law

In the case of an insurance company, specified policy acquisition expenses for any taxable year are required to be capitalized, and generally are amortized over the 120-month period beginning with the first month in the second half of the taxable year.[1151]

A special rule provides for 60-month amortization of the first $5 million of specified policy acquisition expenses with a phase-out. The phase-out reduces the amount amortized over 60 months by the excess of the insurance company's specified policy acquisition expenses for the taxable year over $10 million.

Specified policy acquisition expenses are determined as that portion of the insurance company's general deductions for the taxable year that does not exceed a specific percentage of the net premiums for the taxable year on each of three categories of insurance contracts. For annuity contracts, the percentage is 1.75 percent; for group life insurance contracts, the percentage is 2.05 percent; and for all other specified insurance contracts, the percentage is 7.7 percent.

With certain exceptions, a specified insurance contract is any life insurance, annuity, or noncancellable accident and health insurance contract or combination thereof. A group life insurance contract is any life insurance contract that covers a group of individuals defined by reference to employment relationship, membership in an organization, or similar factor, the premiums for which are determined on a group basis, and the proceeds of which are payable to (or for the benefit of) persons other than the employer of the insured, an organization to which the insured belongs, or other similar person.

[1147] 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.

[1148] Sec. 812.

[1149] Sec. 804(a)(4).

[1150] Secs. 807(a) and (b).

[1151] Sec. 848.

Explanation of Provision

The provision extends the amortization period for specified policy acquisition expenses from a 120-month period to a 180-month period beginning with the first month in the second half of the taxable year. The provision does not change the special rule providing for 60-month amortization of the first $5 million of specified policy acquisition expenses (with phaseout). The provision specifies that for annuity contracts, the percentage is 2.09 percent; for group life insurance contracts, the percentage is 2.45 percent; and for all other specified insurance contracts, the percentage is 9.20 percent.[1152]

Effective Date

The provision applies to taxable years beginning after December 31, 2017. A transition rule permits specified policy acquisition expenses first required to be capitalized in a taxable year beginning before January 1, 2018, to continue to be allowed as a deduction ratably over the 120-month period beginning with the first month in the second half of the taxable year. It is intended that the 60-month amortization rule continue to apply to such amounts eligible for the 60-month amortization rule and first required to be capitalized in a taxable year beginning before January 1, 2018.

J. Tax Reporting for Life Settlement Transactions and Clarification of Tax Basis of Life Insurance Transactions, and Exception to Transfer for Valuable Consideration Rules (secs. 13520–13522 of the Act and secs. 101 and 1016(a) and new sec. 6050Y of the Code)

Prior Law

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[1153]

Under rules known as the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that

[1152] A technical correction may be needed to correct statutory references so that the provision achieves this result.

[1153] Sec. 101(a)(1). In the case of certain accelerated death benefits and viatical settlements, special rules treat certain amounts as amounts paid by reason of the death of an insured (that is, generally, excludable from income). Sec. 101(g). The rules relating to accelerated death benefits provide that amounts treated as paid by reason of the death of the insured include any amount received under a life insurance contract on the life of an insured who is a terminally ill individual, or who is a chronically ill individual (provided certain requirements are met). For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification. A chronically ill individual is one who has been certified by a licensed health care practitioner within the preceding 12-month period as meeting certain ability-related requirements. In the case of a viatical settlement, if any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill is sold to a viatical settlement provider, the amount paid for the sale or assignment of that portion is treated as an amount paid under the life insurance contract by reason of the death of the insured (that is, generally, excludable from income). For this purpose, a viatical settlement provider is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of terminally ill or chronically ill individuals (provided certain requirements are met).

is excludable generally is limited.[1154] Under the limitation, the excludable amount may not exceed the sum of (1) the actual value of the consideration, and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the consideration he pays combined with his subsequent premium payments on the contract are less than the amount of the death benefit he later receives under the contract, then the difference is includable in the buyer's income.

Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract,[1155] or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.[1156]

IRS guidance sets forth more details of the tax treatment of a life insurance policyholder who sells or surrenders the life insurance contract and the tax treatment of other sellers and of buyers of life insurance contracts. The guidance relates to the character of taxable amounts (ordinary or capital) and to the taxpayer's basis in the life insurance contract.

In Revenue Ruling 2009–13,[1157] the IRS ruled that income recognized under section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of a sale of a cash value life insurance contract, the IRS ruled that the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the "inside build-up"), and any excess is long-term capital gain. Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain under the ruling.

In Revenue Ruling 2009–14,[1158] the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includable as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (*e.g.,* premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain, and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

Explanation of Provision

In general

The provision imposes reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the payor in the case of the payment of reportable death benefits. The provision sets

[1154] Sec. 101(a)(2).
[1155] Sec. 101(a)(2)(A).
[1156] Sec. 101(a)(2)(B).
[1157] 2009–21 I.R.B. 1029.
[1158] 2009–21 I.R.B. 1031.

forth rules for determining the basis of a life insurance or annuity contract. Lastly, the provision modifies the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale.

Reporting requirements for acquisitions of life insurance contracts

Reporting upon acquisition of life insurance contract

The reporting requirement applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year.[1159]

Reportable policy sale

A reportable policy sale means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract).[1160] An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

Buyer reporting

Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller.[1161] The information reported by the buyer about the purchase is (1) the buyer's name, address, and taxpayer identification number ("TIN"), (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, (4) the name of the issuer, and (5) the amount of each payment. The statement the buyer provides to any issuer of a life insurance contract is not required to include the amount of the payment or payments for the purchase of the contract.

Reporting of seller's basis in the life insurance contract

On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller (1) the name, address, and TIN of the seller or the transferor to a foreign person, (2) the basis of the contract (*i.e.,* the investment in the contract within the meaning of section 72(e)(6)), and (3) the policy number of the contract.[1162] Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other

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[1159] Sec. 6050Y.

[1160] Sec. 101(a)(3)(B). A substantial family, business or financial relationship with the insured apart from the interest in the life insurance contract is not further defined in the statute. The Treasury Department is directed to provide guidance as to the definition. Transactions to which new section 101(a)(3)(A) does not apply by reason of guidance regarding this definition under new section 101(a)(3)(B) may be subject to reporting under new section 6050Y as provided in such guidance as needed to carry out the purposes of the provision.

[1161] Sec. 6050Y(a).

[1162] Sec. 6050Y(b).

purposes, or information relating to loans, premiums, or death benefits with respect to the contract.

Reporting with respect to reportable death benefits

When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee.[1163] Under this reporting requirement, the payor reports (1) the name, address and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of a payment, (3) the date of each such payment, (4) the gross amount of the payment (5) the payor's estimate of the buyer's basis in the contract.

A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

For purposes of these reporting requirements, a payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale.

Determination of basis

In determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as "cost of insurance").[1164] This reverses the position of the IRS in Revenue Ruling 2009–13 that on sale of a life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance.

Scope of transfer for value rules

The provision provides that the exceptions to the transfer for value rules do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale.[1165] Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

Effective Date

Under the provision, the reporting requirement is effective for reportable policy sales occurring after December 31, 2017, and reportable death benefits paid after December 31, 2017. The clarification of the basis rules for life insurance and annuity contracts is effective for transactions entered into after August 25, 2009. The modification of the exceptions to the transfer for value rules is effective for transfers occurring after December 31, 2017.

[1163] Sec. 6050Y(c).
[1164] Sec. 1016(a)(1)(B).
[1165] Sec. 101(a)(3)(A).

K. Modification of Discounting Rules for Property and Casualty Insurance Companies (sec. 13523 of the Act and sec. 846(c) of the Code)

Prior Law

A property and casualty insurance company generally is subject to tax on its taxable income.[1166] The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions.[1167] Among the items that are deductible in calculating underwriting income are additions to reserves for losses incurred and expenses incurred.

To take account of the time value of money, discounting of unpaid losses is required. All property and casualty loss reserves (unpaid losses and unpaid loss adjustment expenses) for each line of business (as shown on the annual statement) are required to be discounted for Federal income tax purposes.

The discounted reserves are calculated using a prescribed interest rate which is based on the applicable Federal mid-term rate ("mid-term AFR"). The discount rate is the average of the mid-term AFRs effective at the beginning of each month over the 60-month period preceding the calendar year for which the determination is made.

To determine the period over which the reserves are discounted, a prescribed loss payment pattern applies. The prescribed length of time is either the accident year and the following three calendar years, or the accident year and the following 10 calendar years, depending on the line of business. In the case of certain "long-tail" lines of business, the 10-year period is extended, but not by more than five additional years. Thus, prior law limits the maximum duration of any loss payment pattern to the accident year and the following 15 years. The Treasury Department is directed to determine a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years, starting with 1987.

Under the discounting rules, an election is provided permitting a taxpayer to use its own (rather than an industry-wide) historical loss payment pattern with respect to all lines of business, provided that applicable requirements are met.

Treasury publishes discount factors for each line of business to be applied by taxpayers for discounting reserves.[1168] The discount factors are published annually, based on (1) the interest rate applicable to the calendar year, and (2) the loss payment pattern for each line of business as determined every five years.

[1166] Sec. 831(a).

[1167] Sec. 832.

[1168] The most recent property and casualty reserve discount factors published by Treasury are in Rev. Proc. 2016-58, 2016-51 I.R.B. 839, and see Rev. Proc. 2012-44, 2012-49 I.R.B. 645.

Explanation of Provision

The provision modifies the reserve discounting rules applicable to property and casualty insurance companies. In general, the provision modifies the prescribed interest rate, extends the periods applicable under the loss payment pattern, and repeals the election to use a taxpayer's historical loss payment pattern.

Interest rate

The provision provides that the interest rate is an annual rate for any calendar year to be determined by Treasury based on the corporate bond yield curve (rather than the mid-term AFR as under prior law). For this purpose, the corporate bond yield curve means, with respect to any month, a yield curve that reflects the average, for the preceding 60-month period (not 24-month period), of monthly yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available.[1169] It is expected that Treasury will determine a 60-month average corporate bond yield curve for the 60 months preceding the first month of the calendar year for which the determination is made.

Loss payment patterns

The provision extends the periods applicable for determining loss payment patterns. Under the provision, the maximum duration of the loss payment pattern generally is determined by the amount of losses remaining unpaid using aggregate industry experience for each line of business.

Like prior law, the provision provides that Treasury determines a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years.

The prior-law three-year period for discounting certain lines of business other than long-tail lines of business is not modified by the provision.

Under the provision, the prior-law 10-year period following the accident year is extended up to a maximum of 14 more years for the lines of business to which each period applies. To the extent these unpaid losses have not been treated as paid before the 24th year after the accident year, they are treated as paid in that 24th year. The lines of business to which the 10-year period, with any extensions, applies are the auto liability, other liability, medical

[1169] This rule adopts the definition found in section 430(h)(2)(D)(i) of the term "corporate bond yield curve." The definition provides for a rate based on the average of monthly yields on investment grade corporate bonds with varying maturities, so that under the property and casualty reserve discounting rules, with respect to a payment pattern of any duration, a rate may be determined based on corporate bonds of a similar duration. However, section 430, which relates to minimum funding standards for single-employer defined benefit pension plans, includes other rules not relevant to this provision, including rules for determining an "effective interest rate," such as segment rate rules. The term "effective interest rate" along with these other rules, including the segment rate rules, do not apply for purposes of property and casualty insurance reserve discounting.

malpractice, workers' compensation, nonproportional reinsurance, international, and multiple peril lines.[1170]

The provision repeals the prior-law rule providing that in the case of certain long-tail lines of business, the 10-year period is extended, but not by more than five additional years.

Election to use own historical loss payment pattern

The provision repeals the prior-law election permitting a taxpayer to use its own (rather than an aggregate industry-experience-based) historical loss payment pattern with respect to all lines of business.

The Treasury Department and IRS have issued published guidance addressing this provision.[1171]

Effective Date

The provision generally applies to taxable years beginning after December 31, 2017. Under a transitional rule for the first taxable year beginning in 2018, the amount of unpaid losses and expenses unpaid (under section 832(b)(5)(B) and (6)) and the unpaid losses (under sections 807(c)(2) and 805(a)(1)) at the end of the preceding taxable year are determined as if the provision had applied to these items in such preceding taxable year, using the interest rate and loss payment patterns for accident years ending with calendar year 2018. Any adjustment is spread over eight taxable years, *i.e.*, is included in the taxpayer's gross income ratably in the first taxable year beginning in 2018 and the seven succeeding taxable years. For taxable years subsequent to the first taxable year beginning in 2018, the provision applies to such unpaid losses and expenses unpaid (*i.e.*, unpaid losses and expenses unpaid at the end of the taxable year preceding the first taxable year beginning in 2018) by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 2018.

SUBPART C—BANKS AND FINANCIAL INSTRUMENTS

A. Limitation on Deduction for FDIC Premiums (sec. 13531 of the Act and sec. 162 of the Code)

Prior Law

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income. The taxable income of a C corporation[1172] generally comprises gross income less allowable deductions. A taxpayer generally is allowed a deduc-

[1170] A technical correction may be needed to clarify that the 10-year period, with any extensions, applies to the reinsurance and international lines of business.

[1171] Reg-103163-18. 83 Fed. Reg. 55646, November 7, 2018, and Rev. Proc. 2018-13, 2018-7 I.R.B. 356, February 12, 2018.

[1172] Corporations subject to tax are commonly referred to as C corporations after subchapter C of the Code, which sets forth corporate tax rules. Certain specialized entities that invest primarily in real estate related assets (real estate investment trusts) or in stock and securities (regulated investment companies) and that meet other requirements, generally including annual distribution of 90 percent of their income, are allowed to deduct their distributions to shareholders, thus generally paying little or no corporate-level tax despite otherwise being subject to subchapter C.

tion for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[1173]

Corporations that make a valid election pursuant to section 1362 of subchapter S of the Code, referred to as S corporations, generally are not subject to corporate-level income tax on their income. Instead, an S corporation passes through to shareholders its items of income and loss. The shareholders separately take into account their shares of these items on their individual income tax returns.

Banks, thrifts, and credit unions

In general

Financial institutions are subject to the same Federal income tax rules and rates as are applied to other corporations or entities, with specified exceptions.

C corporation banks and thrifts

A bank is generally taxed for Federal income tax purposes as a C corporation. For this purpose a bank generally means a corporation, a substantial portion of whose business is receiving deposits and making loans and discounts, or exercising certain fiduciary powers.[1174] A bank for this purpose generally includes domestic building and loan associations, mutual stock or savings banks, and certain cooperative banks that are commonly referred to as thrifts.[1175]

S corporation banks

A bank is generally eligible to elect S corporation status under section 1362, provided it meets the other requirements for making this election and it does not use the reserve method of accounting for bad debts as described in section 585.[1176]

Special bad debt loss rules for small banks Section 166 provides a deduction for any debt that becomes worthless (wholly or partially) within a taxable year. The reserve method of accounting for bad debts, repealed in 1986[1177] for most taxpayers, is allowed under section 585 for any bank (as defined in section 581) other than a large bank. For this purpose, a bank is a large bank if, for the taxable year (or for any preceding taxable year after 1986), the average adjusted basis of all its assets (or the assets of the controlled group of which it is a member) exceeds $500 million. Deductions for reserves are taken in lieu of a worthless debt deduction under section 166. Accordingly, a small bank is able to take deductions for additions to a bad debt reserve. Additions to the reserve

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[1173] Sec. 162(a). However, certain exceptions apply. No deduction is allowed for: (1) any charitable contribution or gift that would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section; (2) any illegal bribe, illegal kickback, or other illegal payment; (3) certain lobbying and political expenditures; (4) any fine or similar penalty paid to a government for the violation of any law; (5) two-thirds of treble damage payments under the antitrust laws; (6) certain foreign advertising expenses; (7) certain amounts paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person; or (8) certain applicable employee remuneration.

[1174] Sec. 581. See also Treas. Reg. sec. 1.581–1(a).

[1175] While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, and a cooperative bank, there are certain exceptions and special rules for such institutions. Treas. Reg. sec. 1.581–2(a).

[1176] Sec. 1361(b)(2)(A).

[1177] Tax Reform Act of 1986, Pub. L. No. 99–514.

are determined under an experience method that generally looks to the ratio of (1) the total bad debts sustained during the taxable year and the five preceding taxable years to (2) the sum of the loans outstanding at the close of such taxable years.[1178]

Credit unions

Credit unions are exempt from Federal income taxation.[1179] The exemption is based on their status as not-for-profit mutual or cooperative organizations (without capital stock) operated for the benefit of their members, who generally must share a common bond. The definition of common bond has been expanded to permit greater use of credit unions.[1180] While significant differences between the rules under which credit unions and banks operate have existed in the past, most of those differences have disappeared over time.[1181]

FDIC premiums

The Federal Deposit Insurance Corporation ("FDIC") provides deposit insurance for banks and savings institutions. To maintain its status as an insured depository institution, a bank must pay semiannual assessments into the deposit insurance fund. Assessments for deposit insurance are treated as ordinary and necessary business expenses. These assessments, also known as premiums, are deductible once the all events test for the premium is satisfied.[1182]

Explanation of Provision

No deduction is allowed for the applicable percentage of any FDIC premium paid or incurred by the taxpayer. For taxpayers with total consolidated assets of $50 billion or more, the applicable percentage is 100 percent. Otherwise, the applicable percentage is the ratio of the excess of total consolidated assets over $10 billion to $40 billion. For example, for a taxpayer with total consolidated assets of $20 billion, no deduction is allowed for 25 percent of FDIC premiums. The provision does not apply to taxpayers with total consolidated assets (as of the close of the taxable year) that do not exceed $10 billion.

FDIC premium means any assessment imposed under section 7(b) of the Federal Deposit Insurance Act.[1183] The term total consolidated assets has the meaning given such term under section

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[1178] Sec. 585(b)(2).

[1179] Sec. 501(c)(14)(A). For a discussion of the history of and reasons for Federal tax exemption, see United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions*, Report 3070, January 15, 2001, available at https://www.treasury.gov/press-center/press-releases/Documents/report30702.doc.

[1180] The Credit Union Membership Access Act, Pub. L. No. 105–219, allows multiple common bond credit unions. The legislation in part responds to *National Credit Union Administration v. First National Bank & Trust Co.*, 522 U.S. 479 (1998), which interpreted the permissible membership of tax-exempt credit unions narrowly.

[1181] The Treasury Department has concluded that any remaining regulatory differences do not raise competitive equity concerns between credit unions and banks. United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions*, Report 3070, January 15, 2001, p. 2, available at https://www.treasury.gov/press-center/press-releases/Documents/report30702.doc.

[1182] Technical Advice Memorandum 199924060, March 5, 1999, and Rev. Rul. 80–230, 1980–2 C.B. 169, 1980.

[1183] 12 U.S.C. sec. 1817(b).

165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1184]

For purposes of determining a taxpayer's total consolidated assets, members of an expanded affiliated group are treated as a single taxpayer. An expanded affiliated group means an affiliated group as defined in section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears and without regard to the exceptions from the definition of includible corporation for insurance companies and foreign corporations. A partnership or any other entity other than a corporation is treated as a member of an expanded affiliated group if such entity is controlled by members of such group.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

B. Repeal of Advance Refunding Bonds (sec. 13532 of the Act and sec. 149 of the Code)

Prior Law

Section 103 generally provides that gross income does not include interest received on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals).[1185] Bonds issued to finance the activities of charitable organizations described in section 501(c)(3) ("qualified 501(c)(3) bonds") are one type of private activity bond. The exclusion from income for interest on State and local bonds only applies if certain Code requirements are met.

The exclusion for income for interest on State and local bonds applies to refunding bonds but there are limits on advance refunding bonds. A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). Different rules apply to current as opposed to advance refunding bonds. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bond.[1186] Proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed.

Although there is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded, the Code limits advance refundings. The primary Federal tax policy concern with advance refundings is that they result in two issues of tax-exempt

[1184] Pub. L. No. 111–203.
[1185] Sec. 141.
[1186] Sec. 149(d)(5).

bonds that remain outstanding simultaneously for more than 90 days to finance the same project or activity and that thereby results in increased Federal revenue cost for multiple Federal subsidies.[1187] Generally, governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time.[1188] Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all.[1189] Furthermore, in the case of an advance refunding bond that results in interest savings (*e.g.*, a high interest rate to low interest rate refunding), the refunded bond must be redeemed on the first call date 90 days after the issuance of the refunding bond that results in debt service savings.[1190]

Explanation of Provision

The provision repeals the exclusion from gross income for interest on a bond issued to advance refund another tax-exempt bond.

Effective Date

The provision applies to advance refunding bonds issued after December 31, 2017.

SUBPART D—S CORPORATIONS

A. Expansion of Qualifying Beneficiaries of an Electing Small Business Trust (sec. 13541 of the Act and sec. 1361(c) of the Code)

Prior Law

An electing small business trust ("ESBT") may be a shareholder of an S corporation.[1191] Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT.[1192]

The portion of an ESBT which consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

Explanation of Provision

The provision allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

[1187] See S. Rep. No. 99–313 at 828 (1986).

[1188] Sec. 149(d)(3). Bonds issued before 1986 and pursuant to certain transition rules contained in the Tax Reform Act of 1986 may be advance refunded more than one time in certain cases.

[1189] Sec. 149(d)(2).

[1190] Sec. 149(d)(3)(A)(iii) and (B); Treas. Reg. sec. 1.149(d)–1(f)(3). A "call" provision provides the issuer of a bond with the right to redeem the bond prior to the stated maturity.

[1191] Sec. 1361(c)(2)(A)(v).

[1192] Secs. 1361(b)(1)(C) and (c)(2)(B)(v).

Effective Date

The provision takes effect on January 1, 2018.

B. Charitable Contribution Deduction for Electing Small Business Trusts (sec. 13542 of the Act and sec. 641(c) of the Code)

Prior Law

An electing small business trust ("ESBT") may be a shareholder of an S corporation.[1193] The portion of an ESBT that consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT. In addition to nonseparately computed income or loss, an S corporation reports to its shareholders their pro rata share of certain separately stated items of income, loss, deduction, and credit.[1194] For this purpose, charitable contributions (as defined in section 170(c)) of an S corporation are separately stated and taken by the shareholder.

The treatment of a charitable contribution passed through by an S corporation depends on the shareholder. Because an ESBT is a trust, the deduction for charitable contributions applicable to trusts,[1195] rather than the deduction applicable to individuals,[1196] applies to the trust. Generally, a trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which pursuant to the terms of the governing instrument are paid for a charitable purpose. No carryover of excess contributions is allowed. An individual is allowed a charitable contribution deduction limited to certain percentages of adjusted gross income generally with a five-year carryforward of amounts in excess of this limitation.

Explanation of Provision

The provision provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions taken into account by the portion of an ESBT holding S corporation stock.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

[1193] Sec. 1361(c)(2)(A)(v).
[1194] Sec. 1366(a)(1).
[1195] Sec. 642(c).
[1196] Sec. 170.

C. Modification of Treatment of S Corporation Conversions to C Corporations (sec. 13543 of the Act and secs. 481 and 1371 of the Code)

Prior Law

Changes in accounting method

Cash and accrual methods in general

Taxpayers using the cash method generally recognize items of income when actually or constructively received and items of expense when paid. The cash method is administratively easy and provides the taxpayer flexibility in the timing of income recognition. It is the method generally used by most individual taxpayers, including farm and nonfarm sole proprietorships.

Taxpayers using an accrual method generally accrue items of income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[1197] Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all the 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.[1198] Accrual methods of accounting generally result in a more accurate measure of economic income than does the cash method. The accrual method is often used by businesses for financial accounting purposes.

A C corporation, a partnership that has a C corporation as a partner, or a tax-exempt trust or corporation with unrelated business income generally may not use the cash method. Exceptions are made for the aforementioned entities to the extent their average annual gross receipts do not exceed $5 million for all prior years (including prior taxable years of any predecessor of the entity) (the "gross receipts test"),[1199] as well as for farming businesses,[1200] and qualified personal service corporations.[1201] The cash method may not be used by any tax shelter.[1202] In addition,

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[1197] See, *e.g.*, sec. 451. For a discussion of changes made to section 451 by the Act, see the discussion of section 13221 of the Act (Certain Special Rules for Taxable Year of Inclusion).

[1198] See, *e.g.*, sec. 461.

[1199] The Act modifies the gross receipts to apply to taxpayers with average annual gross receipts that do not exceed $25 million for the three prior taxable years. See section 13102 of the Act (Small Business Accounting Method Reform and Simplification).

[1200] 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 (other than evergreen trees that are more than six years old at the time they are severed from their roots). Secs. 448(d)(1) and 263A(e)(4). See also Treas. Reg. sec. 1.263A–4(a)(4).

[1201] 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 (by value) is owned by current or former employees performing such services, their estates, or heirs. Sec. 448(d)(2).

[1202] Secs. 448(a)(3) and (d)(3) and 461(i)(3) and (4). For this purpose, a tax shelter includes: (1) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale; (2) any syndicate (within the meaning of section 1256(e)(3)(B)); or (3) any tax shelter as defined in section 6662(d)(2)(C)(ii). In the case of a farming trade or business, a tax shelter includes any tax shelter as defined in section 6662(d)(2)(C)(ii) or any partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, (1) if at any time interests in such partnership or enterprise have been offered for sale in any offering required

Continued

the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor to the taxpayer.[1203] Such taxpayers generally are required to keep inventories and use an accrual method with respect to inventory items.[1204]

Procedures for changing a method of accounting

A taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for the year.[1205] Except as otherwise provided, section 446(e) requires taxpayers to secure the consent of the Secretary before changing a method of accounting. The regulations under section 446 provide rules for determining (1) what a method of accounting is, (2) how an adoption of a method is adopted,[1206] and (3) how a change in method of accounting is effectuated.[1207]

Section 481 prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a different method of accounting than the prior taxable year (*e.g.*, when changing from the cash method to an accrual method). In computing taxable income for the year of change, the taxpayer must take into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent items of income or expense from being duplicated or omitted (*i.e.*, "section 481(a) adjustments").[1208] The year of change is the taxable year for which the taxable income of the taxpayer is computed under a different method than the prior taxable year.[1209] Congress has provided the Secretary with the authority to prescribe the timing and manner in which such adjustments are taken into account in computing taxable income.[1210] Net section 481(a) adjustments that decrease taxable income generally are taken into account entirely in the taxable year of change, and net section 481(a) adjustments that increase taxable income generally are

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to be registered with any Federal or State agency having authority to regulate the offering of securities for sale or (2) if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs. For this purpose, certain holdings held directly by individuals that are attributable to active farm management activities are not treated as being held by a limited partner or a limited entrepreneur. See the second section 461(j) (relating to farming syndicate defined), as in effect prior to the enactment of the Consolidated Appropriations Act, 2018, Pub. L. No. 115–141, section 401(a)(117), March 23, 2018, which, as part of repealing general deadwood-related provisions, redesignated the second "subsection (j)" (relating to farming syndicate defined) as "subsection (k)".

[1203] Treas. Reg. secs. 1.446–1(c)(2) and 1.471–1.

[1204] Sec. 471 and Treas. Reg. secs. 1.446–1(c)(2) and 1.471–1. However, section 13102 of the Act (Small Business Accounting Method Reform and Simplification) provides an exemption from the requirement to use inventories for taxpayers that meet the $25 million gross receipts test provided in such section. Accordingly, under the Act, such taxpayers are also eligible to use the cash method.

[1205] Treas. Reg. sec. 1.446–1(e)(1).

[1206] See also, Rev. Rul. 90–38, 1990–1 C.B. 57 (holding that a taxpayer adopts a method of accounting (1) when it uses a permissible method of accounting on a single tax return, or (2) when it uses the same impermissible method of accounting on two or more consecutive tax returns).

[1207] Treas. Reg. sec. 1.446–1(e).

[1208] Sec. 481(a)(2) and Treas. Reg. sec. 1.481–1(a)(1).

[1209] Treas. Reg. sec. 1.481–1(a)(1).

[1210] Sec. 481(c). While Treasury regulations generally provide that the entire adjustments required by section 481(a) are taken into account entirely in the taxable year of change, the Secretary has provided the Commissioner with the authority to provide additional guidance regarding the taxable year or years in which section 481(a) adjustments are taken into account. See Treas. Reg. secs. 1.446–1(e)(3), 1.481–1(c)(2), and 1.481–4.

taken into account ratably during the four-taxable-year period beginning with the taxable year of change.[1211]

Post-termination distributions

Termination of a subchapter S election results in the conversion of the S corporation to a C corporation, whether the termination is by shareholder revocation of the election or because the corporation no longer satisfies the definition of a small business corporation.[1212] Distributions of cash by the C corporation to its shareholders during the post-termination transition period are tax-free to the shareholders (to the extent of the amount that was in the S corporation's accumulated adjustment account at the time of conversion) and reduce the shareholders' adjusted basis in the stock.[1213] The post-termination transition period is generally the one-year period after the S corporation election terminates.[1214] A corporation, with the consent of its shareholders, may elect to have this provision not apply.[1215]

Explanation of Provision

Under the provision, any section 481(a) adjustment of an eligible terminated S corporation attributable to the revocation of its S corporation election (*i.e.*, a change from the cash method to an accrual method) is taken into account ratably during the six-taxable-year period beginning with the year of change.[1216] An eligible terminated S corporation is any C corporation that (1) is an S corporation on December 21, 2017 (*i.e.*, the day before enactment of the Act),[1217] (2) revokes its S corporation election under section 1362(a) during the two-year period beginning December 22, 2017 (*i.e.*, the date of such enactment), and (3) has all of same owners (and in identical proportions) on the date the S corporation election is revoked as on December 22, 2017.

Under the provision, in the case of any distribution of money by an eligible terminated S corporation after the post-termination transition period, the eligible terminated S corporation may elect[1218] to allocate the accumulated adjustments account ("AAA") to such distribution, and treat the distribution as chargeable to accumulated earnings and profits ("E&P"), in the same ratio as the AAA bears to the accumulated E&P. The Secretary may prescribe rules for allocation of the AAA and E&P in the case of a distribution of money by an eligible terminated S corporation that has both accumulated E&P and current E&P.

[1211] See section 7.03 of Rev. Proc. 2015–13, 2015–5 I.R.B 419.

[1212] Secs. 1361(b)(1) (definition of small business corporation) and 1361(d) (termination).

[1213] Sec. 1371(e)(1).

[1214] Sec. 1377(b).

[1215] Sec. 1371(e)(2).

[1216] Note that section 13102 of the Act (Small Business Accounting Method Reform and Simplification) expands the universe of partnerships and C corporations eligible to use the cash method to include partnerships or C corporations with average annual gross receipts that do not exceed $25 million for the three prior taxable years. Accordingly, an eligible terminated S corporation with average annual gross receipts that do not exceed $25 million that used the cash method prior to revoking its S corporation election may be eligible to remain on the cash method as a C corporation.

[1217] A clerical correction to the Act may be necessary to clarify that the phrase "date of enactment of the Tax Cuts and Jobs Act" referenced in section 481(d) means the date of enactment of Pub. L. No. 115–97.

[1218] A technical correction may be necessary to reflect this intent.

The Treasury Department has issued published guidance addressing this provision.[1219]

Effective Date

The provision is effective as of December 22, 2017 (*i.e.*, upon enactment).

[1219] See Rev. Proc. 2018–44, 2018–37 I.R.B. 426 (Aug. 22, 2018).

PART VII—EMPLOYMENT

SUBPART A—COMPENSATION

A. Modification of Limitation on Excessive Employee Remuneration (sec. 13601 of the Act and sec. 162(m) of the Code)

Prior Law

In general

An employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense. Section 162(m) provides an explicit limitation on the deductibility of compensation expenses in the case of publicly traded corporate employers. The otherwise allowable deduction for compensation with respect to a covered employee of a publicly held corporation is limited to no more than $1 million per year.[1220] The deduction limitation applies when the deduction attributable to the compensation would otherwise be taken.

Covered employees

Section 162(m) defines a covered employee as (1) the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year and (2) any employee whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934 [1221] ("Exchange Act") by reason of being among the corporation's four most highly compensated officers for the taxable year (other than the chief executive officer).[1222] Treasury regulations under section 162(m) provide that whether an employee is the chief executive officer or among the four most highly compensated officers should be determined pursuant to the executive compensation disclosure rules promulgated under the Exchange Act.[1223]

In 2006, the Securities and Exchange Commission amended certain rules relating to executive compensation, including which officers' compensation must be disclosed under the Exchange Act. Under the new rules, such officers are (1) the principal executive officer (or an individual acting in such capacity), (2) the principal financial officer (or an individual acting in such capacity), and (3) the three most highly compensated officers, other than the principal executive officer or principal financial officer.

In response to the Securities and Exchange Commission's new disclosure rules, the Internal Revenue Service issued updated guid-

[1220] Sec. 162(m). This deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.
[1221] Pub. L. No. 73–291; 15 U.S.C. sec. 78a, *et seq*.
[1222] Sec. 162(m)(3).
[1223] Treas. Reg. sec. 1.162–27(c)(2)(ii).

ance on identifying which employees are covered by section 162(m).[1224] The updated guidance provides that the term "covered employee" means any employee who is (1) as of the close of the taxable year, the principal executive officer (or an individual acting in such capacity) defined in reference to the Exchange Act, or (2) among the three most highly compensated officers[1225] for the taxable year (other than the principal executive officer or principal financial officer), again defined by reference to the Exchange Act. Thus, under current guidance, only four employees are covered under section 162(m) for any taxable year. Under Treasury regulations, the requirement that the individual meet the criteria as of the last day of the taxable year applies to both the principal executive officer and the three highest compensated officers.[1226]

Definition of publicly held corporation

For purposes of the deduction disallowance of section 162(m), a publicly held corporation means any corporation issuing any class of common equity securities required to be registered under section 12 of the Exchange Act.[1227] All U.S. publicly traded companies are subject to this registration requirement, including their foreign affiliates. A foreign company publicly traded through American depository receipts ("ADRs"') is also subject to this registration requirement if more than 50 percent of the issuer's outstanding voting securities are held, directly or indirectly, by residents of the United States and either (i) the majority of the executive officers or directors are United States citizens or residents, (ii) more than 50 percent of the assets of the issuer are located in the United States, or (iii) the business of the issuer is administered principally in the United States. Other foreign companies are not subject to the registration requirement even if their stock is publicly traded through ADRs.

Remuneration subject to the deduction limitation

In general

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in section 280G) that are not deductible by the corporation.[1228]

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account: (1) remuneration payable on a com-

[1224] Notice 2007–49, 2007–25 I.R.B. 1429.
[1225] By reason of being among the officers whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934.
[1226] Treas. Reg. sec. 1.162–27(c)(2)(i).
[1227] Sec. 162(m)(2).
[1228] Sec. 162(m)(4)(F).

mission basis;[1229] (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met ("performance-based compensation");[1230] (3) payments to a tax-favored retirement plan (including salary reduction contributions);[1231] (4) amounts that are excludable from the executive's gross income (such as employer-provided health benefits and miscellaneous fringe benefits[1232]);[1233] and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993.[1234] In addition, remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (*e.g.*, is not performance-based compensation) because the payment of the compensation is deferred until after termination of employment.

Performance-based compensation

Compensation qualifies for the exception for performance-based compensation only if (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation committee consisting solely of two or more outside directors, (3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate majority-approved vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.[1235]

Compensation (other than a stock option or other stock appreciation right ("SAR") that meets certain requirements) is not treated as paid solely on account of the attainment of one or more performance goals unless the compensation is paid to the particular executive pursuant to a pre-established objective performance formula or standard that precludes discretion. A stock option or SAR with an exercise price not less than the fair market value, on the date the option or SAR is granted, of the stock subject to the option or SAR, generally is treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval are met (without the need for certification that the performance standards have been met). This is the case because the amount of compensation attributable to such an option or SAR received by the executive is based solely on an increase in the corporation's stock price. Stock-based compensation is not treated as performance-based if it depends on factors other

[1229] Sec. 162(m)(4)(B).
[1230] Sec. 162(m)(4)(C).
[1231] Treas. Reg. secs. 1.162–27(c)(3)(ii)(A) and (B).
[1232] Secs. 105, 106, and 132.
[1233] Treas. Reg. sec. 1.162–27(c)(3)(ii)(B).
[1234] Treas. Reg. sec. 1.162–27(h).
[1235] Sec. 162(m)(4)(C); Treas. Reg. sec. 162–27(e). A director is considered an outside director if he or she is not a current employee of the corporation (or related entities), is not a former employee of the corporation (or related entities) who is receiving compensation for prior services (other than benefits under a qualified retirement plan), was not an officer of the corporation (or related entities) at any time, and is not currently receiving compensation for personal services in any capacity (*e.g.*, for services as a consultant) other than as a director. Treas. Reg. sec. 1.162–27(e)(3).

than corporate performance, unless all of the general requirements for performance-based compensation are met.[1236]

Explanation of Provision

Definition of covered employee

The provision revises the definition of covered employee to include both the principal executive officer and the principal financial officer. Further, an individual is a covered employee if the individual holds one of these positions at any time during the taxable year. The provision also defines as a covered employee the three (rather than four) most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer) who are required to be reported on the company's proxy statement (*i.e.*, the statement required pursuant to executive compensation disclosure rules promulgated under the Exchange Act) for the taxable year (or who would be required to be reported on such a statement for a company not required to make such a report to shareholders). This includes such officers of a corporation not required to file a proxy statement but which otherwise falls within the revised definition of a publicly held corporation, as well as such officers of a publicly held corporation that would otherwise have been required to file a proxy statement for the year (for example, but for the fact that the corporation delisted its securities or underwent a transaction that resulted in the nonapplication of the proxy statement requirement). The determination of the three most highly compensated officers who are "covered employees" is consistent between a publicly held corporation subject to the executive compensation disclosure rules under the Exchange Act and such a corporation not subject to these disclosure rules. The compensation taken into account to make the determination is total compensation pursuant to these disclosure rules. Therefore, the three highest compensated officers who are "covered employees" under the provision include any employee (other than the principal executive officer or principal financial officer) whose total compensation for the taxable year results in the employee being among the three highest compensated officers for the taxable year, whether or not the officer's compensation is required to be reported to shareholders under the Exchange Act and whether or not such individual was employed on the last day of the taxable year.

In addition, if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died. The provision clarifies that compensation does not fail to be compensation with respect to a covered employee and thus subject to the deduction limit for a taxable year merely because the compensation is includible in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the em-

[1236] Treas. Reg. sec. 1.162–27(e)(2)(vi).

ployee's death, or to a former spouse pursuant to a domestic relations order.

Definition of publicly held corporation

The provision expands the definition of publicly held corporation to include an issuer that is required to file reports under section 15(d) of the Exchange Act. Therefore, in addition to applying to all domestic publicly traded corporations and certain foreign companies publicly traded through ADRs, the provision extends the applicability of section 162(m) to include all foreign companies publicly traded through ADRs.

The definition of an issuer that is required to file reports under section 15(d) of the Exchange Act may also include certain additional corporations that are not publicly traded, such as large private C corporations or S corporations. For example, entities that are required to report under section 15(d) of the Exchange Act include (1) any corporation, whether publicly or non-publicly traded, that issues securities which are held by more than 300 holders of record (1,200 holders of record in the case of a bank, savings and loan holding company, or a bank holding company), and (2) any S corporation or non-publicly traded C corporation that has issued asset-backed securities, regardless of the number of holders of record, unless all of its asset-backed securities are held by affiliates of the corporation.[1237]

It is intended that Treasury apply anti-abuse rules regarding the application of section 162(m) to issuers that file reports under section 15(d) of the Exchange Act, including rules to provide consistency in its application to such issuers.

Performance-based compensation and commissions exceptions

The provision eliminates the exceptions for commissions and performance-based compensation from the definition of compensation subject to the deduction limit. As a result, such compensation is taken into account in determining the amount of compensation with respect to a covered employee for a taxable year that exceeds $1 million and is thus not deductible under section 162.

The Treasury Department has issued published guidance addressing this provision.[1238]

Effective Date

The provision applies to taxable years beginning after December 31, 2017. A transition rule applies to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date.

For purposes of the transition rule, compensation paid pursuant to a plan qualifies for this exception provided that the right to participate in the plan is part of a written binding contract with the covered employee in effect on November 2, 2017. For example, sup-

[1237] See 15 U.S.C. sec. 78o.
[1238] Notice 2018–68, 2018–36 I.R.B. 418.

pose a covered employee was hired by XYZ Corporation on October 2, 2017, and one of the terms of the written employment contract is that the executive is eligible to participate in the 'XYZ Corporation Executive Deferred Compensation Plan' in accordance with the terms of the plan. Assume further that the terms of the plan provide for participation after six months of employment, amounts payable under the plan are not subject to discretion, and the corporation does not have the right to amend materially the plan or to terminate the plan (except on a prospective basis before any services are performed with respect to the applicable period for which such compensation is to be paid). Provided that the other conditions of the binding contract exception are met (*e.g.*, the plan itself is in writing), payments under the plan are grandfathered, even though the employee was not actually a participant in the plan on November 2, 2017.[1239]

The fact that a plan was in existence on November 2, 2017 is not by itself sufficient to qualify the plan for the exception for binding written contracts. The exception is limited to amounts to which a contractual obligation applies on November 2, 2017.

The exception for remuneration paid pursuant to a binding written contract ceases to apply to amounts paid after there has been a material modification to the terms of the contract. The exception also does not apply to new contracts entered into or renewed after November 2, 2017. For purposes of this rule, any contract that is entered into on or before November 2, 2017 and that is renewed after such date is treated as a new contract entered into on the day the renewal takes effect. A contract that is terminable or cancelable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as so terminable or cancelable if it can be terminated or cancelled only by terminating the employment relationship of the covered employee.

For an individual who would have been a covered employee prior to the effective date of the amendments made to section 162(m), the transition rule is limited to the remuneration of such a covered employee that otherwise satisfies the performance-based and commission exceptions under prior law as well as the requirements applicable to a written binding contract in effect on November 2, 2017. As a result, the transition rule generally does not extend to any other remuneration, including salary, deferred compensation, or non-performance-based cash or equity compensation, of such a covered employee. For an individual who is a covered employee as a result of the amendments made by section 13601 of Pub. L. No. 115–97, remuneration that does not satisfy the requirements applicable to a written binding contract in effect on November 2, 2017 is subject to section 162(m). Such remuneration may include deferred compensation and severance that does not satisfy the written binding contract requirements. Remuneration subject to section 162(m) does include equity compensation and other compensatory

[1239] As discussed in the text below, the grandfather treatment ceases to apply if the plan is materially amended.

awards granted after November 2, 2017, even if pursuant to a plan in existence on November 2, 2017.

B. Excise Tax on Excess Tax-Exempt Organization Executive Compensation (sec. 13602 of the Act and new sec. 4960 of the Code)

Prior Law

Taxable employers and other service recipients generally may deduct reasonable compensation expenses.[1240] However, in some cases, compensation in excess of specific levels is not deductible.

A publicly held corporation generally cannot deduct more than $1 million of compensation (that is not compensation otherwise excepted from this limit) in a taxable year for each "covered employee."[1241] For this purpose, a covered employee is the corporation's principal executive officer (or an individual acting in such capacity) defined in reference to the Securities Exchange Act of 1934 ("Exchange Act") as of the close of the taxable year, or any employee whose total compensation is required to be reported to shareholders under the Exchange Act by reason of being among the corporation's three most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer).[1242]

Unless an exception applies, generally a corporation cannot deduct that portion of the aggregate present value of a "parachute payment" which equals or exceeds three times the "base amount" of certain service providers. The nondeductible excess is an "excess parachute payment."[1243] A parachute payment is generally a payment of compensation that is contingent on a change in corporate ownership or control made to certain officers, shareholders, and highly compensated individuals.[1244] An individual's base amount is the average annualized compensation includible in the individual's gross income for the five taxable years ending before the date on which the change in ownership or control occurs.[1245] Certain amounts are not considered parachute payments, including payments under a qualified retirement plan, a simplified employee pension plan, or a simple retirement account.[1246]

These deduction limits generally do not affect a tax-exempt organization.

Explanation of Provision

Under the provision, an employer is liable for an excise tax equal to the corporate tax rate (21 percent) multiplied by the sum of (1) any remuneration (other than an excess parachute payment) in excess of $1 million paid to a covered employee by an applicable tax-exempt organization for a taxable year, and (2) any excess parachute payment (under a new definition for this purpose that relates

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[1240] Sec. 162(a)(1).

[1241] Sec. 162(m)(1). Under section 162(m)(6), another limit applies to deductions for compensation of individuals performing services for certain health insurance providers.

[1242] Notice 2007–49, 2007–2 I.R.B. 1429.

[1243] Secs. 280G(a) and (b)(1).

[1244] Secs. 280G(b)(2) and (c).

[1245] Sec. 280G(b)(3).

[1246] Secs. 401(a), 403(a), 408(k), and 408(p).

solely to separation pay) paid by the applicable tax-exempt organization to a covered employee. Accordingly, the excise tax applies as a result of an excess parachute payment, even if the covered employee's remuneration does not exceed $1 million.

For purposes of the provision, a covered employee is an employee (including any former employee) of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for the taxable year or was a covered employee of the organization (or a predecessor) for any preceding taxable year beginning after December 31, 2016.

For purposes of determining who is a covered employee, all of the compensation of an employee of an applicable tax-exempt organization (or a predecessor), including compensation directly or indirectly paid to an employee by any related person or governmental entity, is taken into account to determine the five highest compensated employees of the organization for the taxable year.[1247] Also for purposes of determining a covered employee, remuneration paid to a licensed medical professional that is directly related to the performance of medical or veterinary services by such professional is not taken into account, whereas remuneration paid to such a professional in any other capacity is taken into account. A medical professional for this purpose includes a doctor, nurse, or veterinarian. Therefore, if a surgeon performs direct medical services as part of his or her medical practice, and also performs services that are not direct medical services (such as teaching, research, or acting as dean, officer, or board member of a hospital), that portion of such a medical professional's remuneration attributable to those services that are direct medical services is not treated as remuneration.

An "applicable tax-exempt organization" is an organization exempt from tax under section 501(a), an exempt farmers' cooperative,[1248] a Federal, State or local governmental entity with excludable income,[1249] or a political organization.[1250] Applicable tax-exempt organizations are intended to include State colleges and universities.[1251]

For purposes of the timing of application of the excise tax, remuneration is treated as paid when there is no substantial risk of forfeiture of the rights to such remuneration. For this purpose, the determination of when a "substantial risk of forfeiture" no longer exists is based on the definition under section 457(f)(3)(B). Accordingly, the tax imposed by this provision can apply to the value of remuneration that is vested (and any increases in such value or vested remuneration) under this definition, even if it is not yet received. Therefore, the excise tax can apply to remuneration at a time that is different than the time remuneration is required to be included in gross income as wages.[1252]

[1247] The compensation used for purposes of determining who is a covered employee is intended to be expansive to most accurately determine the five highest compensated employees, and includes compensation from disregarded entities.

[1248] Sec. 521(b).

[1249] Sec. 115(1).

[1250] Sec. 527(e)(1).

[1251] A technical correction may be necessary to reflect this intent.

[1252] For example, even though remuneration may be vested in one year but paid within the first two and one-half months of the following year such that the income inclusion is required in the year paid, the remuneration is treated as paid for this purpose in the year when vested.

Remuneration for this purpose means wages as defined for income tax withholding purposes,[1253] but does not include any designated Roth contribution.[1254] In addition, the definition of remuneration for this purpose includes amounts required to be included in gross income under section 457(f).[1255] This definition applies to determine the type of compensation that is treated as remuneration but does not control the time when the excise tax is assessed on remuneration that exceeds the $1 million threshold. As described above, the excise tax applies when remuneration (once determined under this definition) is treated as paid (*i.e.*, when the right to the remuneration is no longer subject to a substantial risk of forfeiture, as defined), without regard to when such remuneration is actually received or otherwise required to be included in gross income as wages.

Remuneration of a covered employee includes any remuneration paid with respect to employment of the covered employee by any person or governmental entity related to the applicable tax-exempt organization.[1256] A person or governmental entity is treated as related to an applicable tax-exempt organization if the person or governmental entity (1) controls, or is controlled by, the organization, (2) is controlled by one or more persons that control the organization, (3) is a supported organization[1257] during the taxable year with respect to the organization, (4) is a supporting organization[1258] during the taxable year with respect to the organization, or (5) in the case of a voluntary employees' beneficiary association ("VEBA"),[1259] establishes, maintains, or makes contributions to the VEBA. However, remuneration of a covered employee that is not deductible by reason of the $1 million limit on deductible compensation[1260] is not taken into account for purposes of the provision.

Under the provision, an excess parachute payment is the amount by which any parachute payment exceeds the portion of the base amount allocated to the payment. A parachute payment is a payment in the nature of compensation to (or for the benefit of) a covered employee if the payment is contingent on the employee's separation from employment and the aggregate present value of all such payments equals or exceeds three times the base amount. The

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Additionally, earnings on previously vested remuneration, even if paid or payable in future years, are treated as paid for this purpose as they accrue.

[1253] Sec. 3401(a).

[1254] Under section 402A(c), a designated Roth contribution is an elective deferral (that is, a contribution to a tax-favored employer-sponsored retirement plan made at the election of an employee) that the employee designates as not being excludable from income.

[1255] Such amounts may not be treated as wages under section 3401(a), but are treated as remuneration for purposes of the excise tax application. See Technical Advice Memorandum 199903032, October 2, 1998. Sec. 457(f) applies to an "ineligible" deferred compensation plan of a State or local government or a tax-exempt employer (that is, a plan that does not meet the requirements to be an eligible plan under section 457(b)). Under an ineligible plan, deferred amounts are treated as nonqualified deferred compensation and includible in income for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation. For this purpose, a person's rights to compensation are subject to a substantial risk of forfeiture if the rights are conditioned on the future performance of substantial services by any individual. Earnings post-vesting are generally taxed when paid.

[1256] Sec. 4960(c)(4). A technical correction may be necessary to reflect that the related organization rules also apply to excess parachute payments and for purposes of determining covered employees.

[1257] Sec. 509(f)(3).

[1258] Sec. 509(a)(3).

[1259] Sec. 501(c)(9).

[1260] Sec. 162(m).

base amount is the average annualized compensation includible in the covered employee's gross income for the five taxable years ending before the date of the employee's separation from employment. Parachute payments do not include payments under a qualified retirement plan, a simplified employee pension plan, a simple retirement account, a tax-deferred annuity,[1261] or an eligible deferred compensation plan of a State or local government employer.[1262] Parachute payments include amounts contingent on separation from employment from severance and deferred compensation plans (including supplemental executive retirement plans), and do not exclude *bona fide* severance or separation pay plans under section 457(f) or section 409A.

Payments to employees who are not highly compensated employees (within the meaning of section 414(q)), and payments attributable to medical services of certain licensed medical professionals,[1263] are exempt from the definition of parachute payment.

The employer of a covered employee is liable for the excise tax. If remuneration of a covered employee from more than one employer is taken into account in determining the excise tax, each employer is liable for the tax in an amount that bears the same ratio to the total tax as the remuneration paid by that employer bears to the total remuneration paid by all of the employers to the covered employee. For purposes of these rules, the liability for the excise tax on an excess parachute payment is intended to be treated the same as the liability for the excise tax on remuneration.[1264]

The provision directs the Secretary of the Treasury to prescribe regulations as necessary to prevent avoidance of the excise tax, including regulations to prevent avoidance of the tax through self-employment or through payment or services via a pass-through or other entity to avoid the tax. For example, the excise tax cannot be avoided if an individual who is an employee is classified as an independent contractor and paid as such, or if payment is made to an LLC owned all or in part by an employee or to or by a person or organization unrelated to an applicable tax-exempt organization.

Effective Date

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

C. Treatment of Qualified Equity Grants (sec. 13603 of the Act and new sec. 83(i) of the Code)

Prior Law

Income tax treatment of employer stock transferred to an employee

Specific rules apply to property, including employer stock, transferred to an employee in connection with the performance of serv-

[1261] Sec. 403(b).
[1262] Sec. 457(b).
[1263] Sec. 4960(c)(5)(C). The principles of allocation described above that apply to determine exempt remuneration attributable to medical services also apply to determine exempt payments attributable to medical services for purposes of parachute payments.
[1264] Sec. 4960(c)(4)(C). A technical correction may be necessary to reflect this.

ices.[1265] These rules govern the amount and timing of income inclusion by the employee and the amount and timing of the employer's compensation deduction.

Under these rules, an employee generally must recognize income in the taxable year in which the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier (referred to herein as "substantially vested"). Thus, if the employee's right to the stock is substantially vested when the stock is transferred to the employee, the employee recognizes income in the taxable year of such transfer, in an amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). If at the time the stock is transferred to the employee, the employee's right to the stock is not substantially vested (referred to herein as "nonvested"), the employee does not recognize income attributable to the stock transfer until the taxable year in which the employee's right becomes substantially vested. In this case, the amount includible in the employee's income is the fair market value of the stock as of the date that the employee's right to the stock is substantially vested (less any amount paid for the stock). However, if the employee's right to the stock is nonvested at the time the stock is transferred to the employee, under section 83(b), the employee may elect within 30 days of transfer to recognize income in the taxable year of transfer, referred to as a "section 83(b)" election.[1266] If a proper and timely election under section 83(b) is made, the amount of compensatory income is capped at the amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). A section 83(b) election is available with respect to grants of "restricted stock" (nonvested stock), and does not generally apply to the grant of options.

In general, an employee's right to stock or other property is subject to a substantial risk of forfeiture if the employee's right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services.[1267] An employee's right to stock or other property is transferable if the employee can transfer an interest in the property to any person other than the transferor of the property.[1268] Thus, generally, employer stock transferred to an employee by an employer is not transferable merely because the employee can sell it back to the employer.

In the case of stock transferred to an employee, the employer is allowed a deduction (to the extent a deduction for a business expense is otherwise allowable) equal to the amount included in the

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[1265] Sec. 83. Section 83 applies generally to transfers of any property, not just employer stock, in connection with the performance of services by any service provider, not just an employee. However, the provision described herein applies only with respect to certain employer stock transferred to employees.

[1266] Under Treas. Reg. sec. 1.83–2, the employee makes an election by filing with the Internal Revenue Service a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The employee must also provide a copy of the statement to the employer.

[1267] See section 83(c)(1) and Treas. Reg. sec. 1.83–3(c) for the definition of substantial risk of forfeiture for this purpose.

[1268] Treas. Reg. sec. 1.83–3(d). In addition, under section 83(c)(2), the right to stock is transferable only if any transferee's right to the stock would not be subject to a substantial risk of forfeiture.

employee's income as a result of transfer of the stock.[1269] The employer deduction generally is permitted in the employer's taxable year in which or with which ends the employee's taxable year when the amount is included and properly reported in the employee's income.[1270]

These rules do not apply to the grant of a nonqualified option on employer stock unless the option has a readily ascertainable fair market value.[1271] Instead, these rules apply to the transfer of employer stock to the employee on exercise of the option. That is, if the right to the stock is substantially vested on transfer (the time of exercise), income recognition applies for the taxable year of transfer. If the right to the stock is nonvested on transfer, the timing of income inclusion is determined under the rules applicable to the transfer of nonvested stock. In either case, the amount includible in income by the employee is the fair market value of the stock as of the required time of income inclusion, less the exercise price paid by the employee. A section 83(b) election generally does not apply to the grant of options. If upon the exercise of an option, nonvested stock is transferred to the employee, a section 83(b) election may apply. The employer's deduction is generally determined under the rules that apply to transfers of restricted stock, but a special accrual rule may apply under Treasury regulations when the transferred stock is substantially vested.[1272]

Employment taxes and reporting

Employment taxes generally consist of taxes under the Federal Insurance Contributions Act ("FICA"), tax under the Federal Unemployment Tax Act ("FUTA"), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").[1273] Unless an exception applies under the applicable rules, compensation provided to an employee constitutes wages subject to these taxes.

FICA imposes tax on employers and employees, generally based on the amount of wages paid to an employee during the year. Special rules as to the timing and amount of FICA taxes apply in the case of nonqualified deferred compensation, as defined for FICA purposes.[1274]

The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the OASDI wage base ($127,200 for 2017); and (2) the Medicare or hospital insurance ("HI") tax equal to 1.45 percent of all covered wages.[1275] The employee portion of FICA tax

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[1269] Sec. 83(h).

[1270] Treas. Reg. sec. 1.83–6.

[1271] See section 83(e)(3) and Treas. Reg. sec. 1.83–7. A nonqualified option is an option on employer stock that is not a statutory option, discussed below.

[1272] Treas. Reg. sec. 1.83–6(a)(3).

[1273] Secs. 3101–3128 (FICA), 3301–3311 (FUTA), and 3401–3404 (income tax withholding). Instead of FICA taxes, railroad employers and employees are subject, under the Railroad Retirement Tax Act ("RRTA"), sections 3201–3241, to taxes equivalent to FICA taxes with respect to compensation as defined for RRTA purposes. Sections 3501–3510 provide additional rules relating to all these taxes.

[1274] Sec. 3121(v); Treas. Reg. sec. 31.3121(v)(2)–1.

[1275] 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

generally must be withheld and, along with the employer portion, remitted to the Federal government by the employer. FICA tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.[1276]

FUTA imposes a tax on employers of six percent of wages up to the FUTA wage base of $7,000.

Income tax withholding generally applies when wages are paid by an employer to an employee, based on graduated withholding rates set out in tables published by the Internal Revenue Service ("IRS").[1277] Like FICA tax withholding, income tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.

An employer is required to furnish each employee with a statement of compensation information for a calendar year, including taxable compensation, FICA wages, and withheld income and FICA taxes.[1278] In addition, information relating to certain nontaxable items must be reported, such as certain retirement and health plan contributions. The statement, made on Form W–2, Wage and Tax Statement, must be provided to each employee by January 31 of the succeeding year.[1279]

Statutory options

Two types of statutory options apply with respect to employer stock: incentive stock options ("ISOs") and options provided under an employee stock purchase plan ("ESPP").[1280] Stock received pursuant to a statutory option is subject to special rules, rather than the rules for nonqualified options, discussed above. No amount is includible in an employee's income on the grant, vesting, or exercise of a statutory option.[1281] In addition, generally no deduction is allowed to the employer with respect to the option or the stock transferred to an employee.

If a holding requirement is met with respect to the stock transferred on exercise of a statutory option and the employee later disposes of the stock, the employee's gain generally is treated as capital gain rather than ordinary income. Under the holding requirement, the employee must not dispose of the stock within two years after the date the option is granted and also must not dispose of the stock within one year after the date the option is exercised. If a disposition occurs before the end of the required holding period (a "disqualifying disposition"), the employee recognizes ordinary in-

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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.

[1276] Under section 3501(b), employment taxes with respect to noncash fringe benefits are to be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary of the Treasury. Announcement 85–113, 1985–31 I.R.B. 31, provides guidance on the application of employment taxes with respect to noncash fringe benefits.

[1277] Sec. 3402. Specific withholding rates apply in the case of supplemental wages.

[1278] Secs. 6041 and 6051.

[1279] Employers send Form W–2 information to the Social Security Administration, which records information relating to Social Security and Medicare and forwards the Form W–2 information to the IRS. Employees include a copy of Form W–2 with their income tax returns.

[1280] Sections 421-424 govern statutory options. Section 423(b)(5) requires that, under the terms of an ESPP, all employees granted options generally must have the same rights and privileges.

[1281] Under section 56(b)(3), this income tax treatment with respect to stock received on exercise of an ISO does not apply for purposes of the alternative minimum tax under section 55.

come in the taxable year in which the disqualifying disposition occurs, and the employer may be allowed a corresponding deduction in the taxable year in which such disposition occurs. The amount of ordinary income recognized when a disqualifying disposition occurs generally equals the fair market value of the stock on the date of exercise (that is, when the stock was transferred to the employee) less the exercise price paid.

Employment taxes do not apply with respect to the grant or vesting of a statutory option, transfer of stock pursuant to the option, or a disposition (including a disqualifying disposition) of the stock.[1282] However, certain special reporting requirements apply.

Nonqualified deferred compensation

Compensation is generally includible in an employee's income when paid to the employee. However, in the case of a nonqualified deferred compensation plan,[1283] unless the arrangement either is exempt from or meets the requirements of section 409A, the amount of deferred compensation is first includible in income for the taxable year when not subject to a substantial risk of forfeiture (as defined[1284]), even if payment will not occur until a later year.[1285] In general, to meet the requirements of section 409A, the time when nonqualified deferred compensation will be paid, as well as the amount, must be specified at the time of deferral with limits on further deferral after the time for payment. Various other requirements apply, including that payment can only occur on specific defined events.

Various exemptions from section 409A apply, including transfers of property subject to section 83.[1286] Nonqualified options are not automatically exempt from section 409A, but may be structured so as not to be considered nonqualified deferred compensation.[1287] A restricted stock unit ("RSU") is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU. The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock (or both). An arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the

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[1282] Secs. 3121(a)(22), 3306(b)(19), and the last sentence of section 421(b).

[1283] Compensation earned by an employee is generally paid to the employee shortly after being earned. However, in some cases, payment is deferred to a later period, referred to as "deferred compensation." Deferred compensation may be provided through a plan that receives tax-favored treatment, such as a qualified retirement plan under section 401(a). Deferred compensation provided through a plan that is not eligible for tax–favored treatment is referred to as "nonqualified" deferred compensation.

[1284] Treas. Reg. sec. 1.409A–1(d).

[1285] Section 409A and the regulations thereunder provide rules for nonqualified deferred compensation. Compensation that fails to meet the requirements of section 409A is also subject to an additional income tax of 20 percent on amounts includible in income and a potential interest factor tax ("409A taxes"). Section 409A and the additional 409A taxes apply to increases in the value of the failed compensation each year until it is paid.

[1286] Treas. Reg. sec. 1.409A–1(b)(6).

[1287] Treas. Reg. sec. 1.409A–1(b)(5). In addition, statutory option arrangements are not nonqualified deferred compensation arrangements.

limits, of section 409A. The employer deduction generally is permitted in the employer's taxable year in which or with which ends the employee's taxable year when the amount is included and properly reported in the employee's income.[1288]

Explanation of Provision

In general

The provision allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income attributable to qualified stock transferred to the employee by the employer. An election to defer income inclusion ("inclusion deferral election") with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

Similar to statutory options, employers are not required to offer elections to employees under the new provision unless the employer has made the determination that the various requirements have been or can be met, as applicable. As described below in more detail, an employer must satisfy various requirements and make certain determinations in order for the provision to apply, including information that an employee may not necessarily know in order to make an election. This includes whether the employer is an "eligible corporation," whether the employee is a "qualified employee" (or is instead an "excluded employee" who may not make an election), and whether "qualified stock" has been transferred. This also includes certain requirements that the employer must satisfy under a written plan, and must notify and certify (subject to transition rules) to employees, before an election may be made. In addition, specific employer withholding and reporting obligations cannot be properly met by an employer unless the employer satisfies the various requirements and makes the necessary determinations, and has implemented appropriate procedures to ensure that the withholding and reporting requirements are met.

If an employee elects to defer income inclusion under the provision, the income must be included in the employee's income for the taxable year that includes the earliest of (1) the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer;[1289] (2) the date the employee first becomes an excluded employee (as described below); (3) the first date on which any stock of the employer becomes readily tradable on an established securities market;[1290] (4) the date five years after the first date the employee's right to the stock becomes substantially vested; or (5) the date on which the employee revokes

[1288] Sec. 404(a)(5).

[1289] For purposes of the inclusion deferral election, if shares are substantially vested under the rules of section 83 but the employee has the right to sell such shares to the employer or any other person, the qualified stock is considered transferable and therefore income inclusion immediately applies. Therefore, section 83(i)(1)(B)(i) operates to effectively invalidate the deferral of income inclusion when an employee has been transferred shares that the employee has a right to sell.

[1290] An established securities market is determined for this purpose by the Secretary, but does not include any market unless the market is recognized as an established securities market for purposes of another Code provision.

her inclusion deferral election.[1291] It is intended that the limited circumstances outlined in section 83(c)(3) and applicable regulations apply with respect to the determination of when stock first becomes transferrable or is no longer subject to a substantial risk of forfeiture. For example, income inclusion cannot be delayed due to a lock-up period as a result of an initial public offering.

An inclusion deferral election is made in a manner similar to the manner in which a section 83(b) election is made.[1292] The provision does not apply to income with respect to nonvested stock that is includible as a result of a section 83(b) election. The provision clarifies that other than subsection (i), the provisions of section 83 including subsection (b) shall not apply to RSUs. Therefore, RSUs are not eligible for a section 83(b) election. This is the case because, absent this provision, RSUs are nonqualified deferred compensation and therefore subject to the rules that apply to nonqualified deferred compensation.

An employee may not make an inclusion deferral election for a year with respect to qualified stock if, in the preceding calendar year, the corporation purchased any of its outstanding stock unless at least 25 percent of the total dollar amount of the stock so purchased is stock with respect to which an inclusion deferral election is in effect ("deferral stock") and the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis.[1293] For purposes of this requirement, stock purchased from an individual is not treated as deferral stock (and the purchase is not treated as a purchase of deferral stock) if, immediately after the purchase, the individual holds any deferral stock with respect to which an inclusion deferral election has been in effect for a longer period than the election with respect to the purchased stock. Thus, in general, in applying the purchase requirement, an individual's deferral stock with respect to which an inclusion deferral election has been in effect for the longest periods must be purchased first. A corporation that has deferral stock outstanding as of the beginning of any calendar year and that purchases any of its outstanding stock during the calendar year must report on its income tax return for the taxable year in which, or with which, the calendar year ends the total dollar amount of the outstanding stock purchased during the calendar year and such other information as the Secretary may require for purposes of administering this requirement.

A qualified employee may make an inclusion deferral election with respect to qualified stock attributable to a statutory option.[1294] In that case, the option is not treated as a statutory option and the rules relating to statutory options and related stock do not apply. In addition, an arrangement under which an employee may receive qualified stock is not treated as a nonqualified deferred compensation plan under section 409A with respect to that em-

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[1291] An inclusion deferral election is revoked at the time and in the manner as the Secretary provides.

[1292] Thus, as in the case of a section 83(b) election, the employee must file with the IRS the inclusion deferral election and provide the employer with a copy.

[1293] This requirement is met if the stock purchased by the corporation includes all the corporation's outstanding deferral stock.

[1294] For purposes of the requirement that an ESPP provide employees with the same rights and privileges, the rules of the provision apply in determining which employees have the right to make an inclusion deferral election with respect to stock received under the ESPP.

ployee solely because of the employee's election, or ability to make an election, to defer income recognition with respect to such stock.

Deferred income inclusion applies also for purposes of the employer's deduction of the amount of income attributable to the qualified stock. That is, if an employee makes an inclusion deferral election, the employer's deduction is deferred until the employer's taxable year in which or with which ends the taxable year of the employee for which the amount is included in the employee's income as described in (1)–(5) above.[1295]

Qualified employee and qualified stock

Under the provision, a qualified employee means an individual who is not an excluded employee and who agrees, in the inclusion deferral election, to meet the requirements necessary (as determined by the Secretary) to ensure the income tax withholding requirements of the employer corporation with respect to the qualified stock (as described below) are met. For this purpose, an excluded employee with respect to a corporation is any individual (1) who was a one-percent owner of the corporation at any time during the 10 preceding calendar years,[1296] (2) who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity, (3) who is a family member of an individual described in (1) or (2),[1297] or (4) who has been one of the four highest compensated officers of the corporation for any of the 10 preceding taxable years.[1298] An excluded employee includes an individual who first becomes a one-percent owner or one of the four highest compensated officers in a taxable year, notwithstanding that such individual may not have been among such categories for the 10 preceding taxable years.

Qualified stock is any stock of a corporation if—

- an employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and
- the option or RSU was granted by the corporation to the employee in connection with the performance of services and in a year in which the corporation was an eligible corporation (as described below).

However, qualified stock does not include any stock if, at the time the employee's right to the stock becomes substantially vested, the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation. Stock is qualified stock only if it relates to stock received in connection with options or RSUs, and does not include stock received in connection with other forms of equity compensation, including stock appreciation rights or restricted stock.

A corporation is an eligible corporation with respect to a calendar year if (1) no stock of the employer corporation (or any predecessor)

[1295] Note that the deduction rule under Treas. Reg. sec. 1.83-6(a)(3), which allows an employer a deduction in accordance with its method of accounting when property is substantially vested upon transfer, is not applicable.

[1296] One-percent owner status is determined under the top-heavy rules for qualified retirement plans, under section 416(i)(1)(B)(ii).

[1297] In the case of one-percent owners, this results from application of the attribution rules of section 318 under section 416(i)(1)(B)(i)(I). Family members are determined under section 318(a)(1) and generally include an individual's spouse, children, grandchildren, and parents.

[1298] These officers are determined on the basis of shareholder disclosure rules for compensation under the Securities Exchange Act of 1934, as if such rules applied to the corporation.

is readily tradable on an established securities market during any preceding calendar year,[1299] and (2) the corporation has a written plan under which, in the calendar year, the corporation grants stock options or grants restricted stock units ("RSUs") with the same rights and privileges to receive qualified stock to not less than 80 percent of all employees who provide services to the corporation in the United States or any U.S. possession ("80-percent requirement").[1300] For this purpose, in general, the determination of rights and privileges with respect to stock is determined in a similar manner as provided under the ESPP rules.[1301] However, employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, provided that the number of shares available to each employee is more than a *de minimis* amount. In addition, rights and privileges with respect to the exercise of a stock option are not treated for this purpose as the same as rights and privileges with respect to the settlement of an RSU.[1302] The requirement that 80 percent of all applicable employees be granted stock options or restricted stock units with the same rights and privileges cannot be satisfied in a calendar year by granting a combination of stock options and RSUs; instead all such employees must either be granted stock options or be granted restricted stock units for that year. It is intended that the requirement that 80 percent of all applicable employees be granted stock options or be granted restricted stock units apply consistently to eligible employees in each calendar year, whether they are new hires or existing employees in the relevant year.

For purposes of the provision, corporations that are members of the same controlled group[1303] are treated as one corporation.

Notice, withholding, and reporting requirements

Under the provision, a corporation that transfers qualified stock to a qualified employee must provide a notice to the qualified employee at the time (or a reasonable period before) the employee's right to the qualified stock is substantially vested (and income attributable to the stock would first be includible absent an inclusion deferral election). The notice must (1) certify to the employee that the stock is qualified stock, and (2) notify the employee (a) that the employee may (if eligible) elect to defer income inclusion with respect to the stock and (b) that, if the employee makes an inclusion deferral election, the amount of income required to be included at the end of the deferral period will be based on the value of the stock at the time the employee's right to the stock first becomes substantially vested, notwithstanding whether the value of the

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[1299] This requirement continues to apply up to the time an inclusion deferral election is made. That is, under the provision, no inclusion deferral election may be made with respect to qualified stock if any stock of the corporation is readily tradable on an established securities market at any time before the election is made.

[1300] In applying the requirement that 80 percent of employees receive stock options or RSUs, excluded employees and part-time employees are not taken into account. For this purpose, a part-time employee is defined under section 4980G(d)(4), as an employee who is customarily employed for fewer than 30 hours per week.

[1301] Sec. 423(b)(5).

[1302] Under a transition rule, in the case of a calendar year beginning before January 1, 2018, the 80-percent requirement is applied without regard to whether the rights and privileges with respect to the qualified stock are the same.

[1303] As defined in section 414(b).

stock has declined during the deferral period (including whether the value of the stock has declined below the employee's tax liability with respect to such stock). The notice must also notify the employee that if the employee makes an inclusion deferral election, the amount of income to be included at the end of the deferral period will be subject to withholding as provided under the provision,[1304] and outline the employee's responsibilities with respect to the required withholding. Failure to provide the notice may result in the imposition of a penalty of $100 for each failure, subject to a maximum penalty of $50,000 for all failures during any calendar year.

An inclusion deferral election applies only for income tax purposes. The provision includes specific income tax withholding and reporting requirements with respect to income subject to an inclusion deferral election. The application of FICA and FUTA are not affected. However, when an inclusion deferral election is made with respect to stock transferred in connection with the exercise of an ISO or ESPP (a statutory option), the option is not treated as a statutory option but rather as a nonqualified stock option for FICA and FUTA purposes (in addition to being subject to section 83(i) for income tax purposes).

For the taxable year for which income subject to an inclusion deferral election is required to be included in income by the employee (as described above), the amount required to be included in income is treated as wages with respect to which the employer is required to withhold income tax at a rate not less than the highest income tax rate applicable to individual taxpayers.[1305] The employer must report on Form W–2 the amount of income covered by an inclusion deferral election (1) for the year of deferral and (2) for the year the income is required to be included in income by the employee. In addition, for any calendar year, the employer must report on Form W–2 the aggregate amount of income covered by inclusion deferral elections, determined as of the close of the calendar year.

The Treasury Department has issued published guidance addressing this provision.[1306]

Effective Date

The provision generally applies with respect to stock attributable to options exercised or RSUs settled after December 31, 2017. Therefore, an election under the provision could apply to options or restricted stock units that were previously granted. Under a transition rule, until the Secretary issues regulations or other guidance implementing the 80-percent and employer notice requirements [1307] under the provision, a corporation will be treated as complying with those requirements (respectively) if it complies with a reasonable good faith interpretation of the requirements. It is intended for the transition rule provided with respect to compliance with the

[1304] As described in section 3401(i) and at the rate determined in section 3402(t).

[1305] That is, the maximum rate of tax in effect for the year under section 1. The provision specifies that qualified stock is treated as a noncash fringe benefit for income tax withholding purposes. Sec. 3402(t).

[1306] Notice 2018–97, 2018–52 I.R.B., December 24, 2018.

[1307] Secs. 83(i)(2)(C)(i)(II) and 83(i)(6). The 80-percent requirement includes a written plan requirement.

80–percent and employer notice requirements to not be expanded beyond these specific items, and for the 80-percent requirement for purposes of the transition rule to apply on a calendar year basis in the same manner as it does for purposes of the provision generally. The penalty for a failure to provide the notice required under the provision applies to failures after December 31, 2017.

D. Increase in Excise Tax Rate for Stock Compensation of Insiders in Expatriated Corporations (sec. 13604 of the Act and sec. 4985 of the Code)

Prior Law

Income tax treatment of employee stock compensation

In general

Employers may grant various forms of stock compensation to employees,[1308] including nonstatutory and statutory stock options, restricted stock, restricted stock units, and stock appreciation rights. The tax treatment of these various forms of stock compensation depends on the specific terms and conditions of the arrangement and applicable rules.

Stock compensation treated as property transferred in connection with the performance of services

Section 83 generally governs the taxation of transfers of any property in connection with the performance of services by any service provider. Typically, this encompasses the transfer of stock to an employee which is subject to conditions that amount to a substantial risk of forfeiture, called "restricted stock." Section 83 also generally governs the taxation of nonstatutory (or nonqualified) stock options. In general, an employee's right to stock or other property is subject to a substantial risk of forfeiture if the employee's right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services.[1309]

Generally, an employee must recognize income in the taxable year in which the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier (referred to herein as "substantially vested"). Thus, if the employee's right to the stock is substantially vested when the stock is transferred to the employee, the employee recognizes income in the taxable year of such transfer, in an amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). If at the time the stock is transferred to the employee, the employee's right to the stock is not substantially vested (referred to herein as "nonvested"), the employee does not recognize income attributable to the stock transfer until the taxable year in which the employee's right becomes substantially vested. In this case, the amount includible in the employee's income is the fair market value of the stock as of the date that the

[1308] The terms "employer" and "employee" are used, although the provision herein also applies to individuals who are not employees and the service recipients of such non-employee individuals.

[1309] See section 83(c)(1) and Treas. Reg. sec. 1.83–3(c) for the definition of substantial risk of forfeiture for this purpose.

employee's right to the stock is substantially vested (less any amount paid for the stock).[1310]

These rules do not apply to the grant of a nonqualified option unless the option has a readily ascertainable fair market value.[1311] Instead, these rules generally apply to the transfer of employer stock to the employee on exercise of the option. That is, if the right to the stock is substantially vested on transfer (the time of exercise), income recognition applies for the taxable year of transfer. If the right to the stock is nonvested on transfer, the timing of income inclusion is determined under the rules applicable to the transfer of nonvested stock. In either case, the amount includible in income by the employee is the fair market value of the stock as of the required time of income inclusion, less the exercise price paid by the employee.

Statutory stock options

Two types of statutory options apply with respect to employer stock: incentive stock options ("ISOs"') and options provided under an employee stock purchase plan ("ESPP").[1312] Stock received pursuant to a statutory option is subject to special rules, rather than the rules for nonqualified options, discussed above. Unlike nonqualified options, statutory options may only be considered as such if granted to employees.[1313] No amount is includible in an employee's income on the grant, vesting, or exercise of a statutory option.

If a holding requirement is met with respect to the stock transferred on exercise of a statutory option and the employee later disposes of the stock, the employee's gain generally is treated as capital gain rather than ordinary income. Under the holding requirement, the employee must not dispose of the stock within two years after the date the option is granted and also must not dispose of the stock within one year after the date the option is exercised. If a disposition occurs before the end of the required holding period (a "disqualifying disposition"), the employee recognizes ordinary income in the taxable year in which the disqualifying disposition occurs. The amount of ordinary income recognized when a disqualifying disposition occurs generally equals the fair market value of the stock on the date of exercise (that is, when the stock was transferred to the employee) less the exercise price paid.

Stock compensation treated as deferred compensation

A restricted stock unit ("RSU") is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such

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[1310] Under section 83(b), the employee may elect within 30 days of transfer to recognize income in the taxable year of transfer, referred to as a "section 83(b)" election. If a proper and timely election under section 83(b) is made, the amount of compensatory income is capped at the amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock).

[1311] See section 83(e)(3) and Treas. Reg. sec. 1.83–7. A nonqualified option is an option on employer stock that is not a statutory option, discussed below.

[1312] Sections 421–424 govern statutory options. Section 423(b)(5) requires that, under the terms of an ESPP, all employees granted options generally must have the same rights and privileges.

[1313] Secs. 422(a)(2) and 423(a)(2).

as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU. The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock. An arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the limits, of section 409A,[1314] unless it meets an exemption from section 409A. If the RSU either is exempt from or complies with section 409A, the employee is subject to income taxation on receipt of cash or the transfer of shares attributable to the RSU.

A stock appreciation right ("SAR") is an arrangement under which an employee has the right to receive an amount (in the form of cash or stock) determined by reference to the appreciation in value of one or more shares of employer stock, based on the difference in the stock's value when the employee chooses to exercise the right and the value of the stock on the date of grant of the SAR. An SAR is generally taxable at the time of exercise on the amount of cash or value of stock transferred at the time of exercise of the SAR.[1315]

Various exemptions from section 409A apply, including transfers of property subject to section 83, such as restricted stock.[1316] Nonqualified options and SARs are not automatically exempt from section 409A, but may be structured so as not to be considered nonqualified deferred compensation.[1317] In addition, ISOs and ESPPs are exempt from section 409A.[1318]

Section 4985 excise tax on stock compensation of insiders of expatriated corporations

Under section 4985, certain holders of stock options and other stock-based compensation are subject to an excise tax upon certain transactions that result in an expatriated corporation[1319] (also referred to as corporate inversions).[1320] The provision imposes an excise tax, currently at the rate of 15 percent, on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's expatriation date. Specified stock

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[1314] Section 409A and the regulations thereunder provide rules for nonqualified deferred compensation. Unless an arrangement either is exempt from or meets the requirements of section 409A, the amount of deferred compensation is first includible in income for the taxable year when not subject to a substantial risk of forfeiture (as defined), even if payment will not occur until a later year. In general, to meet the requirements of section 409A, the time when nonqualified deferred compensation will be paid, as well as the amount, must be specified at the time of deferral with limits on further deferral after the time for payment. Various other requirements apply, including that payment can only occur on specific defined events. Compensation that fails to meet the requirements of section 409A is also subject to an additional income tax of 20 percent on amounts includible in income and a potential interest factor tax ("409A taxes"). Section 409A and the additional 409A taxes apply to increases in the value of the failed compensation each year until it is paid.

[1315] Rev. Rul. 80–300, 1980–2 C.B. 165.

[1316] Treas. Reg. sec. 1.409A–1(b)(6).

[1317] Treas. Reg. sec. 1.409A–1(b)(5).

[1318] Treas. Reg. sec. 1.409A–1(b)(5)(ii).

[1319] Sec. 7874(a)(2).

[1320] For further discussion of the tax treatment of expatriated entities before the effective date of section 7874 and concerns that led to the enactment of sections 7874 and 4985, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th* Congress (JCS–5–05), May 2005.

compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, *e.g.*, a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the expatriation date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,[1321] or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),[1322] directors, and 10-percent owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an expatriated corporation (as defined for this purpose) only if gain is recognized in whole or part by any shareholder by reason of the acquisition resulting in the corporate inversion.[1323]

Specified stock compensation subject to the excise tax includes any payment (or right to payment)[1324] granted by the expatriated corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the corporate inversion. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, restricted stock units, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or member). For example, the provision applies to a disqualified individual's nonqualified deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

[1321] An expanded affiliated group is an affiliated group (under section 1504) except that such group is determined without regard to the exceptions for certain corporations and is determined by substituting "more than 50 percent" for "at least 80 percent."

[1322] An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

[1323] As referred to in section 7874(a)(2)(B)(i).

[1324] Under the provision, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. A payment directly tied to the value of the stock is specified stock compensation.

The excise tax applies to any such specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the expatriation date, and to any specified stock compensation awarded in the six-month period beginning with the expatriation date. As a result, for example, if a corporation cancels outstanding options three months before the transaction and then reissues comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, or a simple retirement account. In addition, under the provision, the excise tax does not apply to any stock option that is exercised during the six-month period before the expatriation date or to any stock acquired pursuant to such exercise, if income is recognized under section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock compensation that is exercised, sold, exchanged, distributed, cashed out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

For specified stock compensation held on the expatriation date, the amount of the tax is determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the expatriation date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the expatriation date is valued on the date granted. Under the provision, the cancellation of a non-lapse restriction is treated as a grant.

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants and other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right is determined using an appropriate option-pricing model, as specified or permitted by the Secretary of the Treasury, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the provision. The value of other forms of compensation, such as phantom stock or restricted stock, is the fair market value of the stock as of the date of the expatriation transaction. The value of any deferred compensation that can

be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the expatriation transaction (or the date of cancellation or grant, if applicable).

The excise tax also applies to any payment by the expatriated corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax is determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied is a payment made in respect of the tax. This includes direct payments of the tax and payments to reimburse the individual for payment of the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

To the extent that a disqualified individual is also a covered employee under section 162(m), the limit on the deduction allowed for employee remuneration for such employee is reduced by the amount of any payment (including reimbursements) made in respect of the tax under the provision. As discussed above, this includes direct payments of the tax and payments to reimburse the individual for payment of the tax.

The payment of the excise tax has no effect on the subsequent tax treatment of any specified stock compensation. Thus, the payment of the tax has no effect on the individual's basis in any specified stock compensation and no effect on the tax treatment for the individual at the time of exercise of an option or payment of any specified stock compensation, or at the time of any lapse or forfeiture of such specified stock compensation. The payment of the excise tax is not deductible and has no effect on any deduction that might be allowed at the time of any future exercise or payment.

Explanation of Provision

The provision increases the 15-percent rate of excise tax, imposed on the value of stock compensation held by insiders of an expatriated corporation, to 20 percent.

Effective Date

The provision applies to corporations first becoming expatriated corporations after the date of enactment (*i.e.*, December 22, 2017).

SUBPART B—RETIREMENT PLANS

A. Repeal of Special Rule Permitting Recharacterization of Roth Conversions (sec. 13611 of the Act and sec. 408A(d) of the Code)

Prior Law

Individual retirement arrangements

There are two basic types of individual retirement arrangements ("IRAs"): traditional IRAs,[1325] to which both deductible and nondeductible contributions may be made,[1326] and Roth IRAs, to which only nondeductible contributions may be made.[1327] The principal difference between these two types of IRAs is the timing of income tax inclusion.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is the lesser of a certain dollar amount ($5,500 for 2017) or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. The dollar limit is increased annually ("indexed") as needed to reflect increases in the cost-of living. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions up to $1,000 to an IRA. The IRA catch-up contribution limit is not indexed.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit (reduced by any contributions to Roth IRAs) if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income ("AGI") for the taxable year over certain indexed levels.[1328] To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible after-tax contributions to a traditional IRA (that is, no AGI limits apply), subject to the same contribution limits as the limits on deductible contributions, including catch-up contributions. An individual who has attained age 70½ before the close of a year is not permitted to make contributions to a traditional IRA for that year.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of the individual's basis.[1329] All traditional IRAs of an individual are

[1325] Sec. 408.
[1326] Secs. 219(a) and 408(o).
[1327] Sec. 408A.
[1328] Sec. 219(g).
[1329] Basis results from after-tax contributions to traditional IRAs or rollovers to traditional IRAs of after-tax amounts from other eligible retirement plans.

treated as a single contract for purposes of recovering basis in the IRAs.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels.[1330]

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

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

Separation of traditional and Roth IRA accounts

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

Taxpayers generally may convert an amount in a traditional IRA to a Roth IRA. The amount converted is includible in the taxpayer's income as if a withdrawal had been made.[1331] The conversion is accomplished by a trustee-to-trustee transfer of the amount from the traditional IRA to the Roth IRA, or by a distribution from the traditional IRA and contribution to the Roth IRA within 60 days.

Rollovers to IRAs of distributions from tax-favored employer-sponsored retirement plans (that is, qualified retirement plans, tax-deferred annuity plans, and governmental eligible deferred compensation plans[1332]) are also permitted. For tax-free rollovers, distributions from pretax accounts under an employer-sponsored plan generally must be contributed to a traditional IRA, and distributions from a designated Roth account under an employer-sponsored plan must be contributed only to a Roth IRA. However, a distribution from an employer-sponsored plan that is not from a designated Roth account is also permitted to be rolled over into a Roth IRA, subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, a rollover from a tax-favored employer-

[1330] Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, as discussed below.

[1331] Subject to various exceptions, distributions from an IRA before age 59½ that are includible in income are subject to a 10-percent early distribution tax under section 72(t). An exception applies to an amount includible in income as a result of the conversion from a traditional IRA into a Roth IRA. However, the early distribution tax applies if the taxpayer withdraws the converted amount within five years of the conversion.

[1332] Secs. 401(a), 403(a), 403(b) and 457(b).

sponsored plan to a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions).[1333]

Recharacterization of IRA contributions

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize the contribution as a contribution to the other type of IRA (traditional or Roth) by making a trustee-to-trustee transfer to the other type of IRA before the due date (including extensions) for the individual's income tax return for that year.[1334] In the case of a recharacterization, the contribution will be treated as having been made to the transferee IRA (and not the original, transferor IRA) as of the date of the original contribution. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA.

The amount transferred in a recharacterization must be accompanied by any net income allocable to the contribution. In general, even if a recharacterization is accomplished by transferring a specific asset, net income is calculated as a *pro rata* portion of income on the entire account rather than income allocable to the specific asset transferred. However, when doing a Roth conversion of an amount for a year, an individual may establish multiple Roth IRAs, for example, Roth IRAs with different investment strategies, and divide the amount being converted among the IRAs. The individual can then choose whether to recharacterize any of the Roth IRAs as a traditional IRA by transferring the entire amount in the particular Roth IRA to a traditional IRA.[1335] For example, if the value of the assets in a particular Roth IRA declines after the conversion, the conversion can be reversed by recharacterizing that IRA as a traditional IRA. The individual may then later convert that traditional IRA to a Roth IRA (referred to as a reconversion), including only the lower value in income. Treasury regulations prevent the reconversion from taking place immediately after the recharacterization, by requiring a minimum period to elapse before the reconversion. Generally the reconversion cannot occur sooner than the later of 30 days after the recharacterization or a date during the taxable year following the taxable year of the original conversion.[1336]

Explanation of Provision

Under the provision, the special rule that allows a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA. Thus, recharacterization cannot be used to unwind a Roth conversion. However, recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharac-

[1333] As in the case of a conversion of an amount from a traditional IRA to a Roth IRA, the special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from the Roth IRA within a specified five-year period after the rollover.

[1334] Sec. 408A(d)(6).

[1335] Treas. Reg. sec. 1.408A–5, Q&A–2(b).

[1336] Treas. Reg. sec. 1.408A–5, Q&A–9.

terize it as a contribution to a traditional IRA. In addition, an individual may still make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, but the provision precludes the individual from later unwinding the conversion through a recharacterization.

Effective Date

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

B. Modification of Rules Applicable to Length of Service Award Plans (sec. 13612 of the Act and sec. 457(e) of the Code)

Prior Law

Special rules apply to deferred compensation plans of State and local government and private, tax-exempt employers.[1337] However, an exception to these rules applies in the case of a plan paying solely length of service awards to *bona fide* volunteers (or their beneficiaries) on account of qualified services performed by the volunteers. For this purpose, qualified services consist of firefighting and fire prevention services, emergency medical services, and ambulance services. An individual is treated as a *bona fide* volunteer for this purpose if the only compensation received by the individual for performing qualified services is in the form of (1) reimbursement or a reasonable allowance for reasonable expenses incurred in the performance of such services, or (2) reasonable benefits (including length of service awards) and nominal fees for the services, customarily paid in connection with the performance of such services by volunteers. The exception applies only if the aggregate amount of length of service awards accruing for a *bona fide* volunteer with respect to any year of service does not exceed $3,000.

Explanation of Provision

The provision increases the aggregate amount of length of service awards that may accrue for a *bona fide* volunteer with respect to any year of service to $6,000 and adjusts that amount in $500 increments to reflect changes in cost-of-living for years after the first year the provision is effective. In addition, under the provision, if the plan is a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service. Actuarial present value is to be calculated using reasonable actuarial assumptions and methods, assuming payment will be made under the most valuable form of payment under the plan with payment commencing at the later of the earliest age at which unreduced benefits are payable under the plan or the participant's age at the time of the calculation.

[1337] Sec. 457.

Effective Date

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

C. Extended Rollover Period for Plan Loan Offset Amounts (sec. 13613 of the Act and sec. 402(c) of the Code)

Prior Law

Taxation of retirement plan distributions

A distribution from a tax-favored employer-sponsored retirement plan (that is, a qualified retirement plan, section 403(b) plan, or a governmental section 457(b) plan) is generally includible in gross income, except in the case of a qualified distribution from a designated Roth account or to the extent the distribution is a recovery of basis under the plan or the distribution is contributed to another such plan or an IRA (referred to as eligible retirement plans) in a tax-free rollover.[1338] In the case of a distribution from a retirement plan to an employee under age 59 ½, the distribution (other than a distribution from a governmental section 457(b) plan) is also subject to a 10-percent early distribution tax unless an exception applies.[1339]

A distribution from a tax-favored employer-sponsored retirement plan that is an eligible rollover distribution may be rolled over to an eligible retirement plan.[1340] The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution ("60-day rollover").

Employer-sponsored retirement plans are required to offer an employee a direct rollover with respect to any eligible rollover distribution before paying the amount to the employee. If an eligible rollover distribution is not directly rolled over to an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20-percent income tax withholding.[1341] Employees who do not elect a direct rollover but who roll over eligible distributions within 60 days of receipt also defer tax on the rollover amounts; however, the 20 percent that is withheld remains taxable unless the employee substitutes funds within the 60-day period.

Plan loans

Employer-sponsored retirement plans may provide loans to employees. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan is a deemed distribution from the retirement plan. Among the requirements that the loan must satisfy are that the loan's terms must provide for a repayment period of not more than five years (except for a loan specifically to purchase a home) and for level amortization of

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[1338] Secs. 402(a) and (c), 402A(d), 403(a) and (b), 457(a) and (e)(16).

[1339] Sec. 72(t).

[1340] Certain distributions are not eligible rollover distributions, such as annuity payments, required minimum distributions, hardship distributions, and loans that are treated as deemed distributions under section 72(p).

[1341] Treas. Reg. sec. 1.402(c)–2, Q&A–1(b)(3).

loan payments to be made not less frequently than quarterly.[1342] Thus, if an employee stops making payments on a loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs. A deemed distribution of an unpaid loan balance is generally taxed as though an actual distribution occurred, including being subject to a 10-percent early distribution tax, if applicable. A deemed distribution is not eligible for rollover to another eligible retirement plan.

A plan may also provide that, in certain circumstances (for example, if an employee terminates employment), an employee's obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the amount in an employee's account balance is offset by the amount of the unpaid loan balance, referred to as a loan offset. A loan offset is treated as an actual distribution from the plan equal to the unpaid loan balance (rather than a deemed distribution), and (unlike a deemed distribution) the amount of the distribution is eligible for tax-free rollover to another eligible retirement plan within 60 days. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution, and the plan loan offset amount is generally not subject to 20-percent income tax withholding.

Explanation of Provision

Under the provision, the period during which a plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution is extended from 60 days after the date of the offset, if the plan loan is a qualified plan loan offset. The extended deadline is the due date (including extensions) for filing the Federal income tax return for the taxable year in which the plan loan offset occurs, that is, the taxable year in which the amount is treated as distributed from the plan. Under the provision, a qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, a section 403(b) plan, or a governmental section 457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's severance from employment. As under prior law, a loan offset amount under the provision is the amount by which an employee's account balance under the plan is reduced to repay a loan from the plan.

Effective Date

The provision is effective for plan loan offset amounts treated as distributed in taxable years beginning after December 31, 2017.

[1342] Sec. 72(p).

PART VIII—EXEMPT ORGANIZATIONS

A. Excise Tax Based on Investment Income of Private Colleges and Universities (sec. 13701 of the Act and new sec. 4968 of the Code)

Prior Law

Public charities and private foundations

An organization qualifying for tax-exempt status under section 501(c)(3) is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.[1343] Certain organizations are classified as public charities *per se*, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations, certain organizations providing assistance to colleges and universities, and governmental units.[1344] Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants, or other contributions from governmental units or the general public.[1345] Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public plus revenue arising from activities related to its exempt purposes (*e.g.*, fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.[1346] A supporting organization, *i.e.*, an organization that provides support to another section 501(c)(3) entity that is not a private foundation and meets the requirements of the Code, also is classified as a public charity.[1347]

[1343] The Code does not expressly define the term "public charity," but rather provides exceptions to those entities that are treated as private foundations.

[1344] Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

[1345] Treas. Reg. sec. 1.170A–9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a "facts and circumstances" test. Treas. Reg. sec. 1.170A–9(f)(3).

[1346] To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization's exempt purposes. Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

[1347] Sec. 509(a)(3). Supporting organizations are further classified as Type I, II, or III depending on the relationship they have with the organizations they support. Supporting organizations must support public charities listed in one of the other categories (*i.e., per se* public charities, broadly supported public charities, or revenue generating public charities), and they are not permitted to support other supporting organizations or testing for public safety organizations. Organizations organized and operated exclusively for testing for public safety also are classified as public charities. Sec. 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under section 170.

A section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (*e.g.*, an individual, a family, or a corporation).

Excise tax on investment income of private foundations

Under section 4940(a), private foundations that are recognized as exempt from Federal income tax under section 501(a) (other than exempt operating foundations)[1348] are subject to a two-percent excise tax on their net investment income. Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[1349] equal or exceed the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.[1350] In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements in section 4942.

Private foundations that are not exempt from tax under section 501(a), such as certain charitable trusts, are subject to an excise tax under section 4940(b). The tax is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the tax on unrelated business income that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

Private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.[1351]

Private colleges and universities

Private colleges and universities generally are treated as public charities rather than private foundations[1352] and thus are not subject to the private foundation excise tax on net investment income.

[1348] Exempt operating foundations are exempt from the section 4940 tax. Sec. 4940(d)(1). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation (as defined in section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons. Sec. 4940(d)(2).

[1349] Sec. 4942(g).

[1350] Sec. 4940(e).

[1351] Sec. 4942(d)(2).

[1352] Secs. 509(a)(1) and 170(b)(1)(A)(ii).

Explanation of Provision

The provision imposes an excise tax on an applicable educational institution for each taxable year equal to 1.4 percent of the net investment income of the institution for the taxable year. Net investment income is determined using rules similar to the rules of section 4940(c) (relating to the net investment income of a private foundation).

For purposes of the provision, an applicable educational institution is an eligible education institution (as described in section 25A of the Code):[1353] (1) that has at least 500 students[1354] during the preceding taxable year; (2) more than 50 percent of the students[1355] of which are located in the United States; (3) that is not described in the first section of section 511(a)(2)(B) of the Code (generally describing State colleges and universities); and (4) the aggregate fair market value of the assets of which at the end of the preceding taxable year (other than those assets that are used directly in carrying out the institution's exempt purpose)[1356] is at least $500,000 per student. For these purposes, the number of students of an institution is based on the average daily number of full-time students attending the institution, with part-time students being taken into account on a full-time student equivalent basis.

For purposes of determining whether an educational institution meets the asset-per-student threshold[1357] and for purposes of determining net investment income, assets and net investment income of a related organization with respect to the educational institution are treated as assets and net investment income, respectively, of the educational institution, except that:

- No such amount is taken into account with respect to more than one educational institution; and
- Unless the related organization is controlled by the educational institution or is a supporting organization (described in section 509(a)(3)) with respect to the institution for the taxable year, assets and net investment income that are not intended or available for the use or benefit of the educational institution are not taken into account. For example, assets of a related organization that are earmarked or restricted for (or fairly attributable to) the educational institution would be treated as assets of the educational institution, whereas assets of a related organization that are held for unrelated purposes

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[1353] Section 25A defines an eligible educational institution as an institution (1) which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. sec. 1088), as in effect on August 5, 1977, and (2) which is eligible to participate in a program under title IV of such Act.

[1354] The December 15, 2017, conference agreement required that an applicable educational institution have at least 500 *tuition paying* students and that more than 50 percent of the *tuition paying* students be located in the United States, but the phrase "tuition paying" was stricken before final passage of the Act. In subsequently enacted legislation, the phrase "tuition paying" was reinstated in both places where it had originally appeared (Code sections 4968(b)(1)(A) and (b)(1)(B)). Sec. 41109 of the Bipartisan Budget Act of 2018, Pub. L. No. 115–123, February 9, 2018.

[1355] See *ibid*.

[1356] Assets used directly in carrying out the institution's exempt purpose include, for example, classroom buildings and physical facilities used for educational activities and office equipment or other administrative assets used by employees of the institution in carrying out exempt activities, among other assets.

[1357] In cross-referencing the asset-per-student threshold for this purpose, new section 4968(d)(1) includes a reference to subsection (b)(1)(C) that should instead read "(b)(1)(D)." A clerical correction may be necessary to correct this cross-reference.

(and are not fairly attributable to the educational institution) would be disregarded.

- An organization is treated as related to the institution for this purpose if the organization: (1) controls, or is controlled by, the institution; (2) is controlled by one or more persons that control the institution; or (3) is a supported organization[1358] or a supporting organization[1359] during the taxable year with respect to the institution.

It is intended that the Secretary promulgate regulations to carry out the intent of the provision, including regulations that describe: (1) assets that are used directly in carrying out the educational institution's exempt purpose; (2) the computation of net investment income; and (3) assets that are intended or available for the use or benefit of the educational institution.

The IRS and Treasury Department have issued a notice addressing this provision.[1360]

Effective Date

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

B. Unrelated Business Taxable Income Separately Computed for Each Trade or Business Activity (sec. 13702 of the Act and sec. 512(a) of the Code)

Prior Law

Tax exemption for certain organizations

Section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in section 401(a).

Unrelated business income tax, in general

The unrelated business income tax ("UBIT") generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax–exempt functions.[1361] An organization that is subject to UBIT and that has $1,000 or more of gross unrelated business taxable income must report that income on Form 990–T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may generally engage in a substantial amount of unrelated

[1358] Sec. 509(f)(3).
[1359] Sec. 509(a)(3).
[1360] Notice 2018–55, 2018–26 I.R.B. 773, June 25, 2018.
[1361] Secs. 511–514.

business activity without jeopardizing exempt status. A section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities.[1362] Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

Organizations subject to tax on unrelated business income

Most exempt organizations are subject to UBIT. Specifically, organizations subject to UBIT generally include: (1) organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts);[1363] (2) qualified pension, profit-sharing, and stock bonus plans described in section 401(a);[1364] and (3) certain State colleges and universities.[1365]

Exclusions from unrelated business taxable income

Certain types of income are specifically excluded from unrelated business taxable income, such as dividends, interest, royalties, and certain rents,[1366] unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.[1367] Certain types of activities are not considered unrelated trade or business activities, such as activities in which substantially all the work is performed by volunteers, which involve the sale of donated goods, or which are carried on for the convenience of members, students, patients, officers, or employees of a charitable organization.[1368] Additional activities exempt from UBIT include certain activities of trade shows and State fairs,[1369] conducting bingo games,[1370] and the distribution of low-cost items incidental to the solicitation of charitable contributions.[1371] Organizations liable for UBIT may also be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.[1372]

Specific deduction against unrelated business taxable income

In computing unrelated business taxable income, an exempt organization may take a specific deduction of $1,000. This specific deduction may not be used to create a net operating loss that will be carried back or forward to another year.[1373]

In the case of a diocese, province of a religious order, or a convention or association of churches, there is also allowed a specific deduction with respect to each parish, individual church, district, or other local unit. The specific deduction is equal to the lower of

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[1362] Treas. Reg. sec. 1.501(c)(3)–1(e).
[1363] Sec. 511(a)(2)(A).
[1364] Sec. 511(a)(2)(A).
[1365] Sec. 511(a)(2)(B).
[1366] Sec. 512(b).
[1367] Sec. 512(b)(13).
[1368] Sec. 513(a).
[1369] Sec. 513(d)
[1370] Sec. 513(f).
[1371] Sec. 513(h).
[1372] See section 55 prior to amendment by the Act. For a discussion of the repeal of the corporate alternative minimum tax for taxable years beginning after December 31, 2017, see the description of sections 12001–12003 of the Act (Alternative Minimum Tax).
[1373] Sec. 512(b)(12).

$1,000 or the gross income derived from any unrelated trade or business regularly carried on by the local unit.[1374]

Operation of multiple unrelated trades or businesses

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income the deductions directly connected with the unrelated trade or business.[1375] In determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of the deductions allowed with respect to such activities.[1376] As a result, an organization may use a deduction from one unrelated trade or business to offset income from another, thereby reducing total unrelated business taxable income.

Explanation of Provision

For an organization with more than one unrelated trade or business, the provision requires that unrelated business taxable income first be computed separately with respect to each trade or business and without regard to the specific deduction generally allowed under section 512(b)(12). The organization's unrelated business taxable income for a taxable year is the sum of the amounts (not less than zero) computed for each separate unrelated trade or business, less the specific deduction allowed under section 512(b)(12).[1377] A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose.

The result of the provision is that a deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year. The provision generally does not, however, prevent an organization from using a deduction from one taxable year to offset income from the same unrelated trade or business activity in another taxable year, where appropriate.

It is intended that the Secretary issue guidance concerning when an activity will be treated as a separate unrelated trade or business for purposes of the provision. For example, it is intended that the Secretary consider whether it would be appropriate in certain cases to permit an organization that maintains an investment portfolio to treat multiple investment activities as one unrelated trade or business.

The IRS and Treasury Department have issued a notice addressing this provision.[1378]

[1374] *Ibid.*

[1375] Sec. 512(a).

[1376] Treas. Reg. sec. 1.512(a)–1(a).

[1377] An exempt organization that makes charitable contributions generally is permitted to deduct its charitable contributions in computing its unrelated business taxable income whether or not the contributions are directly connected with an unrelated trade or business. It is not intended that an exempt organization that has more than one unrelated trade or business be required to allocate its deductible charitable contributions among its various unrelated trades or businesses.

[1378] Notice 2018–67, 2018–36 I.R.B. 409, September 4, 2018.

Effective Date

The provision is effective for taxable years beginning after December 31, 2017. Under a special transition rule, net operating losses arising in a taxable year beginning before January 1, 2018, that are carried forward to a taxable year beginning on or after such date are not subject to the provision.

C. Unrelated Business Taxable Income Increased by Amount of Certain Fringe Benefit Expenses for which Deduction is Disallowed (sec. 13703 of the Act and sec. 512 of the Code)

Prior Law

Tax exemption for certain organizations

Section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in section 401(a).

Unrelated business income tax, in general

The unrelated business income tax ("UBIT") generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.[1379] An organization that is subject to UBIT and that has $1,000 or more of gross unrelated business taxable income must report that income on Form 990–T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may generally engage in a substantial amount of unrelated business activity without jeopardizing exempt status. A section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities.[1380] Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income the deductions directly connected with the unrelated trade or business.[1381] In determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of the deductions allowed with respect to such activities.[1382] As a result, an organization may use a deduction from one unrelated trade or business to offset in-

[1379] Secs. 511–514.
[1380] Treas. Reg. sec. 1.501(c)(3)–1(e).
[1381] Sec. 512(a).
[1382] Treas. Reg. sec. 1.512(a)–1(a).

come from another, thereby reducing total unrelated business taxable income.

Organizations subject to tax on unrelated business income

Most exempt organizations are subject to UBIT. Specifically, organizations subject to UBIT generally include: (1) organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts);[1383] (2) qualified pension, profit-sharing, and stock bonus plans described in section 401(a);[1384] and (3) certain State colleges and universities.[1385]

Exclusions from unrelated business taxable income

Certain types of income are specifically excluded from unrelated business taxable income, such as dividends, interest, royalties, and certain rents,[1386] unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.[1387] Certain types of activities are not considered unrelated trade or business activities, such as activities in which substantially all the work is performed by volunteers, which involve the sale of donated goods, or which are carried on for the convenience of members, students, patients, officers, or employees of a charitable organization.[1388] Additional activities exempt from UBIT include certain activities of trade shows and State fairs,[1389] conducting bingo games,[1390] and the distribution of low-cost items incidental to the solicitation of charitable contributions.[1391] Organizations liable for UBIT may also be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.[1392]

Specific deduction against unrelated business taxable income

In computing unrelated business taxable income, an exempt organization may take a specific deduction of $1,000. This specific deduction may not be used to create a net operating loss that will be carried back or forward to another year.[1393]

In the case of a diocese, province of a religious order, or a convention or association of churches, there is also allowed a specific deduction with respect to each parish, individual church, district, or other local unit. The specific deduction is equal to the lower of $1,000 or the gross income derived from any unrelated trade or business regularly carried on by the local unit.[1394]

[1383] Sec. 511(a)(2)(A).
[1384] Sec. 511(a)(2)(A).
[1385] Sec. 511(a)(2)(B).
[1386] Sec. 512(b).
[1387] Sec. 512(b)(13).
[1388] Sec. 513(a).
[1389] Sec. 513(d).
[1390] Sec. 513(f).
[1391] Sec. 513(h).
[1392] See section 55 prior to amendment by the Act. For a discussion of the repeal of the corporate alternative minimum tax for taxable years beginning after December 31, 2017, see the description of sections 12001–12003 of the Act (Alternative Minimum Tax).
[1393] Sec. 512(b)(12). For a discussion of changes made to the net operating loss rules after 2017, see the description of section 13302 of the Act (Modification of Net Operating Loss Deduction).
[1394] *Ibid.*

Explanation of Provision

Under the provision, unrelated business taxable income of a tax-exempt organization is increased to the extent that a deduction is not allowable by reason of section 274 for any item with respect to qualified transportation fringe benefits[1395] or any parking facility used in connection with qualified parking.[1396] The determination of unrelated business taxable income associated with providing qualified transportation fringes, including parking facilities used in connection with qualified parking, is intended to be consistent with the determination of the deduction disallowance under section 274.[1397] The amendments to section 274, as enacted, do not result in a deduction disallowance for items with respect to on-premises athletic facilities,[1398] and therefore, such items are not included in unrelated business taxable income.

The provision does not apply to any item directly connected with an unrelated trade or business that is regularly carried on by the organization. The provision grants the Secretary specific authority to issue regulations or other guidance necessary or appropriate to carry out the provision, including regulations or guidance providing for the appropriate allocation of depreciation and other costs with respect to facilities used for parking. The $1,000 specific deduction available to organizations under section 512(b)(12) remains in effect and may be used to offset unrelated business taxable income resulting from this provision.

Effective Date

The provision is effective for amounts paid or incurred after December 31, 2017.

[1395] See sec. 132(f).

[1396] See sec. 132(f)(5)(C).

[1397] A technical correction may be needed to reflect this intent. For a discussion on qualified transportation fringe items no longer deductible by reason of section 274, including appropriate allocation of depreciation and other costs, see description of section 13304 of the Act (Limitation on Deduction by Employers of Expenses for Fringe Benefits).

[1398] Sec. 132(j)(4).

PART IX—OTHER PROVISIONS

SUBPART A—CRAFT BEVERAGE MODERNIZATION AND TAX REFORM

A. Production Period for Beer, Wine, and Distilled Spirits (sec. 13801 of the Act and sec. 263A(f) of the Code)

Prior Law

In general

The uniform capitalization ("UNICAP") rules require certain direct and indirect costs allocable to real property or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.[1399] For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

In the case of interest expense, the uniform capitalization rules apply only to interest paid or incurred during the property's production period[1400] and that is allocable to property produced by the taxpayer or acquired for resale which (1) is either real property or property with a class life of at least 20 years, (2) has an estimated production period exceeding two years, or (3) has an estimated production period exceeding one year and a cost exceeding $1,000,000.[1401] The production period with respect to any property is the period beginning on the date on which production of the property begins,[1402] and ending on the date on which the property is ready to be placed in service or held for sale.[1403] In the case of property that is customarily aged (*e.g.*, tobacco, wine, and whiskey) before it is sold, the production period includes the aging period.[1404]

[1399] Sec. 263A.

[1400] See Treas. Reg. sec. 1.263A–12.

[1401] Sec. 263A(f).

[1402] In the case of tangible personal property, the production period begins on the first date the taxpayer's accumulated production expenditures, including planning and design expenditures, are at least five percent of the taxpayer's total estimated accumulated production expenditures for the property unit. Treas. Reg. sec. 1.263A–12(c)(3). Thus, the production period may begin before physical production activity has commenced. See Treas. Reg. sec. 1.263A–12(c)(3). For example, in the case of the beer, wine, and distilled spirits industry, the production period may include time spent planning and designing ingredients, production space, or production personnel.

[1403] Sec. 263A(f)(4)(B), prior to amendment by the Act. The production period for a unit of property produced for sale ends on the date that the unit is ready to be held for sale and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are complete. Treas. Reg. sec. 1.263A–12(d)(1).

[1404] See Treas. Reg. sec. 1.263A–12(d)(1). See also Tech. Adv. Mem. 9327007, Mar. 31, 1993 (holding that producers of wine must include the time that wine ages in bottles as part of the production period, which concludes when the wine vintage is officially released to the distribution chain). For beer, the aging period occurs between the fermentation period and bottling (or other types of packaging, such as kegs), and can vary based on the type of yeast and the

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Exceptions from UNICAP

Section 263A provides a number of exceptions to the general capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have $10 million or less of average annual gross receipts for the preceding three-taxable year period;[1405] such taxpayers are not required to include additional section 263A costs in inventory.

Another exception exists for taxpayers who raise, harvest, or grow trees.[1406] Under this exception, section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the UNICAP rules do not apply to any animal or plant having a reproductive period of two years or less, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under section 447 or 448(a)(3)).[1407]

Freelance authors, photographers, and artists also are exempt from section 263A for any qualified creative expenses.[1408] 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.

Explanation of Provision

The provision temporarily excludes the aging periods for beer,[1409] wine,[1410] and distilled spirits[1411] from the production period as determined for purposes of the UNICAP interest capitalization rules. Thus, under the provision, producers of beer, wine and distilled spirits (other than spirits unfit for beverage purposes) are able to deduct interest expenses (subject to any other applicable limitation) attributable to a shorter production period that does not include the aging period of the beer, wine, or distilled spirits.[1412]

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strength of the beer. In the case of distilled spirits, aging is the period after distillation and before bottling.

[1405] Sec. 263A(b)(2)(B). Under prior law, no statutory exception is available for small taxpayers who produce property subject to section 263A. However, a *de minimis* rule under Treasury regulations treats producers that use the simplified production method and incur total indirect costs of $200,000 or less in a taxable year as having no additional indirect costs beyond those normally capitalized for financial accounting purposes. Treas. Reg. sec. 1.263A–2(b)(3)(iv). However, section 13102 of the Act (Small Business Accounting Method Reform and Simplification) expands the exception for small taxpayers from the uniform capitalization rules. Under that provision, any producer or reseller that meets the $25 million gross receipts test is exempted from the application of section 263A.

[1406] Sec. 263A(c)(5).

[1407] Sec. 263A(d). See also section 13102 of the Act (Small Business Accounting Method Reform and Simplification) which expands the universe of farming C corporations that may use the cash method to include any farming C corporation that meets the $25 million gross receipts test.

[1408] Sec. 263A(h).

[1409] As defined in section 5052(a).

[1410] As defined in section 5041(a).

[1411] As defined in section 5002(a)(8), except such spirits that are unfit for use for beverage purposes.

[1412] The provision defines a period of time during which section 263A does not apply to interest costs incurred during the aging period. Application of the provision is not a change in method of accounting subject to section 481 as a taxpayer's method of accounting for capitalizable interest costs is unchanged. However, if a taxpayer capitalizes aging period interest costs paid or accrued after December 31, 2017, and before January 1, 2020, and wants to no longer capitalize such costs, such a change is a change in method of accounting subject to section 481.

The provision does not apply to interest costs paid or accrued after December 31, 2019.

Effective Date

The provision is effective for interest costs paid or accrued after December 31, 2017, and before January 1, 2020.

B. Reduced Rate of Excise Tax on Beer (sec. 13802 of the Act and sec. 5051(a) of the Code)

Prior Law

Federal excise taxes are imposed at different rates on distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are administered, collected, and enforced by the Alcohol and Tobacco Tax and Trade Bureau ("TTB"), except the taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau of the Department of Homeland Security (under delegation by the Secretary of the Treasury).

Liability for the excise tax on beer arises when the alcohol is produced or imported but is not payable until the beer is removed from the brewery or customs custody for consumption or sale. Generally, beer may be transferred between commonly owned breweries without payment of tax; however, tax liability follows these products. Imported bulk beer may be released from customs custody without payment of tax and transferred in bond to a brewery, which becomes liable for the tax on such beer. Beer may be exported without payment of tax and may be withdrawn from a brewery without payment of tax or free of tax for certain authorized uses, including industrial uses and non-beverage uses.[1413]

The rate of tax on beer is $18 per barrel (31 gallons).[1414] Brewers producing fewer than two million barrels of beer during a calendar year ("small brewers") are subject to a reduced tax rate of $7 per barrel on the first 60,000 barrels of beer domestically produced and removed each year.[1415] The credit reduces the effective per-gallon tax rate from approximately 58 cents per gallon to approximately 22.6 cents per gallon for this beer.

In the case of a controlled group, the two million barrel limitation for small brewers is applied to the controlled group, and the 60,000 barrels eligible for the reduced rate of tax, are apportioned among the brewers who are component members of such group. The term "controlled group" has the meaning assigned to it by sec. 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in sec. 1563(a).

Individuals may produce limited quantities of beer for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

[1413] Sec. 5053.
[1414] Sec. 5051.
[1415] Sec. 5051(a)(2).

Explanation of Provision

The provision temporarily lowers the rate of tax on beer to $16 per barrel on the first six million barrels brewed by the brewer or imported by the importer. In general, in the case of a controlled group of brewers, the six million barrel limitation is applied and apportioned at the level of the controlled group. Beer brewed or imported in excess of the six million barrel limit continues to be taxed at $18 per barrel. In the case of small brewers, such brewers are taxed at a rate of $3.50 per barrel on the first 60,000 barrels domestically produced, and $16 per barrel on any further barrels produced. The same rules applicable to controlled groups under prior law apply with respect to this limitation.

For barrels of beer that have been brewed or produced outside of the United States and imported into the United States, the reduced tax rate may be assigned by the brewer to any importer of such barrels pursuant to requirements set forth by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services and the Secretary of the Department of Homeland Security. These requirements are to include: (1) a limitation to ensure that the number of barrels of beer for which the reduced tax rate has been assigned by a brewer to any importer does not exceed the number of barrels of beer brewed or produced by such brewer during the calendar year which were imported into the United States by such importer; (2) procedures that allow a brewer and an importer to elect whether to receive the reduced tax rate; (3) requirements that the brewer provide any information as the Secretary of the Treasury determines necessary and appropriate for purposes of assignment of the reduced tax rate; and (4) procedures that allow for revocation of eligibility of the brewer and the importer for the reduced tax rate in the case of erroneous or fraudulent information provided in (3) which the Secretary of the Treasury deems to be material for qualifying for the reduced tax rate.

Any importer making an election to receive the reduced tax rate shall be deemed to be a member of the controlled group of the brewer, within the meaning of section 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in section 1563(a).[1416]

Under rules issued by the Secretary of the Treasury, two or more entities (whether or not under common control) that produce beer marketed under a similar brand, license, franchise, or other arrangement shall be treated as a single taxpayer for purposes of the excise tax on beer.

The provision does not apply to beer removed after December 31, 2019.

Effective Date

The provision is effective for beer removed after December 31, 2017.

[1416] Members of the controlled group may include foreign corporations.

C. Transfer of Beer Between Bonded Facilities (sec. 13803 of the Act and sec. 5414 of the Code)

Prior Law

Federal excise taxes are imposed at different rates on distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are administered, collected, and enforced by the Alcohol and Tobacco Tax and Trade Bureau ("TTB"), except the taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau of the Department of Homeland Security (under delegation by the Secretary of the Treasury).

Liability for the excise tax on beer arises when the alcohol is produced or imported but is not payable until the beer is removed from the brewery or customs custody for consumption or sale. Generally, beer may be transferred between commonly owned breweries without payment of tax; however, tax liability follows these products. Imported bulk beer may be released from customs custody without payment of tax and transferred in bond to a brewery, which becomes liable for the tax on such beer. Beer may be exported without payment of tax and may be withdrawn from a brewery without payment of tax or free of tax for certain authorized uses, including industrial uses and non-beverage uses.[1417]

The rate of tax on beer is $18 per barrel (31 gallons).[1418] Brewers producing fewer than two million barrels of beer during a calendar year ("small brewers") are subject to a reduced tax rate of $7 per barrel on the first 60,000 barrels of beer domestically produced and removed each year.[1419] The credit reduces the effective per-gallon tax rate from approximately 58 cents per gallon to approximately 22.6 cents per gallon for this beer.

Individuals may produce limited quantities of beer for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

Transfer rules and removals without tax

Certain removals or transfers of beer are exempt from tax. Beer may be transferred without payment of the tax between bonded premises under certain conditions specified in the regulations.[1420] The tax liability accompanies the beer that is transferred in bond. However, beer may only be transferred without payment of tax between breweries if both breweries are owned by the same brewer.

Explanation of Provision

The provision temporarily relaxes the shared ownership requirement of section 5414. Thus, under the provision, a brewer may transfer beer from one brewery to another without payment of tax, provided that: (i) the breweries are owned by the same person; (ii)

[1417] Sec. 5053.
[1418] Sec. 5051.
[1419] Sec. 5051(a)(2).
[1420] Sec. 5414.

one brewery owns a controlling interest in the other; (iii) the same person or persons have a controlling interest in both breweries; or (iv) the proprietors of the transferring and receiving premises are independent of each other, and the transferor has divested itself of all interest in the beer so transferred, and the transferee has accepted responsibility for payment of the tax.

For purposes of transferring the tax liability pursuant to (iv) above, such relief from liability shall be effective from the time of removal from the transferor's bonded premises, or from the time of divestment, whichever is later.

The provision does not apply for calendar quarters beginning after December 31, 2019.

Effective Date

The provision applies to any calendar quarters beginning after December 31, 2017.

D. Reduced Rate of Excise Tax on Certain Wine (sec. 13804 of the Act and sec. 5041(c) of the Code)

Prior Law

In general

Excise taxes are imposed on the wine, according to the wine's alcohol content and carbonation levels. The following table outlines the rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (sec. 5041):	
"Still wines"[1421] not more than 14 percent alcohol	$1.07 per wine gallon[1422]
"Still wines" more than 14 percent, but not more than 21 percent, alcohol.	$1.57 per wine gallon
"Still wines" more than 21 percent, but not more than 24 percent, alcohol.	$3.15 per wine gallon
"Still wines" more than 24 percent alcohol	$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	$3.40 per wine gallon
Artificially carbonated wines	$3.30 per wine gallon

Liability for the excise taxes on wine arises when the wine is produced or imported but is not payable until the wine is removed from the bonded wine cellar or winery, or from customs control, for consumption or sale. Generally, bulk and bottled wine may be transferred between bonded premises; however, the tax liability on such wine becomes the responsibility of the transferee. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn from a wine cellar or winery without payment of tax or free of tax for certain authorized uses, including industrial uses and non-beverage uses.[1423]

[1421] A "still wine" is a non-effervescent or minimally effervescent wine containing no more than 0.392 grams of carbon dioxide per hundred milliliters of wine. Champagne wine typically contains more than twice that amount.

[1422] A wine gallon is a U.S. liquid gallon.

[1423] Sec. 5042.

Reduced rates and exemptions for certain wine producers

Domestic wine producers having aggregate annual production not exceeding 250,000 gallons ("small domestic producers") receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.[1424] The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit may not be applied to the tax liability on sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term "controlled group" has the meaning assigned to it by section 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in section 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

Explanation of Provision

The provision temporarily modifies the credit against the wine excise tax for small domestic producers, by removing the 250,000 wine gallon domestic production limitation (and thus making the credit available for all wine producers and importers). Additionally, under the provision, the credit may be applied to the tax liability on sparkling wine. With respect to wine produced in, or imported into, the United States during a calendar year, the credit amount is (1) $1.00 per wine gallon for the first 30,000 wine gallons of wine, plus; (2) 90 cents per wine gallon on the next 100,000 wine gallons of wine, plus; (3) 53.5 cents per wine gallon on the next 620,000 wine gallons of wine.[1425] There is no phaseout of the credit.

In the case of any wine gallons of wine that have been produced outside of the United States and imported into the United States, the tax credit allowable may be assigned by the person who produced such wine (the "foreign producer") to any electing importer of such wine gallons pursuant to requirements established by the Secretary of the Treasury, in consultation with the Secretary of Health and Human Services and the Secretary of the Department of Homeland Security. These requirement are to include: (1) a limitation to ensure that the number of wine gallons of wine for which the tax credit has been assigned by a foreign producer to any importer does not exceed the number of wine gallons of wine produced by such foreign producer, during the calendar year, which were imported into the United States by such importer; (2) procedures that allow the election of a foreign producer to assign, and an importer

[1424] Sec. 5041(c).

[1425] The credit rate for hard cider is tiered at the same level of production or importation, but is equal to 6.2 cents, 5.6 cents and 3.3 cents, respectively.

to receive, the tax credit; (3) requirements that the foreign producer provide any information that the Secretary of the Treasury determines to be necessary and appropriate for purposes of assigning the tax credit; and (4) procedures that allow for revocation of eligibility of the foreign producer and the importer for the tax credit in the case of erroneous or fraudulent information provided in (3) which the Secretary of the Treasury deems to be material for qualifying for the reduced tax rate.

Any importer making an election to receive the reduced tax rate shall be deemed to be a member of the controlled group of the winemaker, within the meaning of section 1563(a), except that the phrase "more than 50 percent" is substitute for the phrase "at least 80 percent" in each place it appears in section 1563(a).[1426]

The provision does not apply to wine removed after December 31, 2019.

Effective Date

The provision applies to wine removed after December 31, 2017.

E. Adjustment of Alcohol Content Level for Application of Excise Tax Rates (sec. 13805 of the Act and sec. 5041(b) of the Code)

Prior Law

In general

Excise taxes are imposed on the wine, according to the wine's alcohol content and carbonation levels. The following table outlines the rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (sec. 5041).	
"Still wines"[1427] not more than 14 percent alcohol	$1.07 per wine gallon[1428]
"Still wines" more than 14 percent, but not more than 21 percent, alcohol.	$1.57 per wine gallon
"Still wines" more than 21 percent, but not more than 24 percent, alcohol.	$3.15 per wine gallon
"Still wines" more than 24 percent alcohol	$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	$3.40 per wine gallon
Artificially carbonated wines	$3.30 per wine gallon

Liability for the excise taxes on wine arises when the wine is produced or imported but is not payable until the wine is removed from the bonded wine cellar or winery, or from customs control, for consumption or sale. Generally, bulk and bottled wine may be transferred between bonded premises; however, the tax liability on such wine becomes the responsibility of the transferee. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn from a wine cellar

[1426] Members of the controlled group may include foreign corporations.

or winery without payment of tax or free of tax for certain authorized uses, including industrial uses and non-beverage uses.[1429]

Reduced rates and exemptions for certain wine producers

Domestic wine producers having aggregate annual production not exceeding 250,000 gallons ("small domestic producers") receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.[1430] The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit may not be applied to the tax liability on sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term "controlled group" has the meaning assigned to it by section 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in section 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

Explanation of Provision

The provision temporarily modifies alcohol-by-volume levels of the first two tiers of the excise tax on wine, by changing 14 percent to 16 percent. Thus, under the provision, a wine producer or importer may produce or import "still wine" that has an alcohol-by-volume level of up to 16 percent and remain subject to the lowest rate of $1.07 per wine gallon.

The provision does not apply to wine removed after December 31, 2019.

Effective Date

The provision applies to wine removed after December 31, 2017.

[1427] A "still wine" is a non-effervescent or minimally effervescent wine containing no more than 0.392 grams of carbon dioxide per hundred milliliters of wine. Champagne wine typically contains more than twice that amount.

[1428] A wine gallon is a U.S. liquid gallon.

[1429] Sec. 5042.

[1430] Sec. 5041(c).

F. Definition of Mead and Low Alcohol by Volume Wine (sec. 13806 of the Act and sec. 5041 of the Code)

Prior Law

In general

Excise taxes are imposed on the wine, according to the wine's alcohol content and carbonation levels. The following table outlines the rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (sec. 5041).	
"Still wines"[1431] not more than 14 percent alcohol	$1.07 per wine gallon[1432]
"Still wines" more than 14 percent, but not more than 21 percent, alcohol.	$1.57 per wine gallon
"Still wines" more than 21 percent, but not more than 24 percent, alcohol.	$3.15 per wine gallon
"Still wines" more than 24 percent alcohol	$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	$3.40 per wine gallon
Artificially carbonated wines	$3.30 per wine gallon

Liability for the excise taxes on wine arises when the wine is produced or imported but is not payable until the wine is removed from the bonded wine cellar or winery, or from customs control, for consumption or sale. Generally, bulk and bottled wine may be transferred between bonded premises; however, the tax liability on such wine becomes the responsibility of the transferee. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn from a wine cellar or winery without payment of tax or free of tax for certain authorized uses, including industrial uses and non-beverage uses.[1433]

Reduced rates and exemptions for certain wine producers

Domestic wine producers having aggregate annual production not exceeding 250,000 gallons ("small domestic producers") receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.[1434] The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit may not be applied to the tax liability on sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term "controlled group" has the meaning assigned to it by section 1563(a), except that the phrase "more than 50 percent" is substituted for the

[1431] A "still wine" is a non-effervescent or minimally effervescent wine containing no more than 0.392 grams of carbon dioxide per hundred milliliters of wine. Champagne wine typically contains more than twice that amount.
[1432] A wine gallon is a U.S. liquid gallon.
[1433] Sec. 5042.
[1434] Sec. 5041(c).

phrase "at least 80 percent" in each place it appears in section 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

Explanation of Provision

The provision temporarily designates mead and certain sparkling, low alcohol-by-volume wines to be taxed at the lowest rate applicable to "still wine," of $1.07 per wine gallon of wine. Mead is defined as a wine that contains not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,[1435] which is derived solely from honey and water, contains no fruit product or fruit flavoring, and contains less than 8.5 percent alcohol-by-volume. The sparkling wines eligible to be taxed at the lowest rate are those wines that contain not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,[1436] which are derived primarily from grapes or grape juice concentrate and water, which contain no fruit flavoring other than grape, and which contain less than 8.5 percent alcohol by volume.

The provision does not apply to wine removed after December 31, 2019.

Effective Date

The provision applies to wine removed after December 31, 2017.

G. Reduced Rate of Excise Tax on Certain Distilled Spirits (sec. 13807 of the Act and sec. 5001 of the Code)

Prior Law

An excise tax is imposed on all distilled spirits produced in, or imported into, the United States.[1437] The tax liability arises the moment the alcohol is produced or imported but payment of the tax is not required until a subsequent withdrawal or removal from the distillery, or, in the case of an imported product, from customs custody or bond.[1438]

Distilled spirits are taxed at a rate of $13.50 per proof gallon.[1439] Liability for the excise tax on distilled spirits arises when the alcohol is produced but is not determined and payable until bottled distilled spirits are removed from the bonded premises of the distilled spirits plant where they are produced, or customs custody. Generally, bulk distilled spirits may be transferred in bond between bonded premises; however, tax liability follows these products. Im-

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[1435] The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.

[1436] The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.

[1437] Secs. 5001.

[1438] Secs. 5006, 5043, and 5054.

[1439] A "proof gallon" is a U.S. liquid gallon of proof spirits, or the alcoholic equivalent thereof. Generally a proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol. On lesser quantities, the tax is paid proportionately. Credits are allowed for wine content and flavors content of distilled spirits. Sec. 5010.

ported bulk distilled spirits may be released from customs custody without payment of tax and transferred in bond to a distillery. Distilled spirits may be exported without payment of tax and may be withdrawn from a distillery without payment of tax or free of tax for certain authorized uses, including industrial uses and non-beverage uses.

A portion of the revenues from the distilled spirits excise tax imposed on rum imported or brought into[1440] the United States (less certain administrative costs) is transferred ("covered over") to Puerto Rico and the U.S. Virgin Islands.[1441] The amount covered over is $10.50 per proof gallon ($13.25 per proof gallon during the period from July 1, 1999, through December 31, 2016).

Eligible distilled spirits wholesale distributors and distillers receive an income tax credit for the average cost of carrying previously imposed excise tax on beverages stored in their warehouses.[1442]

Explanation of Provision

The provision temporarily institutes a tax rate schedule for distilled spirits based on annual quantity removed or imported. The rate of tax is lowered to $2.70 per proof gallon on the first 100,000 proof gallons of distilled spirits produced, $13.34 for all proof gallons in excess of that amount but below 22,130,000 proof gallons, and $13.50 for amounts thereafter. The provision contains rules so as to prevent members of the same controlled group from receiving the lower rate on more than 100,000 proof gallons of distilled spirits. Importers of distilled spirits are eligible for the lower rates.

The provision does not apply to distilled spirits removed after December 31, 2019.

Effective Date

The provision applies to distilled spirits removed after December 31, 2017.

H. Bulk Distilled Spirits (sec. 13808 of the Act and sec. 5212 of the Code)

Prior Law

An excise tax is imposed on all distilled spirits produced in, or imported into, the United States.[1443] The tax liability arises the moment the alcohol is produced or imported but payment of the tax is not required until a subsequent withdrawal or removal from the distillery, or, in the case of an imported product, from customs custody or bond.[1444]

Distilled spirits are taxed at a rate of $13.50 per proof gallon.[1445] Liability for the excise tax on distilled spirits arises when the alco-

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[1440] Because Puerto Rico is inside U.S. customs territory, articles entering the United States from that commonwealth are "brought into" rather than "imported into" the U.S.

[1441] Sec. 7652.

[1442] Sec. 5011. Section 5011 is administered and enforced by the IRS.

[1443] Secs. 5001.

[1444] Secs. 5006, 5043, and 5054.

[1445] A "proof gallon" is a U.S. liquid gallon of proof spirits, or the alcoholic equivalent thereof. Generally a proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol. On lesser quan-

hol is produced but is not determined and payable until bottled distilled spirits are removed from the bonded premises of the distilled spirits plant where they are produced, or customs custody. Generally, bulk distilled spirits may be transferred in bond between bonded premises; however, tax liability follows these products. Imported bulk distilled spirits may be released from customs custody without payment of tax and transferred in bond to a distillery. Distilled spirits may be exported without payment of tax and may be withdrawn from a distillery without payment of tax or free of tax for certain authorized uses, including industrial uses and non-beverage uses.

A portion of the revenues from the distilled spirits excise tax imposed on rum imported or brought into[1446] the United States (less certain administrative costs) is transferred ("covered over") to Puerto Rico and the U.S. Virgin Islands.[1447] The amount covered over is $10.50 per proof gallon ($13.25 per proof gallon during the period from July 1, 1999, through December 31, 2016).

Eligible distilled spirits wholesale distributors and distillers receive an income tax credit for the average cost of carrying previously imposed excise tax on beverages stored in their warehouses.[1448]

Explanation of Provision

The provision temporarily allows distillers to transfer spirits in bond in containers other than bulk containers without payment of tax.

The provision does not apply to distilled spirits transferred in bond after December 31, 2019.

Effective Date

The provision applies to distilled spirits transferred in bond after December 31, 2017.

SUBPART B—MISCELLANEOUS PROVISIONS

A. Modification of Tax Treatment of Alaska Native Corporations and Settlement Trusts (sec. 13821 of the Act and secs. 646 and 6039H and new secs. 139G and 247 of the Code)

Prior Law

The Alaska Native Claims Settlement Act ("ANCSA")[1449] established Native Corporations[1450] to hold property for Alaska Natives. Alaska Natives are generally the only permitted common shareholders of those corporations under section 7(h) of ANCSA, unless

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tities, the tax is paid proportionately. Credits are allowed for wine content and flavors content of distilled spirits. Sec. 5010.

[1446] Because Puerto Rico is inside U.S. customs territory, articles entering the United States from that commonwealth are "brought into" rather than "imported into" the U.S.

[1447] Sec. 7652.

[1448] Sec. 5011. Section 5011 is administered and enforced by the IRS.

[1449] 43 U.S.C. 1601 *et seq*.

[1450] Defined at 43 U.S.C. 1602(m). Sec. 646(h)(2).

a Native Corporation specifically allows other shareholders under specified procedures.

ANCSA permits a Native Corporation to transfer money or other property to an Alaska Native Settlement Trust ("Settlement Trust")[1451] for the benefit of beneficiaries who constitute all or a class of the shareholders of the Native Corporation, to promote the health, education and welfare of beneficiaries, and to preserve the heritage and culture of Alaska Natives.[1452]

Native Corporations and Settlement Trusts, as well as their shareholders and beneficiaries, are generally subject to tax under the same rules and in the same manner as other taxpayers that are corporations, trusts, shareholders, or beneficiaries.

Special rules allow an election to use a more favorable tax regime for transfers of property by a Native Corporation to a Settlement Trust and for income taxation of the Settlement Trust.[1453] There is also simplified reporting to beneficiaries.[1454]

Under the special tax rules, a Settlement Trust may make an irrevocable election to pay tax on taxable income at the lowest rate specified for individuals (rather than the highest rate that is generally applicable to trusts) and to pay tax on capital gains at a rate consistent with being subject to such lowest rate of tax.[1455] As described further below, beneficiaries may generally thereafter exclude from gross income distributions from a trust that has made this election.[1456] Also, contributions from a Native Corporation to an electing Settlement Trust[1457] generally will not result in the recognition of gross income by beneficiaries on account of the contribution.[1458] An electing Settlement Trust remains subject to generally applicable requirements for classification and taxation as a trust.

A Settlement Trust distribution is excludable from the gross income of beneficiaries to the extent of the taxable income of the Settlement Trust for the taxable year and all prior taxable years for which an election was in effect, decreased by income tax paid by the Trust, plus tax-exempt interest from State and local bonds for the same period.[1459] Amounts distributed in excess of the amount excludable are taxed to the beneficiaries as if distributed by the sponsoring Native Corporation in the year of distribution by the Trust, which means that the beneficiaries must include in gross income as dividends the amount of the distribution, up to the current and accumulated earnings and profits of the Native Corporation.[1460] Amounts distributed in excess of the current and accumulated earnings and profits are not included in gross income by the beneficiaries.

[1451] Defined at 43 U.S.C. 1602(t). Sec. 646(h)(4).

[1452] With certain exceptions, once an Alaska Native Corporation has made a conveyance to a Settlement Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Settlement Trust.

[1453] Sec. 646.

[1454] Sec. 6039H.

[1455] Sec. 646(b) and (c).

[1456] Sec. 646(e).

[1457] Defined at sec. 646(h)(1).

[1458] Sec. 646(d)(1).

[1459] Sec. 646(e)(1).

[1460] Sec. 646(e)(3).

A special loss disallowance rule reduces (but not below zero) any loss that would otherwise be recognized upon disposition of stock of a sponsoring Native Corporation by a proportion, determined on a per share basis, of all contributions to all electing Settlement Trusts by the sponsoring Native Corporation.[1461] This rule prevents a stockholder from being able to take advantage of a decrease in value of a Native Corporation that is caused by a transfer of assets from the Native Corporation to a Settlement Trust.

The fiduciary of an electing Settlement Trust is obligated to provide certain information relating to distributions from the trust in lieu of reporting requirements under section 6034A.[1462]

The election to pay tax at the lowest rate is not available in certain disqualifying cases where transfer restrictions have been modified to allow a transfer of either: (a) a beneficial interest that would not be permitted by section 7(h) of ANCSA if the interest were Settlement common stock,[1463] or (b) any stock in an Alaska Native Corporation that would not be permitted by section 7(h) of ANCSA if it were Settlement common stock and the Native Corporation thereafter makes a transfer to the Trust.[1464] Where an election is already in effect at the time of such disqualifying transfer, the special rules applicable to an electing trust cease to apply and rules generally applicable to trusts apply. In addition, the distributable net income of the trust is increased by undistributed current and accumulated earnings and profits of the trust, limited by the fair market value of trust assets at the date the trust becomes so disposable. The effect is to cause the trust to be taxed at regular trust rates on the amount of recomputed distributable net income not distributed to beneficiaries, and to cause the beneficiaries to be taxed on the amount of any distributions received consistent with the applicable tax rate bracket.

Explanation of Provision

The provision comprises three separate but related sections.[1465]

Assignments to Alaska Native Settlement Trusts

The first section allows a Native Corporation to assign certain payments described in ANCSA to a Settlement Trust without having to recognize gross income from those payments, provided the assignment is in writing and the Native Corporation has not received the payment prior to assignment.[1466] The Settlement Trust is required to include the assigned payment in gross income when received with the same character as if such payment was received by the Native Corporation. The Native Corporation is not allowed a deduction for the assigned payment.

[1461] Sec. 646(i).
[1462] Sec. 6039H.
[1463] Defined at 43 U.S.C. 1602(p). Sec. 646(h)(3).
[1464] Sec. 646(f).
[1465] The Act does not amend section 646.
[1466] The amount and scope of any assignment must be described with reasonable particularity and may either be in a percentage of one or more such payments or in a fixed dollar amount. Further, such assignment must specify a duration either in perpetuity or for a period of time, and whether it is revocable.

Contributions to Alaska Native Settlement Trusts

The second section allows a Native Corporation to elect annually to deduct contributions made to a Settlement Trust.[1467] If the contribution is in cash, the deduction is in the amount of cash contributed. If the contribution is in property other than cash, the deduction is the amount of the Native Corporation's adjusted basis in the contributed property (or the fair market value of such property, if less than the Native Corporation's adjusted basis), and no gain or loss may be recognized on the contribution. The Native Corporation's deduction is limited to the amount of its taxable income [1468] for that year, and any excess may be carried forward 15 succeeding years. The Native Corporation's earnings and profits for the taxable year are reduced by the amount of any deduction claimed for that year.

Generally, the Settlement Trust must include income equal to the deduction by the Native Corporation. For contributions of property other than cash, the Settlement Trust takes a basis in the property equal to the adjusted basis of such property in the hands of the Native Corporation immediately before the contribution (or the fair market value of such property immediately before such contribution, if less than the Native Corporation's adjusted basis), and may elect to defer recognition of the income associated with such property until the Settlement Trust sells or exchanges the property, in whole or in part.[1469] In that case, any income that is deferred (*i.e.,* the amount of income that would have been included upon contribution absent the election to defer) is treated as ordinary income, while any gain in excess of the amount of income that is deferred takes the same character as if the election had not been made. The provision permits the amendment of the terms of any Settlement Trust agreement within one year of the enactment of the provision (*i.e.,* within one year of December 22, 2017) to allow this election, with certain restrictions.

If property subject to this election is disposed of within the first taxable year subsequent to the taxable year in which the property was contributed to the Settlement Trust, the election is voided with respect to such property, and the Settlement Trust is required to pay any tax applicable to the disposition of the property, including any applicable interest, and an additional amount equal to 10 percent of the amount of the tax with interest. The provision provides for a four-year assessment period in which to assess the tax, interest, and penalty amounts.

Information reporting

The third section of the provision requires any Native Corporation which has made an election to deduct contributions to a Settlement Trust as described above to furnish a statement to the Settle-

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[1467] A Native Corporation makes the election to deduct contributions to a Settlement Trust for a specific taxable year by including a statement with its original or amended income tax return. See IRS News Release IR–2018–16, January 30, 2018. Any election may be revoked on a timely filed amendment or supplement to the Native Corporation's income tax return.

[1468] As determined without regard to such deduction.

[1469] To make such election, the Settlement Trust must identify and describe with reasonable particularity the contributed property on a statement attached to its original or amended income tax return for the year in which the property was contributed. See IRS News Release IR–2018–16, January 30, 2018.

ment Trust not later than January 31 of the calendar year subsequent to the calendar year in which the contribution was made. The statement must include: (1) the total amount of contributions to which the election applies; (2) for each contribution, whether the contribution was in cash; (3) for each non-cash contribution, the date that the contributed property was acquired by the Native Corporation and the adjusted basis and fair market value of such property on the contribution date; (4) the date on which each contribution was made to the Settlement Trust; and (5) such information as the Secretary determines is necessary or appropriate for the identification of each contribution and the accurate inclusion of income relating to such contributions by the Settlement Trust.

Effective Date

The provision relating to the exclusion for ANCSA payments assigned to Settlement Trusts is effective to taxable years beginning after December 31, 2016.

The provision relating to the deduction of contributions to Settlement Trusts is effective for taxable years for which the Native Corporation's refund or credit statute of limitations period has not expired, and the provision provides a limited waiver of the refund or credit statute of limitations period in the event that the limitation period expires before the end of the one-year period beginning on the date of enactment (*i.e.,* the one-year period beginning on December 22, 2017). The waiver period ends at the termination of that one-year period.

The provision relating to the reporting requirement applies to taxable years beginning after December 31, 2016.

B. Amounts Paid for Aircraft Management Services (sec. 13822 of the Act and sec. 4621(e) of the Code)

Prior Law

Excise tax on taxable transportation by air

For domestic passenger transportation, section 4261 imposes an excise tax on amounts paid for taxable transportation. In general, for domestic flights, the tax consists of two parts: a 7.5 percent *ad valorem* tax applied to the amount paid and a flat dollar amount for each flight segment (consisting of one takeoff and one landing). "Taxable transportation" generally means transportation by air which begins and ends in the United States. The tax is paid by the person making the payment subject to tax and the tax is collected by the person receiving the payment. For commercial freight aviation, the *ad valorem* tax is 6.25 percent of the amount paid for transportation

In determining whether a flight constitutes taxable transportation and whether the amounts paid for such transportation are subject to tax, the Internal Revenue Service ("IRS") has looked at who has "possession, command, and control" of the aircraft based on the relevant facts and circumstances.[1470]

[1470] See, *e.g.*, Rev. Rul. 60–311, 1960–2 C.B. 341, which held that, since the company in question retains the elements of possession, command, and control of the aircraft and performs all

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Applicability to aircraft management services

Generally, an aircraft management services company ("management company") has as its business purpose the management of aircraft owned by other corporations or individuals ("aircraft owners"). In this function, management companies provide aircraft owners, among other things, with administrative and support services (such as scheduling, flight planning, and weather forecasting), aircraft maintenance services, the provision of pilots and crew, and compliance with regulatory standards. Although the arrangement between management companies and aircraft owners may vary, aircraft owners generally pay management companies a monthly fee to cover the fixed expenses of maintaining the aircraft (such as insurance, maintenance, and recordkeeping) and a variable fee to cover the cost of using the aircraft (such as the provision of pilots, crew, and fuel).

In March 2012, the IRS issued a Chief Counsel Advice determining that a management company provided all of the essential elements necessary for providing transportation by air and the owner relinquished possession, command and control to the management company.[1471] Thus, the management company was determined to be providing taxable transportation to the owner and was required to collect the appropriate federal excise tax from the aircraft owner and remit it to the IRS. The Chief Counsel Advice resulted in increased audit activity by the IRS on aircraft management companies.

In May 2013, the IRS suspended assessment of the federal excise tax with respect to aircraft management services while it developed guidance on the tax treatment of aircraft management issues. In a 2015 opinion,[1472] an Ohio district court held that the existing revenue rulings (in effect for the tax period April 1, 2005, through June 30, 2009, the period that was the subject of the litigation) regarding the possession, command and control test, failed to provide precise and not speculative notice of a collection obligation as it related to whole-aircraft management contracts.[1473] As a result, the court ruled as a matter of law that because precise and not speculative notice was not received, the aircraft management company plaintiff did not have a collection obligation with respect to the Federal excise tax on payments received for whole-aircraft management services.

In 2017, the IRS decided not to pursue examination of the issue of whether amounts paid to aircraft companies by the owners or lessors of the aircraft are taxable until further guidance is made available. According to the IRS, for any exam in suspense the aircraft management fee issue was conceded and the taxpayers were

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services in connection with the operation of the aircraft, the company is, in fact, furnishing taxable transportation to the lessee; and the tax on the transportation of persons applies to the portion of the total payment which is allocable to the transportation of persons, provided such allocation is made on a fair and reasonable basis. If no allocation is made, the tax applies to the total payment for the lease of the aircraft.

[1471] Chief Coun. Adv. 201210026, March, 2012.

[1472] *Netjets Large Aircraft Inc. v. United States*, 116 A.F.T.R. 2d. 2015–6776 (S.D. Ohio, 2015).

[1473] The district court held that such notice is required to persons having a deputy tax collection obligation under the rationale of the Supreme Court's holding in *Central Illinois Public Service Company v. United States*, 435 U.S. 21 (1978).

notified accordingly.[1474] The IRS has not issued further guidance on this issue.

Explanation of Provision

The provision exempts certain payments related to the management of private aircraft from the excise taxes imposed on taxable transportation by air. Exempt payments are those amounts paid by an aircraft owner for management services related to maintenance and support of the owner's aircraft or flights on the owner's aircraft. Applicable services include support activities related to the aircraft itself, such as its storage, maintenance, and fueling, and those related to its operation, such as the hiring and training of pilots and crew, as well as administrative services such as scheduling, flight planning, weather forecasting, obtaining insurance, and establishing and complying with safety standards. Aircraft management services also include such other services as are necessary to support flights operated by an aircraft owner.

Payments for flight services are exempt only to the extent that they are attributable to flights on an aircraft owner's own aircraft.[1475] Thus, if an aircraft owner makes a payment to a management company for the provision of a pilot and the pilot provides his services on the aircraft owner's aircraft, such payment is not subject to Federal excise tax. However, if the pilot provides his services to the aircraft owner on an aircraft other than the aircraft owner's (for instance, on an aircraft that is part of a fleet of aircraft available for third-party charter services), then such payment is subject to Federal excise tax.

The provision provides a pro rata allocation rule in the event that a monthly payment made to a management company is allocated in part to exempt services and flights on the aircraft owner's aircraft, and in part to flights on aircraft other than the aircraft owner's. In such a circumstance, Federal excise tax must be collected on that portion of the payment attributable to flights on aircraft not owned by the aircraft owner.

Under the provision, a lessee of an aircraft is considered an aircraft owner provided that the lease is not a "disqualified lease." A disqualified lease is any lease of an aircraft from a management company (or a related party) for a term of 31 days or less.

[1474] See also, Kerry Lynch, *IRS To Shelve Pending Audits on Aircraft Management Fees, AINonline* (July 17, 2017) http://www.ainonline.com/aviation-news/business-aviation/2017-07-17/irs-shelve-pending-audits-aircraft-management-fees.

[1475] Examples of arrangements that cannot qualify a person as an "aircraft owner" include ownership of stock in a commercial airline and participation in a fractional ownership aircraft program. Ownership of stock in a commercial airline cannot qualify an individual as an "aircraft owner" of a commercial airline's aircraft, and amounts paid for transportation on such flights remain subject to the tax under section 4261. Similarly, participation in a fractional ownership aircraft program does not constitute "aircraft ownership" for purposes of this standard. Amounts paid to a fractional ownership aircraft program for transportation under such a program are exempt from the ticket tax under section 4261(j) if the aircraft is operating under subpart K of part 91 of title 14 of the Code of Federal Regulations ("subpart K"), and flights under such program are subject to both the fuel tax levied on non-commercial aviation an additional fuel surtax under section 4043 of the Code. A business arrangement seeking to circumvent that surtax by operating outside of subpart K, allowing an aircraft owner the right to use any of a fleet of aircraft, be it through an aircraft interchange agreement, through holding nominal shares in a fleet of aircraft, or any other arrangement that does not reflect true tax ownership of the aircraft being flown upon, is not considered ownership for purposes of the provision.

Effective Date

The provision is effective for amounts paid after the date of enactment.

C. Opportunity Zones (sec. 13823 of the Act and new secs. 1400Z–1 and 1400Z–2 of the Code)

Prior Law

Congress has occasionally provided incentives aimed at encouraging economic growth and investment in distressed communities by providing Federal tax benefits to businesses located within designated boundaries.[1476]

One of these incentives is a Federal income tax credit, the new markets tax credit, which totals 39 percent of a taxpayer investment in a qualified community development entity ("CDE").[1477] In general, the credit is allowed to a taxpayer who makes a qualified equity investment in a CDE which further invests in a qualified active low-income community business. CDEs are required to make investments in low-income communities (generally communities with poverty rates that equal or exceed 20 percent or whose median family income is less than 80 percent of the statewide median income). The credit is allowed over seven years, five percent in each of the first three years and six percent in each of the next four years. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed. The Department of Treasury's Community Development Financial Institutions Fund ("CDFI") allocates the new markets tax credits.

The maximum annual amount of qualified equity investments is $3.5 billion for calendar years 2010 through 2019. Any amount of unused allocation may be carried forward for five calendar years. The new markets tax credit expires on December 31, 2019. No amount of unused allocation limitation may be carried to any calendar year after 2024.

Explanation of Provision

In general

The provision allows taxpayers to make an election when investing in a qualified opportunity fund. The election results in the fol-

[1476] Such designated areas were referred to as empowerment zones, the District of Columbia Enterprise ("DC") Zone, and the Gulf Opportunity ("GO") Zone, and each of these designations and attendant tax incentives have expired. The designations and tax incentives for the DC Zone and the GO Zone generally expired after December 31, 2011. See secs. 1400(f), 1400N(h), 1400N(c)(5), 1400N(a)(2)(D), 1400N(a)(7)(C), and 1400N(d). The empowerment zones program and attendant tax incentives were extended in the Bipartisan Budget Act of 2018 through December 31, 2017. Secs. 1391(d)(1). Pub. L. No. 115–123, sec. 40311. Additional areas that were designated as renewal communities under section 1400E received tax benefits that expired as of December 31, 2009, except that a zero-percent capital gains rate applies with respect to gain from the sale through December 31, 2014, of a qualified community asset acquired after December 31, 2001, and before January 1, 2010, and held for more than five years. For more information on these programs and attendant tax incentives, see Joint Committee on Taxation, *Incentives for Distressed Communities: Empowerment Zones and Renewal Communities* (JCX–38–09), October 5, 2009.

[1477] Sec. 45D.

lowing three tax benefits: (1) the temporary deferral of inclusion in gross income of capital gains,[1478] (2) the partial exclusion of such capital gains from gross income to the extent invested in the qualified opportunity fund for a certain length of time, and (3) the permanent exclusion of post-acquisition capital gains from the sale or exchange of an interest in a qualified opportunity fund held for at least 10 years.

The provision allows for the designation of certain low-income community population census tracts as qualified opportunity zones.[1479] In addition, a limited number of other census tracts that are not low-income communities can be designated if they are contiguous to a designated low-income community and the median family income of such tracts does not exceed 125 percent of the median family income of the contiguous low-income community. The designation of a population census tract as a qualified opportunity zone remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation.

The chief executive officer of the State, possession, or the District of Colombia (*i.e.*, Governor or mayor in the case of the District of Columbia) may submit nominations for a limited number of opportunity zones to the Secretary for certification and designation. If the number of low-income communities in a State is less than 100, the Governor may designate up to 25 tracts, otherwise the Governor may designate tracts not exceeding 25 percent of the number of low-income communities in the State.[1480]

Qualified opportunity funds

A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property. The provision intends that the certification process for a qualified opportunity fund will be carried out in a manner similar to the process for allocating the new markets tax credit. The Secretary is granted the authority to administer this process.

If a qualified opportunity fund fails to meet the 90 percent requirement, unless the fund establishes reasonable cause, the fund is required to pay a monthly penalty of the excess of the amount equal to 90 percent of its aggregate assets, over the aggregate amount of qualified opportunity zone property held by the fund multiplied by the underpayment rate in the Code.[1481] If the fund is a partnership, the penalty is taken into account proportionately as part of each partner's distributive share.

[1478] A technical correction may be needed to reflect this intent.

[1479] See sec. 45D(e) for the definition of low-income community.

[1480] In subsequently enacted legislation, Congress passed a special rule for Puerto Rico such that each population census tract in Puerto Rico that is a low-income community is deemed certified and designated as a qualified opportunity zone, effective on the date of enactment of Pub. L. No. 115–97 (December 22, 2017). Sec. 41115 of the Bipartisan Budget Act of 2018, Pub. L. No. 115–123, February 9, 2018.

[1481] Sec. 6621.

Qualified opportunity zone property

Qualified opportunity zone property means: (1) qualified opportunity zone stock, (2) qualified opportunity zone partnership interest, and (3) qualified opportunity zone business property.

Qualified opportunity zone stock consists of stock in a domestic corporation that is a qualified opportunity zone business. There are three requirements that must be met for property to be considered qualified opportunity zone stock.[1482] First, the stock must be acquired at original issuance (directly or indirectly through an underwriter) solely for cash after December 31, 2017. Second, the corporation must have been a qualified opportunity zone business when the stock was issued (or, for a new corporation, was being organized to be a qualified opportunity zone business). Third, the corporation must qualify as a qualified opportunity zone business during substantially all of the qualified opportunity fund's holding period for the stock.

Qualified opportunity zone partnership interest consists of capital or profits interests in a domestic partnership that is a qualified opportunity zone business. There are three requirements that must be met for property to be considered a qualified opportunity zone partnership interest.[1483] First, the interest must be acquired from the partnership solely for cash after December 31, 2017. Second, the partnership must have been a qualified opportunity zone business when the interest was acquired (or, for a new partnership, was being organized to be a qualified opportunity zone business). Third, the partnership must qualify as a qualified opportunity zone business during substantially all of the qualified opportunity fund's holding period for the interest.

Qualified opportunity zone business property consists of tangible property used in the trade or business of a qualified opportunity fund or qualified opportunity zone business. There are three main requirements that must be met for property to be considered qualified opportunity zone business property.[1484] First, the property must be acquired by purchase[1485] after December 31, 2017. Second, the original use of the property in the qualified opportunity zone must begin with the qualified opportunity fund or qualified opportunity zone business, or the qualified opportunity fund or qualified opportunity zone business must substantially improve the property. Only new or substantially improved property qualifies as opportunity zone business property.[1486] Third, substantially all of the property must be in a qualified opportunity zone during substantially all of qualified opportunity fund or qualified opportunity zone business's holding period for the property. Property is treated as substantially improved only if capital expenditures on the property in the 30 months after acquisition exceeds the property's adjusted basis on the date of acquisition.

A qualified opportunity zone business is any trade or business in which substantially all of the underlying value of the tangible prop-

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[1482] Sec. 1400Z–2(d)(2)(B).
[1483] Sec. 1400Z–2(d)(2)(C).
[1484] Sec. 1400Z–2(d)(2)(D).
[1485] Certain related party purchases are excluded. See secs. 1400Z–2(d)(2)(D)(i)(I), 1400Z–2(d)(2)(D)(iii), and 1400Z–2(e)(2).
[1486] A technical correction may be necessary to reflect this intent.

erty owned or leased by the business is qualified opportunity zone business property.

In addition, (1) at least 50 percent of the total gross income of the trade or business must be derived from the active conduct of business in the qualified opportunity zone, (2) a substantial portion of the business's intangible property must be used in the active conduct of business in the qualified opportunity zone, and (3) less than 5 percent of the average of the aggregate adjusted bases of the property of the business is attributable to nonqualified financial property.[1487] Nonqualified financial property means debt, stock, partnership interests, annuities, and derivative financial instruments (including options, futures, forward contracts, and notional principal contracts), other than (1) reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of no more than 18 months, and (2) accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of inventory property.[1488] Seventh, the business cannot be a golf course, country club, massage parlor, hot tub or suntan facility, racetrack or other facility used for gambling, or store whose principal business is the sale of alcoholic beverages for consumption off premises.[1489]

Tangible property that ceases to be a qualified opportunity zone business property continues to be treated as a qualified opportunity zone business property for the lesser of five years after the date on which such tangible property ceases to be so qualified, or the date on which such tangible property is no longer held by the qualified opportunity zone business.[1490]

Tax treatment of a deferred-gain investment

A taxpayer may elect to temporarily defer and partially exclude capital gains from gross income to the extent that the taxpayer invests the amount of those gains in a qualified opportunity fund. The maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of the asset sale that produced the gain to be deferred. Capital gains in excess of the deferred amount must be recognized and included in gross income.

In the case of any investment in a qualified opportunity fund, only a portion of which consists of the investment of gain with respect to which an election is made, such investment is treated as two separate investments, consisting of one investment that includes only amounts to which the election applies (herein "deferred-gain investment"), and a separate investment consisting of other amounts. The temporary deferral and permanent exclusion provisions do not apply to the separate investment. For example, if a taxpayer sells stock at a gain and invests the entire sales proceeds (capital and return of basis) in a qualified opportunity zone fund, an election may be made only with respect to the capital gain amount. No election may be made with respect to amounts attrib-

[1487] Sec. 1400Z–2(d)(3)(A)(ii).
[1488] Secs. 1400Z–2(d)(3)(A)(ii), 1397C(b)(8), and 1397C(e).
[1489] Secs. 1400Z–2(d)(3)(A)(iii) and 144(c)(6)(B).
[1490] Sec. 1400Z–2(d)(3)(B).

utable to a return of basis, and no special tax benefits apply to such amounts.

The basis of a deferred-gain investment in a qualified opportunity zone fund immediately after its acquisition is zero. If the deferred-gain investment in the qualified opportunity zone fund is held by the taxpayer for at least five years, the basis in the deferred-gain investment is increased by 10 percent of the original deferred gain. If the opportunity zone asset or investment is held by the taxpayer for at least seven years, the basis in the deferred gain investment is increased by an additional five percent of the original deferred gain. Some or all of the deferred gain is recognized on the earlier of the date on which the qualified opportunity zone investment is disposed of or December 31, 2026. The amount of gain recognized is the excess of the lesser of the amount deferred and the current fair market value of the investment (taking into account any increases at the end of five or seven years). The taxpayer's basis in the investment is increased by the amount of gain recognized. No election under the provision may be made after December 31, 2026.

Exclusion of capital gains from the sale or exchange of an investment in a qualified opportunity fund

The provision excludes from gross income the post-acquisition capital gains on deferred-gain investments in opportunity zone funds that are held for at least 10 years. Specifically, in the case of the sale or exchange of an investment in a qualified opportunity zone fund held for more than 10 years, a further election is allowed by the taxpayer to modify the basis of such deferred-gain investment in the hands of the taxpayer to be the fair market value of the deferred-gain investment at the date of such sale or exchange.

In the case of a fund organized as a pass-through entity, investors recognize gains and losses associated with both deferred-gain and non-deferred gain investments in the fund, under the rules generally applicable to pass-through entities. Thus, for example, investor-partners in a fund organized as a partnership would recognize income and increase their basis with respect to their distributive share of the fund's taxable income.

The Treasury Department has proposed guidance addressing this provision.[1491]

Example

Assume a taxpayer sells stock for a gain of $1,000 on January 1, 2019, and invests $1,000 in the stock of a qualified opportunity fund. Assume also that the taxpayer holds the investment for 10 years and then sells the investment for $1,500.

The taxpayer's initial basis in the deferred-gain investment is zero. After five years, the basis is increased to $100. After seven years, the basis is increased to $150. At the end of 2026, assume that the fair market value of the deferred-gain investment is at least $1,000, and thus the taxpayer has to recognize $850 of the deferred capital gain. So at that point the basis in the deferred-

[1491] Notice 2018–48, 2018–28 I.R.B. 9, (July 9, 2018), and Prop. Treas. Reg. sec. 1.1400Z–2.

gain investment is $1,000 ($150 + $850). If the taxpayer holds the deferred-gain investment for 10 years and makes the election to increase the basis, the $500 post-acquisition capital gain on the sale is excluded.

Effective Date

The provision is effective on the date of enactment (*i.e.*, on December 22, 2017).

SUBTITLE D—INTERNATIONAL TAX PROVISIONS

PRIOR LAW

The following discussion provides an overview of general principles of taxation of cross-border activity as well as a detailed explanation of provisions in prior law that are relevant to the provisions in the Act.

A. General Overview of International Principles of Taxation

International law generally recognizes the right of each sovereign nation to prescribe rules to regulate conduct and persons (whether natural or juridical) with a sufficient nexus to the sovereign nation. The nexus may be based on nationality, *i.e.,* a nexus based on a connection between the relevant person and the sovereign nation, or may be territorial, *i.e.,* a nexus based on a connection between the relevant conduct and the sovereign nation.[1492] Nonetheless, most legal systems respect limits on the extent to which their laws may be given extraterritorial effect. The broad acceptance of such norms extends to authority to regulate cross-border trade and economic dealings, including taxation.

The exercise of sovereign jurisdiction to tax is usually based on either the nationality of the person taxed or the jurisdiction in which the taxed conduct occurs. These concepts have been refined and adapted to form the principles for determining whether sufficient nexus with a jurisdiction exists to conclude that the jurisdiction may enforce its right to tax. The elements of nexus and the nomenclature of the principles may differ based on whether the tax is a direct tax or an indirect tax. A direct tax is imposed directly on a person (known as a capitation tax), property, or income from property, the burden of which the taxpayer bears and generally cannot shift to another. In contrast, indirect taxes are taxes on consumption or the production of goods or services, such as sales or use taxes, value-added taxes, or customs duties.[1493] Taxpayers may be able to shift the burden of indirect taxes to others (*e.g.,* by raising prices).

Although governments since ancient times have imposed direct taxes on property and indirect taxes and duties on specific transactions, the history of direct taxes in the form of income taxes is relatively recent.[1494] When determining how to allocate the right to tax a particular item of income, most jurisdictions consider principles based on either the source of the income or the residence of the person earning the income. By contrast, when determining how

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[1492] See American Law Institute, Restatement *(Third) of Foreign Relations Law of the United States*, secs. 402 and 403 (1987).

[1493] Maria S. Cox, Fritz Neumark, et al., "Taxation," *Encyclopedia Britannica*, https://www.britannica.com/topic/taxation/Classes-of-taxes. Whether a tax is considered a direct tax or indirect tax has varied over time, and no single definition is used. For a review of the significance of these terms in Federal tax history, see Alan O. Dixler, "Direct Taxes Under the Constitution: A Review of the Precedents," *Tax History Project, Tax Analysts, available at* http://www.taxhistory.org/thp/readings.nsf/ArtWeb/2B34C7FBDA41D9DA8525730800067017?OpenDocument.

[1494] The earliest western income tax system is traceable to the British Tax Act of 1798, enacted in 1799 to raise funds needed to prosecute the Napoleonic Wars, and rescinded in 1816. See A.M. Bardopoulos, *eCommerce and the Effects of Technology on Taxation, Law*, Governance and Technology Series 22, DOI 10.1007/978-3-319-15449-7—2, (Springer 2015), at Section 2.2. "History of Tax," pp. 23-24; see also http://www.parliament.uk/about/living-heritage/transformingsociety/private-lives/taxation/overview/incometax/.

to allocate the right to collect indirect taxes, most jurisdictions consider either the origin or the destination of the item being taxed. The balance of this Part A describes the source, residence, origin, and destination principles in more detail and how jurisdictions resolve overlapping claims of jurisdiction.

1. Source and residence principles

Direct taxes based on a person's citizenship, nationality, or residence are residence-based taxes. Such taxes may reach the worldwide activities of such person, and, for that reason, are the broadest assertion of taxing authority. For individuals, the test for residence may depend on citizenship, nationality, a physical presence test, or some combination. For all other persons, determining residency may be as simple as determining the person's place of organization, or may require more complex consideration of the person's management and control, or even level of activities in a jurisdiction.

Direct taxes based on where activities occur, or where property is located, are source-based taxes. If a person conducts activities or owns property in a jurisdiction, taxing such activities or property may require allocation and apportionment of expenses attributable to the activity or property to ensure that only the portion of profits that have the required nexus with the jurisdiction are subject to tax. Most jurisdictions, including the United States, have rules for determining the source of items of income and expense in a broad range of categories, such as compensation for services, dividends, interest, royalties, and gains.

2. Origin and destination principles

Indirect taxes based on the place where goods are produced or services are performed—irrespective of the residence of the owners of the means of production, where the goods go after being produced, or the residence of the recipients of the services—are origin-based taxes. Indirect taxes based on where goods or services are used or consumed are destination-based taxes. The most common form of indirect tax is the destination-based value-added tax ("VAT"). Over 160 countries have adopted a VAT,[1495] which is generally a tax imposed and collected on the value added at every stage in the production and distribution of a good or service. Although there are several ways to compute the taxable base for a VAT, the amount of value added can generally be thought of as the difference between the value of sales (outputs) and purchases (inputs) of a business.[1496] The United States does not have a VAT,

[1495] Alan Schenk, Victor Thuronyi, and Wei Cui, *Value Added Tax: A Comparative Approach*, Cambridge University Press, 2015. Consistent with the OECD International VAT/GST Guidelines, the term VAT refers to all broad-based final consumption taxes, regardless of the acronym used to identify any particular one. Thus, many countries that call their national consumption tax a GST (general sales tax) are included in the estimate of the number of countries with a VAT.

[1496] Nearly all jurisdictions use the credit-invoice method of calculating value added to determine VAT liability. Under the credit-invoice method, a tax is imposed on the seller for all of its sales. The tax is calculated by applying the tax rate to the sales price of the good or service, and the amount of tax is generally disclosed on the sales invoice. A business credit is provided for all VAT levied on purchases of taxable goods and services (*i.e.*, "inputs") used in the seller's business. The ultimate consumer (*i.e.*, a nonbusiness purchaser), however, does not receive a credit with respect to his or her purchases. The VAT credit for inputs prevents the imposition

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nor is there a Federal sales or use tax. However, the majority of the States have enacted sales or use taxes, including both origin-based taxes and destination-based taxes.[1497]

With respect to cross-border transactions, the OECD has recommended that the destination principle be adopted for all indirect taxes, in part to conform to the treatment of such transactions for purposes of customs duties. The OECD defines the destination principle as "the principle whereby, for consumption tax purposes, internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption."[1498] A jurisdiction may adopt the convention that consumption occurs at the place of business or residence of the customer. Such proxies are needed to determine the location of consumption by persons other than individuals, because such persons are more able to move the location of use of goods, services, or intangibles in response to imposition of tax.

3. Resolving overlapping or conflicting jurisdiction to tax

Widely-accepted norms govern what constitutes a reasonable regulatory action by a sovereign state that will be respected by other sovereign states. General consensus on the limits of state jurisdiction helps to reduce conflicts from extraterritorial state action. In addition, jurisdictions have developed mechanisms to resolve common conflicts. For example, mechanisms to eliminate double taxation address situations in which the source and residency determinations of two jurisdictions result in duplicative assertion of taxing authority over the same item.

When the same item is subject to tax under the rules of two or more jurisdictions, double taxation is usually mitigated by bilateral tax treaties or by laws permitting credit for taxes paid to another jurisdiction. The United States is a partner in numerous bilateral treaties that aim to avoid international double taxation and prevent tax avoidance and evasion. Another related objective of these treaties is the removal of barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. The current United States Model Income Tax Convention (known as the U.S. model treaty), with its accompanying preamble, reflects the most recent comprehensive state-

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of multiple layers of tax with respect to the total final purchase price (*i.e.*, a "cascading" of the VAT). As a result, the net tax paid at a particular stage of production or distribution is based on the value added by that taxpayer at that stage of production or distribution. In theory, the total amount of tax paid with respect to a good or service from all levels of production and distribution should equal the sales price of the good or service to the ultimate consumer multiplied by the VAT rate.

To receive an input credit with respect to any purchase, a business purchaser is generally required to possess an invoice from a seller that contains the name of the purchaser and indicates the amount of tax collected by the seller on the sale of the input to the purchaser. At the end of a reporting period, a taxpayer may calculate its tax liability by subtracting the cumulative amount of tax stated on its purchase invoices from the cumulative amount of tax stated on its sales invoices.

[1497] EY, *Worldwide VAT, GST and Sales Tax Guide 2015*, p. 1021, available at http://www.ey.com/Publication/vwLUAssets/Worldwide-VAT-GST-and-sales-tax-guide-2015/$FILE/Worldwide%20VAT,%20GST%20and%20Sales%20Tax%20Guide%202015.pdf.

[1498] See OECD, "Recommendation of the Council on the application of value added tax/goods and services tax to the international trade in services and intangibles as approved on September 27, 2016," [C(2016)120], appendix, page 3, reproduced in the appendix, OECD, *International VAT/GST Guidelines*, OECD Publishing, 2017.

ment of the United States' negotiating position with respect to tax treaties.[1499] Bilateral agreements are also used to permit limited mutual administrative assistance between jurisdictions.[1500]

In addition to entering into bilateral treaties, jurisdictions have worked in multilateral organizations to develop common principles to alleviate double taxation. Those principles are generally reflected in the provisions of the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (known as the OECD model treaty),[1501] a precursor of which was first developed by a predecessor organization in 1958, which in turn has antecedents from work by the League of Nations in the 1920s.[1502] As a consensus document, the OECD model treaty is intended to aid countries in constructing their own bilateral treaties. The provisions have developed over time as practice with actual bilateral treaties leads to unexpected results and new issues are raised by parties to the treaties.[1503]

4. International principles as applied in the U.S. tax system

The United States imposes residence-based taxation on U.S. persons, taxing them on their worldwide income, whether derived in the United States or abroad, with limited deferral of taxation of income earned by foreign corporations owned by U.S. shareholders, and imposes source-based taxation on U.S.-source income of nonresident alien individuals and other foreign persons. Under this system (sometimes described as the U.S. hybrid system), the application of the Code differs depending on whether income arises from outbound investment (*i.e.*, investment by U.S. persons outside the United States) or inbound investment (*i.e.*, investment by non-U.S. persons in the United States).

[1499] The current U.S. model treaty is available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf; the preamble is available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US%20Model-2016.pdf. Treasury periodically updates the U.S. model treaty to reflect developments in the negotiating position of the United States. Such changes include provisions that were successfully included in bilateral treaties concluded by the United States, as well as new proposed measures not yet included in any bilateral treaty. Treasury published the current U.S. model treaty on February 17, 2016.

[1500] Although U.S. courts extend comity to foreign judgments in some instances, they are not required to recognize or assist in enforcement of foreign judgments for collection of taxes, consistent with the common law "revenue rule" in *Holman v. Johnson*, 1 Cowp. 341, 98 Eng. Rep. 1120 (K.B. 1775). American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States*, sec. 483 (1987). The rule retains vitality in U.S. case law. See generally *Pasquantino v. United States*, 544 U.S. 349 (2005) (a conviction for criminal wire fraud arising from an intent to defraud Canadian tax authorities was found not to conflict "with any well-established revenue rule principle[,]" and thus was not in derogation of the revenue rule). To the extent it is abrogated, it is done so in bilateral treaties, to ensure reciprocity. At present, the United States has such agreements in force with five jurisdictions: Canada, Denmark, France, the Netherlands, and Sweden.

[1501] OECD (2014), Model Tax Convention on Income and on Capital: Condensed Version 2014, OECD Publishing, 2014, available at http://dx.doi.org/10.1787//mtc_cond-2014-en. The multinational organization, dedicated to global development, was first established in 1961 by the United States, Canada, and 18 European countries, and has since expanded to 35 members.

[1502] See "Report by the Experts on Double Taxation," League of Nations Document E.F.S. 73/F19 (1923), which was a report commissioned by the League at its second assembly; see also Lara Friedlander and Scott Wilkie, "Policy Forum: The History of Tax Treaty Provisions—And Why It Is Important to Know About It," 54 *Canadian Tax Journal* No. 4 (2006).

[1503] For example, the OECD initiated a multi-year study on base-erosion and profit shifting in response to concerns of multiple members. For an overview of that project, see Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX–139–15), November 30, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

B. Principles Common to Inbound and Outbound Taxation

While the United States taxes inbound and outbound investment differently, certain rules are common to the taxation of both, including residency rules, entity classification rules, source determination rules, and transfer pricing rules.

1. Residence

U.S. persons are subject to U.S. tax on their worldwide income, while foreign persons are subject to U.S. tax only on income that has sufficient connection with the United States. The Code defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships and corporations.[1504] The term "resident" is defined only with respect to individuals. Noncitizens who are lawfully admitted as permanent residents of the United States in accordance with immigration laws (colloquially referred to as green card holders) are U.S. residents for tax purposes. In addition, noncitizens who meet a substantial presence test and are not otherwise exempt from U.S. taxation are also taxable as U.S. residents.[1505]

Domestic corporations are subject to U.S. tax on their worldwide income, whereas partnerships (whether foreign or domestic) generally are not subject to U.S. tax at the entity level. Rather, partners generally are taxed based on the activities of the partnership. Partnerships and corporations are domestic if organized or created under the laws of the United States, any State, or the District of Columbia, unless, in the case of a partnership, the Secretary prescribes otherwise by regulation.[1506] All other partnerships and corporations (*i.e.*, those organized under the laws of foreign countries) are foreign.[1507] Other jurisdictions may use factors such as situs or management and control to determine residence. As a result, legal entities may have more than one tax residence, or, in some cases, no residence. In such cases, bilateral treaties may resolve conflicting claims of residence.

In certain cases, a foreign corporation that acquires a domestic corporation or partnership may be treated as a domestic corporation for Federal tax purposes.[1508] That result generally applies following 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; (2) 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 (often 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 owner-

[1504] Sec. 7701(a)(30).
[1505] Sec. 7701(b).
[1506] Sec. 7701(a)(4).
[1507] Sec. 7701(a)(5) and (9). Entities organized in a possession or territory of the United States are not considered to have been organized under the laws of the United States.
[1508] Sec. 7874. The Treasury Department and the IRS have promulgated detailed guidance, through both regulations and several notices, addressing these requirements under section 7874 since the section was enacted in 2004, and have sought to expand the reach of the section or reduce the tax benefits of inversion transactions.

ship (the "expanded affiliated group"), does not have substantial business activities in the entity's country of organization, compared to the total worldwide business activities of the expanded affiliated group. If the above requirements are satisfied except that the "stock held by reason of" the acquisition is less than 80 percent but at least 60 percent of the stock of the foreign corporation, the foreign corporation is not treated as a domestic corporation but certain "inversion gain" of the acquired entity must be recognized and other consequences may apply to post-acquisition restructuring.[1509]

2. Entity classification

Certain entities other than "*per se* corporations" are eligible to elect their classification for Federal tax purposes under the "check-the-box" regulations,[1510] which affects the determination of the source of the income, availability of tax credits, and other tax attributes. Both foreign and domestic entities may make the election. As a result, an entity that operates in the United States and at least one other jurisdiction may be treated as a hybrid entity (*i.e.*, treated as a partnership or disregarded entity for U.S. tax purposes but as a corporation for foreign tax purposes) or a reverse hybrid entity (*i.e.*, treated as a corporation for U.S. tax purposes but as a partnership or disregarded entity for foreign tax purposes).

3. Source of income rules

Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor or recipient, and the location of the activities or assets that generate the income.

Interest

Interest is from U.S. sources if paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if paid by a U.S. resident individual, a domestic corporation, or a partnership engaged in a trade or business in the United States.[1511] Interest paid by the U.S. branch of a foreign corporation also is from U.S. sources.[1512]

Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.[1513] Thus, dividends paid by a domestic corporation generally are U.S.-source income. Similarly, dividends paid by a foreign corporation generally are foreign-source income. Under a special rule, dividends from a foreign corporation engaged

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[1509] In addition, an excise tax may be imposed on certain stock compensation of executives of companies that undertake inversion transactions. Sec. 4985.

[1510] Treas. Reg. sec. 301.7701–1, et seq.

[1511] Sec. 861(a)(1); Treas. Reg. sec. 1.861–2(a)(1). Certain exceptions apply. For example, interest paid on deposits with foreign branches of domestic corporations or domestic partnerships engaged in commercial banking is foreign source, as is interest paid by foreign branches of certain domestic financial institutions.

[1512] Sec. 884(f)(1).

[1513] Secs. 861(a)(2) and 862(a)(2).

in a trade or business in the United States may be treated as partly U.S.-source and partly foreign-source.[1514]

Rents and royalties

Rental and royalty income is sourced by reference to the location or place of use of the property.[1515] Rental income from property located in the United States (or from any interest in such property) is from U.S. sources. Royalty income includes amounts paid for the use of or for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property.

Income from sales of personal property

Subject to exceptions, income from the sale of personal property is sourced according to the residence of the seller.[1516]

Several exceptions to that general rule apply. For example, income from the sale of inventory property is generally sourced to the place of sale, which is determined by where title to the property passes.[1517] If the sale is by a nonresident and is attributable to an office or other fixed place of business in the United States, however, the gain is income from U.S. sources without regard to the place of sale, unless it is sold for use, disposition, or consumption outside the United States and a foreign office materially participates in the sale.[1518] Income from the sale of inventory property that a taxpayer produces (in whole or in part) in the United States and sells outside the United States, or that a taxpayer produces (in whole or in part) outside the United States and sells in the United States, is partly U.S.-source and partly foreign-source.[1519]

Gain on the sale of depreciable property is divided between U.S.-source and foreign-source in the same ratio that the depreciation was previously deductible for U.S. tax purposes.[1520] Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible property.[1521]

Personal services income

Compensation for labor or personal services is generally sourced to the place of performance. Thus, compensation for labor or personal services performed in the United States generally is U.S.-source income, subject to an exception for amounts that meet certain *de minimis* criteria.[1522]

[1514] Sec. 861(a)(2)(B).
[1515] Sec. 861(a)(4).
[1516] Sec. 865(a).
[1517] Secs. 865(b), 861(a)(6), 862(a)(6); Treas. Reg. sec. 1.861–7(c).
[1518] Sec. 865(e)(2).
[1519] Sec. 863(b). While sections 863(b) and 865(e)(2) may appear to conflict when a nonresident produces outside the United States and then sells through a U.S. office for use, disposition, or consumption in the United States, in such cases the income generally is partly U.S.-source and partly foreign-source.
[1520] Sec. 865(c).
[1521] Sec. 865(d).
[1522] Sec. 861(a)(3).

Insurance income

Underwriting income from issuing insurance or annuity contracts generally is U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.[1523]

Transportation income

Transportation income is any income derived from, or in connection with, the use (or hiring or leasing for use) of a vessel or aircraft (or a container used in connection therewith) or the performance of services directly related to such use.[1524] That definition does not encompass land transport except to the extent directly related to shipping by vessel or aircraft, but regulations provide an analogous rule for determining the source of income from transportation services other than shipping or aviation. In general, income from furnishing transportation that both begins and ends in the United States is U.S.-source income, and 50 percent of income attributable to transportation that either begins or ends in the United States is U.S.-source income.

An exemption from U.S. tax is provided for transportation income of foreign persons from countries that extend reciprocal relief to U.S. persons. A nonresident alien individual with income from the international operation of a ship may qualify, provided that the foreign country in which such individual is resident grants an equivalent exemption to individual residents of the United States.[1525] A similar exemption from U.S. tax is provided for gross income derived by a foreign corporation from the international operation of a ship or aircraft, provided that the foreign country in which the corporation is organized grants an equivalent exemption to corporations organized in the United States.[1526]

Income from space or ocean activities or international communications

For U.S. persons, all income from space or ocean activity and 50 percent of income from international communications is U.S.-source income. For foreign persons, generally no income from a space or ocean activity or from international communications is U.S.-source income.[1527] International communications income attributable to an office or other fixed place of business in the United States, however, is U.S.-source income.[1528]

Amounts received with respect to guarantees of indebtedness

Amounts received, directly or indirectly, from a noncorporate resident or from a domestic corporation for the provision of a guarantee of indebtedness of such person are income from U.S. sources.[1529] In addition, amounts received, directly or indirectly, from a foreign person, for the provision of a guarantee of indebtedness of that foreign person are income from U.S. sources if the

[1523] Sec. 861(a)(7).
[1524] Sec. 863(c)(3).
[1525] Sec. 872(b)(1).
[1526] Sec. 883(a)(1) and (2).
[1527] Sec. 863(d).
[1528] Sec. 863(e).
[1529] Sec. 861(a)(9).

amounts received are connected with income that is effectively connected with the conduct of a trade or business in the United States.

4. Intercompany transfers

Transfer pricing

A basic U.S. tax principle applicable in dividing profits from a transaction between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in a similar transaction with unrelated parties bargaining at arm's length (the "arm's-length standard"). The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to prevent erosion of the U.S. tax base by taxpayers that improperly shift income attributable to the United States to a related foreign company.[1530] Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing. The arm's-length standard is difficult to administer in situations in which no sufficiently comparable transaction can be found to use to evaluate the appropriateness of pricing in a transaction between related parties. When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in part by the same transfer pricing rules of section 482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

Section 482 authorizes the Secretary to allocate income, deductions, credits, or allowances among related business entities[1531] when necessary to clearly reflect income or otherwise prevent tax avoidance. Comprehensive Treasury regulations under that section generally adopt the arm's-length standard as the method for determining whether a particular allocation is appropriate.[1532] The regulations generally attempt to identify the income of each related party to a transaction that would have resulted had the parties been dealing at arm's length. For income from intangible property, section 482 provides, "in the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[1533]

[1530] For a detailed description of the U.S. transfer pricing rules, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX–37–10), July 20, 2010, pp. 18–50.

[1531] The term "related" as used herein refers to relationships described in section 482, which refers to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

[1532] Section 1059A buttresses section 482 by limiting the extent to which costs used to determine custom valuation can also be used to determine basis in property imported from a related party. A taxpayer that imports property from a related party may not assign a value to the property for cost purposes that exceeds its customs value.

[1533] H.R. Rep. No. 99-426, p. 423.

Gain recognition on outbound transfers

If a transfer of intangible property to a foreign affiliate occurs in connection with certain corporate transactions, nonrecognition rules that may otherwise apply are suspended. The transferor of intangible property must recognize gain from the transfer as though the transferor had sold the intangible (regardless of the stage of development of the intangible property) in exchange for payments contingent on the use, productivity, or disposition of the transferred property in amounts that would have been received either annually over the useful life of the property or upon disposition of the property after the transfer.[1534] The appropriate amounts of those imputed payments are determined using transfer-pricing principles. Final regulations issued in 2016 eliminated two possible interpretations of existing law that taxpayers were using to claim that outbound transfers of foreign goodwill and going concern value in nonrecognition transactions were not subject to taxation at all (*i.e.,* neither immediately under section 367(a) nor over the useful life of the property under section 367(d)).[1535] However, the Secretary subsequently announced[1536] that Treasury is considering reinstating an exception for the outbound transfer of foreign goodwill and going concern value used in the active conduct of a trade or business in administratively simple cases with little potential for abuse.[1537]

C. U.S. Tax Rules Applicable to Nonresident Aliens and Foreign Corporations (Inbound)

Nonresident aliens and foreign corporations generally are subject to U.S. tax only on their U.S.-source income. There are two broad types of U.S.-source income of foreign taxpayers: income that is "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") and income that is "effectively connected with the conduct of a trade or business within the United States" ("ECI"). FDAP income, although nominally subject to a statutory 30-percent gross-basis tax withheld at its source, in many cases is exempt or subject to a reduced rate of tax under the Code or a bilateral income tax treaty. ECI generally is subject to the same U.S. tax rules and rates that apply to business income derived by U.S. persons.

1. Gross-basis taxation of U.S.-source income

Certain income received by foreign persons from U.S. sources is subject to a 30-percent gross-basis tax (*i.e.,* a tax on gross income without reduction for related expenses), which is collected by withholding at the source of the payment. FDAP income subject to the 30-percent tax includes interest, dividends, rents, salaries, wages,

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[1534] Sec. 367(d).

[1535] See T.D. 9803, 81 F.R. 91012 (December 17, 2016). Treas. Reg. sec. 1.367(d)-1(b) now provides that the rules of section 367(d) apply to transfers of intangible property as defined under Treas. Reg. sec. 1.367(a)–-1(d)(5) after September 14, 2015, and to any transfers occurring before that date resulting from entity classification elections filed on or after September 15, 2015.

[1536] U.S. Treasury Department, *Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Executive Order 13789,* October 2, 2017.

[1537] For the relevant legislative history, see H.R. Rep. No. 98–432, 98th Cong., 2d Sess. 1318–1320 (March 5, 1984) and Conference Report, H.R. Rep. No. 98–861, 98th Cong. 2d Sess. 951–957 (June 23, 1984).

premiums, annuities, compensations, remunerations, and emoluments. The categories of income subject to the 30-percent tax and the categories for which withholding is required are generally coextensive.

FDAP income of nonresident aliens and foreign corporations that is not ECI is subject to the 30-percent tax.[1538] The items enumerated in defining FDAP income are illustrative, and the words "annual or periodical" are "merely generally descriptive" of the payments within the purview of the statute.[1539]

Exclusions from FDAP income

FDAP income encompasses a broad range of gross income, but has important exceptions. Capital gains of nonresident aliens are generally foreign source; however, capital gains of nonresident aliens present in the United States for 183 days or more [1540] during the year are income from U.S. sources subject to gross-basis taxation.[1541] In addition, U.S-source gains from the sale or exchange of intangibles are subject to tax and withholding if they are contingent on the productivity of the property sold.[1542]

Interest on bank deposits may qualify for exemption from treatment as FDAP income on two grounds. First, interest on deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, is U.S.-source income but is exempt from the 30-percent tax when paid to a foreign person.[1543] Second, interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not U.S.-source income and thus is not subject to U.S. tax.[1544] Interest and original issue discount on certain short-term obligations also is exempt from U.S. tax when paid to a foreign person.[1545] In addition, there is generally no information reporting required with respect to payments of such exempt amounts.[1546]

Although FDAP income includes U.S.-source portfolio interest, such interest is specifically exempt from the 30-percent gross-basis tax. Portfolio interest is any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person.[1547] Portfolio interest, however, does not include interest received by a 10-percent shareholder,[1548] certain contingent inter-

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[1538] Secs. 871(a) and 881. FDAP income that is ECI is taxed as ECI.

[1539] *Commissioner* v. *Wodehouse,* 337 U.S. 369, 393 (1949).

[1540] For purposes of this rule, whether a person is considered a resident in the United States is determined by application of the rules under section 7701(b).

[1541] Sec. 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as effectively connected income under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA").

[1542] Secs. 871(a)(1)(D) and 881(a)(4).

[1543] Secs. 871(i)(2)(A) and 881(d); Treas. Reg. sec. 1.1441–1(b)(4)(ii).

[1544] Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441—1(b)(4)(iii).

[1545] Secs. 871(g)(1)(B) and 881(a)(3); Treas. Reg. sec. 1.1441–1(b)(4)(iv).

[1546] Treas. Reg. sec. 1.1461–1(c)(2)(ii)(A) and (B). A bank must report interest if the recipient is a nonresident alien who resides in a country with which the United States has a satisfactory exchange of information program under a bilateral agreement and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049–4(b)(5) and –8. The IRS publishes lists of the countries whose residents are subject to the reporting requirements, and those countries with respect to which the reported information is automatically exchanged. See Rev. Proc. 2017–31, supplementing Rev. Proc. 2014–64.

[1547] Sec. 871(h)(2).

[1548] Sec. 871(h)(3).

est,[1549] interest received by a controlled foreign corporation from a related person,[1550] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[1551]

Withholding of 30-percent gross-basis tax

The 30-percent tax on FDAP income is generally collected by means of withholding.[1552] Withholding on FDAP payments to foreign payees is required unless the withholding agent,[1553] *i.e.,* the person making the payment to the foreign person, can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[1554]

Often the income subject to withholding is the only income of the foreign person subject to any U.S. tax. As long as the foreign person has no ECI and the withholding is sufficient to satisfy the tax liability with respect to FDAP income, the foreign person generally is not required to file a U.S. Federal income tax return. Accordingly, the withholding of the 30–percent gross–basis tax generally represents the collection of the foreign person's final tax liability.

To the extent that a withholding agent withholds an amount, the withheld tax is credited to the foreign recipient of the income.[1555] If the agent withholds more than is required, and that results in an overpayment of tax, the foreign recipient may file a claim for refund.

2. Net-basis taxation of U.S.-source income

The United States taxes ECI on a net basis.[1556]

U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in a U.S. trade or business if the partnership, estate, or trust is so engaged.[1557]

Whether a foreign person is engaged in a U.S. trade or business is a factual question that has generated much case law. Basic issues include whether the activity rises to the level of a trade or business, whether a trade or business has sufficient connections to the United States, and whether the relationship between the foreign person and persons performing activities in the United States for the foreign person is sufficient to attribute those activities to the foreign person.

The trade or business rules differ from one activity to another. The term "trade or business within the United States" expressly in-

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[1549] Sec. 871(h)(4).
[1550] Sec. 881(c)(3)(C).
[1551] Sec. 881(c)(3)(A).
[1052] Secs. 1441 and 1442.
[1053] A withholding agent includes any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441–7(a).
[1054] Secs. 871, 881, 1441, and 1442; Treas. Reg. sec. 1.1441–1(b).
[1555] Sec. 1462.
[1556] Secs. 871(b) and 882.
[1557] Sec. 875.

cludes the performance of personal services within the United States.[1558] If, however, a nonresident alien individual performs personal services for a foreign employer, and the individual's total compensation for the services and period in the United States are minimal ($3,000 or less in total compensation and 90 days or fewer of physical presence in a year), the individual is not considered to be engaged in a U.S. trade or business.[1559] Detailed rules govern whether trading in stock or securities or commodities constitutes the conduct of a U.S. trade or business.[1560] A foreign person who trades in stock or securities or commodities in the United States through an independent agent generally is not treated as engaged in a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which trades are carried out. A foreign person who trades stock or securities or commodities for the person's own account also generally is not considered to be engaged in a U.S. trade or business so long as the foreign person is not a dealer in stock or securities or commodities.

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation. Under each treaty, the United States is permitted to tax business profits only to the extent those profits are attributable to a U.S. permanent establishment of the foreign person. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business. For example, a permanent establishment typically requires the maintenance of a fixed place of business over a significant period of time.

Effectively connected income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is "effectively connected" with the business. Specific statutory rules govern whether income is ECI.[1561]

In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross-basis U.S. taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the U.S. trade or business were a material factor in the realization of the amount (the "asset use" and "business activities" tests).[1562] Under the asset use and business activities tests, due regard is given to whether such asset or such income, gain, or loss was accounted for through the trade or business. All other U.S.-source non-FDAP income is treated as ECI.[1563]

A foreign person who is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered

[1558] Sec. 864(b).
[1559] Sec. 864(b)(1).
[1560] Sec. 864(b)(2) and Prop. Treas. Reg. sec. 1.864(b)–1.
[1561] Sec. 864(c).
[1562] Sec. 864(c)(2).
[1563] Sec. 864(c)(3).

to be ECI.[1564] Foreign-source income not included in one of those categories generally is exempt from U.S. tax.

A foreign person's income from foreign sources generally is considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income is in one of the following categories: (1) rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trademarks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) income derived from the sale or exchange (outside the United States), through the U.S. office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange.[1565] Foreign-source dividends, interest, and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 percent (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income.[1566]

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if the agent either has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or has a stock of merchandise from which he regularly fills orders on behalf of the foreign person.[1567] If a foreign person has a U.S. office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office was a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived.[1568]

Special rules apply in determining the ECI of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code is treated as ECI if the income is attributable to its United States business.[1569]

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S.

[1564] This income is subject to net-basis U.S. taxation after allowance of a credit for any foreign income tax imposed on the income. See sec. 906.
[1565] Sec. 864(c)(4)(B).
[1566] Sec. 864(c)(4)(D)(i).
[1567] Sec. 864(c)(5)(A).
[1568] Sec. 864(c)(5)(B).
[1569] Sec. 864(c)(4)(C).

trade or business in that year.[1570] If, however, income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the income or gain is ECI if the income or gain would have been ECI in the prior year.[1571] If any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within 10 years after the cessation, the income or gain attributable to the disposition of the property is ECI if the income or gain would have been ECI had the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business.[1572]

Transportation income from U.S. sources is treated as effectively connected with a foreign person's conduct of a U.S. trade or business only if the foreign person has a fixed place of business in the United States that is involved in the earning of such income and substantially all of such income of the foreign person is attributable to regularly scheduled transportation.[1573] If the transportation income is effectively connected with conduct of a U.S. trade or business, the transportation income, along with transportation income that is from U.S. sources because the transportation both begins and ends in the United States, may be subject to net-basis taxation. Income of certain foreign persons from the international operation of a ship or aircraft may be eligible for an exemption, provided that the jurisdiction in which the foreign person is organized provides an equivalent exemption for U.S. persons.[1574]

Allowance of deductions

Taxable ECI is computed by taking into account deductions associated with gross ECI. Regulations address the allocation and apportionment of deductions between ECI and other income. Certain deductions may be allocated and apportioned on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. Specific rules provide for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. In general, interest is allocated and apportioned based on assets rather than income.

3. Special rules

FIRPTA

A foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") is treated as ECI.[1575] Thus, a foreign

[1570] Sec. 864(c)(1)(B).
[1571] Sec. 864(c)(6).
[1572] Sec. 864(c)(7).
[1573] Sec. 887(b)(4).
[1574] See sec. 883(a)(1), (2), and (c). The most recent compilation of countries that the United States recognizes as providing exemptions lists countries in three groups: 27 countries are eligible for exemption on the basis of a review of the law of the foreign jurisdiction; 39 countries exchanged diplomatic notes with the United States that grant exemption to some extent; and more than 50 countries are parties with the United States to bilateral income tax treaties that include a shipping article. Rev. Rul. 2008–17, 2008–1 C.B. 626, modified by Ann. 2008–57, 2008–C.B. 1192, 2008.
[1575] Sec. 897(a).

person subject to tax on such a disposition is required to file a U.S. tax return. In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as ECI is generally required to withhold U.S. tax from the payment.[1576] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's overall tax liability for the taxable year.

Branch profits taxes

A domestic corporation is subject to U.S. income tax on its net income. The earnings of the domestic corporation may be subject to a second tax, this time at the shareholder level, when dividends are paid. When the shareholders are foreign, the second-level tax may be collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to withholding tax. To approximate those second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign shareholders, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted (to the head office) out of, or amounts of interest that are deducted by, the U.S. branch of the foreign corporation. Those branch taxes may be reduced or eliminated under an applicable income tax treaty.[1577]

Under the branch profits tax, the United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount."[1578] The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its ECI.[1579] Limited categories of earnings and profits attributable to a foreign corporation's ECI are excluded in calculating the dividend equivalent amount.[1580]

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (*i.e.*, the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business).[1581] The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore generally is subject to 30-percent withholding tax if paid to a

[1576] Sec. 1445 and regulations thereunder.
[1577] See Treas. Reg. secs. 1.884–1(g) and –5.
[1578] Sec. 884(a).
[1579] Sec. 884(b).
[1580] See sec. 884(d)(2) (excluding, *e.g.*, earnings and profits attributable to gain from the sale of domestic corporation stock that constitutes a USRPI subject to FIRPTA).
[1581] Sec. 884(b).

foreign person.[1582] Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, also may be subject to 30-percent withholding tax.[1583] For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by the trade or business.

Earnings stripping

Earnings stripping generally refers to the process whereby a taxpayer reduces its U.S. taxable income by making deductible payments to a related foreign person. Taxpayers are limited in their ability to engage in certain earnings stripping transactions that involve interest payments. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for disqualified interest paid or accrued by the payor in a taxable year is generally disallowed to the extent of the payor's excess interest expense.[1584] Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest,[1585] to unrelated parties in certain cases in which a related party guarantees the debt, or to a REIT by a taxable REIT subsidiary of that REIT. Excess interest expense is the amount by which the payor's net interest expense (*i.e.*, the excess of interest paid or accrued over interest income) exceeds 50 percent of its adjusted taxable income (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Interest disallowed under these rules can be carried forward indefinitely and is allowed as a deduction to the extent of excess limitation in a subsequent tax year. Any excess limitation (*i.e.*, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

D. U.S. Tax Rules Applicable to Foreign Activities of U.S. Persons (Outbound)

1. In general

In general, income earned directly by a U.S. person from the conduct of a foreign business is taxed currently,[1586] but income earned indirectly by a separate foreign legal entity operating the foreign business is not, provided that the entity is treated as a corporation for U.S. tax purposes. Instead, active foreign business income earned by a U.S. person indirectly through an interest in a foreign

[1582] Sec. 884(f)(1)(A).
[1583] Sec. 884(f)(1)(B).
[1584] Sec. 163(j).
[1585] If a treaty reduces the tax rate on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the tax rate imposed without regard to the treaty, reduced by the tax rate imposed under the treaty, bears to the tax rate imposed without regard to the treaty. Sec. 163(j)(5)(B).
[1586] A U.S. citizen or resident living abroad may be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs under section 911. For a description of this exclusion, see *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX–42–11), September 6, 2011, p. 52.

corporation generally is not subject to U.S. tax until the income is distributed as a dividend to the U.S. person. Certain anti-deferral regimes may cause the U.S. owner to be taxed currently in the United States on certain categories of passive or highly mobile income earned by the foreign corporation regardless of whether the income has been distributed as a dividend to the U.S. owner. The main anti-deferral regimes that provide such exceptions are the controlled foreign corporation ("CFC") rules of subpart F[1587] and the passive foreign investment company ("PFIC") rules.[1588] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[1589]

2. Anti-deferral regimes

Subpart F

Subpart F,[1590] applicable to CFCs and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that are within the meaning of the term "United States shareholder," which refers only to those U.S. persons who own at least 10 percent of the stock (measured by vote only).[1591]

Subpart F income

Under the subpart F rules, the United States generally taxes the 10-percent U.S. shareholders of a CFC on their *pro rata* shares of certain income of the CFC ("subpart F income"), without regard to whether the income is distributed to the shareholders.[1592] In effect, the United States treats the 10-percent U.S. shareholders of a CFC as having received a current distribution of the CFC's subpart F income. With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one jurisdiction to another. Subpart F income consists of foreign base company income,[1593] insurance income,[1594] and certain income relating to international boycotts and other violations of public policy.[1595]

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 in-

[1587] Secs. 951–964.
[1588] Secs. 1291–1298.
[1589] Secs. 901, 902, 960, and 1293(f).
[1590] Secs. 951–964.
[1591] Secs. 951(b), 957, and 958. The term "United States shareholder" is used interchangeably herein with "U.S. shareholder."
[1592] Sec. 951(a).
[1593] Sec. 954.
[1594] Sec. 953.
[1595] Sec. 952(a)(3)–(5).

come, foreign base company services income, and foreign base company oil-related income.[1596]

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Finally, special rules under subpart F with respect to related person insurance income[1597] address captive insurance companies.[1598] Under these rules, the threshold for determining control is reduced to 25 percent, and any level of stock ownership by a U.S. person in such corporation is sufficient for the person to be treated as a U.S. shareholder.

Investments in U.S. property

The 10-percent U.S. shareholders of a CFC also are required to include in income currently their *pro rata* shares of the corporation's untaxed earnings invested in certain items of U.S. property.[1599] 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.[1600] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[1601] The inclusion rule for investment of earnings in U.S. property is intended to prevent taxpayers from avoiding U.S. tax on dividend repatriations by repatriating CFC earnings through non-dividend payments, such as loans to U.S. persons.

Subpart F exceptions

Several exceptions to the broad definition of subpart F income permit continued deferral for income from certain transactions, dividends, interest, and certain rents and royalties received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized.[1602] 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

[1596] Sec. 954.

[1597] Sec. 953(c). Related person insurance income is defined to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (within the meaning of the provision) in the foreign corporation receiving the income or a person related to such a shareholder.

[1598] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS–10–87), May 4, 1987, p. 968.

[1599] Secs. 951(a)(1)(B) and 956.

[1600] Sec. 956(c)(1).

[1601] Sec. 956(c)(2).

[1602] Sec. 954(c)(3).

greater than 90 percent of the maximum U.S. corporate income tax rate (*i.e.,* more than 90 percent of 35 percent, or 31.5 percent).[1603]

A provision colloquially referred to as the "CFC look-through" rule excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC to the extent attributable or properly allocable to non-subpart-F income of the payor.[1604] The look-through rule applies to taxable years of foreign corporations beginning before January 1, 2020, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

There is also an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of banking or financing business ("active financing income").[1605] 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 exclusion. 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 exclusion 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 exclusion applies to certain income derived from certain cross border transactions.

For a securities dealer, foreign personal holding company income excludes 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.[1606] In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that, for securities dealers, this exception generally takes precedence over the exception for active financing income.

Certain income of a qualifying insurance company (or a qualifying branch of a qualifying insurance company) with respect to risks located within the home country of the branch or within the CFC's country of organization are also excluded from foreign personal holding company income. Further, additional exclusions apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that certain requirements, including reserve requirements, are met.[1607]

[1603] Sec. 954(b)(4).
[1604] Sec. 954(c)(6).
[1605] Sec. 954(h).
[1606] Sec. 954(c)(2)(C).
[1607] Subject to approval by the IRS, a taxpayer may establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization,

Continued

Exclusion of previously taxed earnings and profits

A 10-percent U.S. shareholder of a CFC may exclude from its income actual distributions of earnings and profits from the CFC that were previously included in the 10–percent U.S. shareholder's income under subpart F.[1608] Any income inclusion (under section 956) resulting from investments in U.S. property may also be excluded from the 10-percent U.S. shareholder's income when such earnings are ultimately distributed.[1609] Ordering rules provide that distributions from a CFC are treated as coming first out earnings and profits of the CFC that have been previously taxed under 956, then subpart F income, then other earnings and profits.[1610]

Basis adjustments

In general, a 10-percent U.S. shareholder of a CFC increases the basis in its CFC stock by the amount of any subpart F inclusions.[1611] Similarly, a 10-percent U.S. shareholder of a CFC generally reduces its basis in its CFC stock by the amount of any distributions that the 10–percent U.S. shareholder receives from the CFC that are excluded from its income as previously taxed under subpart F.[1612]

Passive foreign investment companies

The Tax Reform Act of 1986[1613] established the PFIC anti-deferral regime. A PFIC is generally defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[1614] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. Under one set of rules, U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[1615] Under another set of rules for PFICs that are qualified electing funds, electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[1616] A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[1617]

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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.

[1608] Sec. 959(a)(1).
[1609] Sec. 959(a)(2).
[1610] Sec. 959(c).
[1611] Sec. 961(a).
[1612] Sec. 961(b).
[1613] Pub. L. No. 99–514.
[1614] Sec. 1297.
[1615] Sec. 1291.
[1616] Secs. 1293–1295.
[1617] Sec. 1296.

Under the PFIC regime, passive income is any income of a kind that would be foreign personal holding company income, including dividends, interest, royalties, rents, and certain gains on the sale or exchange of property, commodities, or foreign currency. However, among other exceptions, passive income does not include any income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.[1618] In applying the insurance exception, the IRS analyzes whether risks assumed under contracts issued by a foreign company organized as an insurer are truly insurance risks, whether the risks are limited under the terms of the contracts, and the status of the company as an insurance company.[1619]

Other anti-deferral regimes and coordination rules

The subpart F and PFIC rules are not the only anti-deferral regimes. Other rules that impose current U.S. taxation on income earned through corporations include the accumulated earnings tax rules [1620] and the personal holding company rules.

Rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a PFIC with respect to a particular shareholder if the corporation is also a CFC and the shareholder is a 10-percent U.S. shareholder. That is, subpart F trumps the PFIC rules.

3. Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed to claim credit for foreign income taxes they pay. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed as a dividend or is included in the domestic corporation's income under the anti-deferral rules.[1621]

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. [1622] The limit is computed by multiplying a taxpayer's total pre-credit 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

[1618] Sec. 1297(b)(2)(B).
[1619] Notice 2003–34, 2003–C.B. 1 990, June 9, 2003. See also Prop. Treas. Reg. sec. 1.1297–4.
[1620] Secs. 531–537.
[1621] Secs. 901, 902, 960, and 1291(g).
[1622] Secs. 901 and 904.

carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[1623]

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each limitation category by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category, on the other. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[1624] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on certain ratios.[1625] Interest expense is apportioned based on 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 ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.[1626]

The term "affiliated group" is determined by reference to the rules for determining whether corporations are eligible to file consolidated returns, with certain modifications.[1627] These rules generally exclude foreign corporations from an affiliated group.[1628] Interest expense allocation rules permitting a U.S. affiliated group to elect to apportion the interest expense of the members of the U.S. affiliated group on a worldwide basis were modified in 2004, and initially effective for taxable years beginning after December 31, 2008.[1629] The effective date of the modified rules has been delayed to January 1, 2021.[1630] A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group.

The foreign tax credit limitation is applied separately to passive category income and to general category income.[1631] Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. All other income is in the general category. Passive income is treated as general category income if earned by a qualifying financial services entity or if highly taxed (i.e., if the foreign tax rate is determined to exceed the highest tax rate specified in section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC are assigned to the passive category to the extent the payments or inclusions are allocable to passive category income of the

[1623] Sec. 904(c).
[1624] Treas. Reg. sec. 1.861–8(b) and Temp. Treas. Reg. sec. 1.861–8T(c).
[1625] Temp. Treas. Reg. sec. 1.861–9T and Treas. Reg. sec. 1.861–17.
[1626] Sec. 864(e)(1) and (6); Temp. Treas. Reg. sec. 1.861–14T(e)(2).
[1627] Secs. 864(e)(5) and 1504.
[1628] Sec. 1504(b)(3).
[1629] Sec. 864(f).
[1630] See Hiring Incentives to Restore Employment Act, Pub. L. No. 111–147, sec. 551(a).
[1631] Sec. 904(d). The foreign tax credit limitation is also applied separately to certain additional separate categories. See Treas. Reg. sec. 1.904–4(m).

CFC.[1632] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[1633]

Special rules apply to the allocation of income and losses from foreign and U.S. sources within each category of income.[1634] Foreign losses from one category first offset foreign-source income from other categories. Any remaining overall foreign loss offsets U.S.-source income. The same principle applies to losses from U.S. sources. In subsequent years, any losses deducted against another category or source of income are recaptured. That is, an equal amount of income from the same category or source that generated a loss in a prior year is recharacterized as income from the other category or source against which the loss was deducted. Foreign-source income in a particular category may be fully recharacterized as income in another category, whereas only up to 50 percent of income from one source in any subsequent year may be recharacterized as income from the other source.

A taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[1635]

4. Special rules

Dual consolidated loss rules

A dual consolidated loss ("DCL") is any net operating loss of a domestic corporation if the corporation is subject to an income tax of a foreign country without regard to whether such income is from sources in or outside such foreign country, or if the corporation is subject to such a tax on a residence basis (a "dual resident corporation").[1636] A DCL generally cannot be used to reduce the taxable income of any member of the corporation's affiliated group. Losses of a separate unit of a domestic corporation (a foreign branch or an interest in a hybrid entity owned by the corporation) are subject to this limitation in the same manner as if the unit were a wholly-owned subsidiary of such corporation. An exemption applies to a DCL with respect to which the corporation makes a domestic use election (*i.e.,* an election to use the loss only for domestic, and not foreign, tax purposes).[1637] Recapture is required, however, upon the occurrence of certain triggering events, including the conversion of a separate unit to a foreign corporation and the transfer of 50 percent or more of the assets of a separate unit within a 12-month period.[1638]

[1632] Sec. 904(d)(3).
[1633] Sec. 904(d)(4).
[1634] Sec. 904(f) and (g).
[1635] Sec. 909.
[1636] Sec. 1503(d). The DCL rules presuppose the loss was used for foreign tax purposes.
[1637] Treas. Reg. sec. 1.1503(d)–6(d).
[1638] See Treas. Reg. sec. 1.1503(d)–6(e)(1).

Temporary dividends-received deduction for repatriated foreign earnings

In 2004, Congress enacted section 965, a temporary provision intended to encourage U.S. multinational companies to repatriate foreign earnings.[1639] Under that provision, for one taxable year certain dividends received by a U.S. corporation from its CFCs were eligible for an 85-percent dividends-received deduction. At the taxpayer's election, this deduction was available for dividends received either during the taxpayer's first taxable year beginning on or after October 22, 2004, or during the taxpayer's last taxable year beginning before such date.

The temporary deduction was subject to a number of general limitations. First, the deduction applied only to cash repatriations generally in excess of the taxpayer's average repatriation level calculated for a three-year base period preceding the year of the deduction. Second, the amount eligible for the deduction was generally limited to the amount of earnings shown as permanently invested outside the United States on the taxpayer's recent audited financial statements. Third, to qualify for the deduction, dividends were required to be invested in the United States according to a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.[1640]

No foreign tax credit (or deduction) was allowed for foreign taxes attributable to the deductible portion of any dividend.[1641] For this purpose, the taxpayer was permitted to specifically identify which dividends were treated as carrying the deduction and which dividends were not. In other words, the taxpayer was allowed to choose which of its dividends were treated as meeting the base-period repatriation level (and thus carry foreign tax credits, to the extent otherwise allowable), and which of its dividends were treated as part of the excess eligible for the deduction (and thus subject to proportional disallowance of any associated foreign tax credits).[1642] Deductions were disallowed for expenses that were directly allocable to the deductible portion of any dividend.[1643]

Domestic international sales corporations

A domestic international sales corporation ("DISC") is a domestic corporation that satisfies the following conditions: 95 percent of its gross receipts must be qualified export receipts; 95 percent of the sum of the adjusted bases of all its assets must be attributable to the sum of the adjusted bases of qualified export assets; the corporation must have no more than one class of stock; the par or stated value of the outstanding stock must be at least $2,500 on each day of the taxable year; and an election must be in effect to

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[1639] American Jobs Creation Act of 2004, Pub. L. 108–357, sec. 421.

[1640] Section 965(b)(4). The plan was required to provide for the reinvestment of the repatriated dividends in the United States, including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for the purposes of job retention or creation.

[1641] Sec. 965(d)(1).

[1642] Accordingly, taxpayers generally were expected to pay regular dividends out of high-taxed CFC earnings (thereby generating deemed-paid credits available to offset foreign-source income) and section 965 dividends out of low-taxed CFC earnings (thereby availing themselves of the 85-percent deduction).

[1643] Sec. 965(d)(2).

be taxed as a DISC.[1644] In general, a DISC is not subject to corporate-level tax and offers limited deferral of tax liability to its shareholders.[1645] DISC income attributable to a maximum of $10 million annually of qualified export receipts is generally exempt from income tax at both the corporate and shareholder level. Shareholders must pay interest to account for the benefit of deferring the tax liability on undistributed DISC income related to this $10 million maximum annual amount.[1646] Such entities are also referred to as interest charge DISCs, or IC–DISCs. Shareholders of a DISC are deemed to receive a dividend out of current earnings and profits from qualified export receipts in excess of $10 million.[1647] Gain on the sale of DISC stock is treated as a dividend to the extent of accumulated DISC income.[1648] The shareholders of a corporation which is not a DISC, but was a DISC in a previous taxable year, and which has previously taxed income or accumulated DISC income, are also required to pay interest on the deferral benefit, and gain on the sale or exchange of stock in such corporation is treated as a dividend.

[1644] Sec. 992(a) and (b). A corporation that fails to satisfy either or both of the 95-percent tests is deemed to satisfy such tests if it makes a *pro rata* distribution of its gross receipts that are not qualified export receipts and the fair market value of its assets that are not qualified export assets. Sec. 992(c).

[1645] Sec. 991. Prior to the 1984 Revenue Act (Pub. L. 98–369), DISCs were eligible for more generous tax benefits that were eliminated in favor of the since-repealed foreign sales corporation regime ("FSC"). An overview of the history of the DISCs and FSCs regimes is provided in Joseph Isenbergh, Vol. 3 *U.S. Taxation of Foreign Persons and Foreign Income,* Para. 81. (Fourth Ed. 2016).

[1646] The rate is the average of one-year constant maturity Treasury yields. The deferral benefit is the excess of the amount of tax for which the shareholder would be liable if deferred DISC income were included as ordinary income over the actual tax liability of such shareholder. Sec. 995(f).

[1647] The amount of the deemed distribution is the sum of several items, including qualified export receipts in excess of $10 million. See sec. 955(b).

[1648] Sec. 995(c).

PART I—OUTBOUND TRANSACTIONS

SUBPART A—ESTABLISHMENT OF PARTICIPATION EXEMPTION SYSTEM FOR TAXATION OF FOREIGN INCOME

A. Deduction for Foreign-Source Portion of Dividends Received by Domestic Corporations from Specified 10-Percent Owned Foreign Corporations (sec. 14101 of the Act and sec. 904(b) and new sec. 245A of the Code)

Explanation of Provision

Background on prior law

To limit multiple levels of corporate tax in the case of tiered corporate structures, corporations are allowed a dividends received deduction ("DRD"). U.S. corporations are permitted a deduction for qualifying dividends received from other U.S. corporations. The amount of the DRD is calculated as a percentage of the dividend received. The DRD percentage is based on the amount of stock that the recipient U.S. corporation owns in the paying U.S. corporation, as follows: (1) 50 percent if the ownership is less than 20 percent; (2) 65 percent if the ownership is at least 20 percent and less than 80 percent; and (3) 100 percent if the ownership is at least 80 percent.[1649] A U.S. corporation may also be eligible for a DRD for dividends received from a qualified 10-percent owned foreign corporation with respect to the U.S.-source portion of the dividends.[1650]

In general

The provision exempts certain foreign income of certain domestic corporations by means of a 100-percent DRD for the foreign-source portion of dividends received from a specified 10-percent owned foreign corporation. A specified 10-percent owned foreign corporation is any foreign corporation (other than a PFIC that is not also a CFC) with respect to which any domestic corporation is a U.S. shareholder.[1651] A corporate U.S. shareholder of a CFC receiving a dividend from a 10-percent owned foreign corporation shall be allowed a DRD with respect to the subpart F inclusion attributable to such dividend in the same manner as a dividend would be allowable under section 245A.[1652] However, certain dividends that qualify for the DRD may result in an inclusion under section 951(a)

[1649] Sec. 243. The Act changed the DRD percentages. The changes to section 243 are discussed in greater detail in the explanation of section 13002 of the Act.

[1650] Sec. 245. The DRD on the eligible portion of the dividend is based on the percentage of stock ownership of the foreign corporation, as described in section 243.

[1651] Sec. 245A(b). Under section 951(b) as revised by section 14214 of the Act, a domestic corporation is a U.S. shareholder of a foreign corporation if it owns, within the meaning of section 958(a), or is considered as owning by applying the rules of section 958(b), 10 percent or more of the vote or value of the foreign corporation.

[1652] A technical correction may be necessary to reflect this intent.

(subpart F) or section 951A ("GILTI") in cases in which any such inclusion is reduced under section 951(a)(2)(B) by reason of a dividend or in certain cases in which the CFC ceases to have a U.S. shareholder with section 958(a) ownership.[1653]

The term "dividend received" is intended to be interpreted broadly, consistently with the meaning of the phrases "amount received as dividends'" and "dividends received" under sections 243 and 245, respectively. For example, if a domestic corporation indirectly owns stock of a foreign corporation through a partnership and the domestic corporation would qualify for the DRD with respect to dividends from the foreign corporation if the domestic corporation owned such stock directly, the domestic corporation would be allowed the DRD with respect to its distributive share of the partnership's dividend from the foreign corporation. However, the provisions of section 245A are intended to apply only to amounts that are treated as dividends for Federal income tax purposes. Furthermore, the dividend cannot be a CFC–PFIC's section 1291(d)(2)(B) "purging" dividend.[1654] Under section 245A(g), the Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of this section, including regulations for the treatment of U.S. shareholders owning stock of a specified 10-percent owned foreign corporation through a partnership.

The DRD is available only to C corporations that are neither RICs nor REITs.[1655]

Foreign-source portion of a dividend

The foreign-source portion of any dividend equals the amount of the dividend multiplied by the percentage of undistributed earnings that are attributable neither to ECI nor to certain dividends received from domestic corporations.[1656] Undistributed earnings are the amount of the earnings and profits of a specified 10-percent owned foreign corporation[1657] as of the close of the taxable year of the specified 10-percent owned foreign corporation in which the dividend is distributed and not reduced by dividends[1658] distributed during that taxable year.

For example, assume a domestic corporation ("U.S. Parent") wholly owns a specified 10-percent owned foreign corporation ("SFC"). At the beginning of year 1, SFC has no accumulated earnings and profits. SFC has $1,000 of current-year earnings and prof-

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[1653] Technical corrections may be necessary to reflect this intent.

[1654] Sec. 245A(f).

[1655] An S corporation's taxable income is computed in the same manner as an individual (sec. 1363(b)) so that deductions allowable only to corporations, including the section 245A deduction, do not apply. See Report by the House Committee on Ways and Means to accompany H.R. 6055, Subchapter S Revision Act of 1982, H. Rep. No. 97-826, p. 14; and Report by the Senate Committee on Finance to accompany H.R. 6055, Subchapter S Revision Act of 1982, S. Rep. 97-640, p. 15. The Code provides that deductions for corporations provided in part VIII of subchapter B, which include the DRD under section 245A, do not apply in computing RIC taxable income (sec. 852(b)(2)(C)) or REIT taxable income (sec. 857(b)(2)(A)). Therefore, the DRD under section 245A is not available for RICs or REITs.

[1656] Sec. 245A(c). Such dividends include any dividend received (directly or through a wholly owned foreign corporation) from a domestic corporation at least 80 percent of the stock of which is owned (directly or through such wholly owned foreign corporation) by the specified 10-percent owned foreign corporation.

[1657] Computed in accordance with sections 964(a) and 986.

[1658] Note that pursuant to section 959(d), a distribution of previously taxed income ("PTI") does not constitute a dividend.

its for year 1, of which $250 is attributable to ECI. SFC makes a single distribution of $1,500 to U.S. Parent in year 1. The amount of the $1,500 distribution that is a dividend is $1,000 because SFC has only $1,000 of E&P in year 1.[1659] Of that amount, $750 is the foreign-source portion and eligible for the 100-percent DRD under section 245A (the $1,000 dividend * ($750 of E&P that is not ECI / $1,000 of total E&P)).

Holding period requirement

A domestic corporation is not permitted a DRD in respect of any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. For this purpose, the holding period requirement is satisfied only if the specified 10-percent owned foreign corporation is a specified 10-percent owned foreign corporation at all times during the period and the taxpayer is a U.S. shareholder with respect to such specified 10-percent owned foreign corporation at all times during the period.[1660]

Foreign tax credit disallowance

No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any dividend that qualifies for the DRD. For example, assume $100 of foreign income taxes are withheld from a $1,000 dividend from a specified 10-percent owned foreign corporation to a domestic corporation. The foreign-source portion of the dividend is $800, and an $800 DRD is allowed. No foreign tax credit or deduction will be allowed for $80 of the foreign income taxes pursuant to section 245A(d), and no foreign tax credit or deduction will be allowed for the remaining $20 of foreign income taxes pursuant to section 245(a)(8).

For purposes of computing the foreign tax credit limitation, a domestic corporation that is a U.S. shareholder of a specified 10-percent owned foreign corporation must determine its foreign-source taxable income (and entire taxable income) by disregarding any dividend for which the DRD is taken, and any deductions properly allocable or apportioned to income (other than amounts includible under section 951(a)(1) or 951A(a)) with respect to stock of such foreign corporation, or the stock to the extent income with respect to the stock is other than amounts includible under section 951(a)(1) or 951A(a).[1661]

Hybrid dividends

The DRD is not available for any hybrid dividend. A hybrid dividend is an amount received from a CFC for which section 245A(a) would allow a DRD and for which the CFC received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States. Furthermore, no foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any hybrid dividend.

[1659] Secs. 301(c)(1) and 316.
[1660] Sec. 246(c)(5).
[1661] Sec. 904(b)(4).

If a CFC for which a domestic corporation is a U.S. shareholder receives a hybrid dividend from any other CFC for which that domestic corporation is a U.S. shareholder, the hybrid dividend will be treated as subpart F income, and, notwithstanding any other provision of the Code, the U.S. shareholder will include in income its *pro rata* share of the income under section 951(a).[1662] This tiered hybrid dividend rule applies to an amount treated as a dividend in the hands of the recipient CFC (as opposed to amounts allowed the DRD) and for which the distributing CFC received a deduction or other tax benefit.[1663]

Effective Date

The provision applies to distributions made after (and for purposes of determining a taxpayer's foreign tax credit limitation under section 904, deductions with respect to taxable years ending after) December 31, 2017.[1664]

B. Special Rules Relating to Sales or Transfers Involving Specified 10-Percent Owned Foreign Corporations (sec. 14102 of the Act and secs. 367(a)(3), 961, 964(e), and 1248 and new sec. 91 of the Code)

Explanation of Provision

Background on prior law

Gain recognized by a U.S. person on the sale or exchange of the stock of a foreign corporation may be recharacterized as a dividend to the extent of the E&P attributable to that stock if the U.S. person owned, directly, indirectly or constructively, 10 percent or more (by vote) of the stock of the foreign corporation while the foreign corporation was a CFC at any time during the preceding five-year period.[1665] Similarly, section 964(e) requires a CFC to include in income as a dividend gain recognized on the sale or exchange of the stock of another foreign corporation to the same extent that it would have been so included under section 1248(a) if the CFC were a U.S. person.

Certain branch loss recapture rules prevent a taxpayer from deducting losses incurred by a foreign branch against U.S. taxable income and then incorporate the branch when it is profitable. Prior law required a U.S. corporation to recapture the loss deduction to the extent of built-in gain in the branch assets that are transferred outside the U.S. tax jurisdiction to a foreign corporation in an otherwise tax-free transaction.[1666] Under prior law, the recapture

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[1662] This is the result even if, for example, the dividend would normally be entitled to look-through treatment under section 954(c)(6), the subpart F income would normally be reduced by deductions pursuant to section 954(b)(5), or the subpart F income would normally be limited by current earnings and profits under section 952(c).

[1663] A technical correction may be necessary to reflect this intent.

[1664] A technical correction may be necessary to reflect the intent that the DRD be excluded from adjusted current earnings ("ACE") adjustments for purposes of the corporate alternative minimum tax ("AMT") as applicable to certain fiscal-year taxpayers for their 2017 taxable year.

[1665] Sec. 1248(a).

[1666] Sec. 367(a)(3)(C) as in effect before the enactment of the Act. Section 367(a)(3)(C) was enacted to prevent a U.S. corporation from using losses of a foreign branch to offset its taxable income without having to pay U.S. tax on the associated future income after the branch's incorporation.

amount was limited to unrealized asset appreciation and treated as foreign-source income.

Section 367 generally requires gain recognition on many types of otherwise tax-free transfers by U.S. persons to foreign corporations, unless a specific exception applies. One such exception under prior law provided that property transferred to a foreign corporation for use by the transferee in the active conduct of a trade or business outside of the United States is not subject to tax.[1667]

In general

The provision establishes limitations on the ability to obtain duplicative tax benefits from losses in specified 10-percent foreign corporations and transfers of certain foreign branch losses to such foreign corporations, as described below. It provides a new coordination rule under section 1248 to ensure that gain upon the sale or exchange of stock in the specified 10-percent foreign corporation that is recharacterized as a dividend under section 1248 is treated as a "dividend received" for purposes of applying section 245A, and further prescribes basis adjustments with respect to loss from such sales or exchanges. The ability to transfer foreign branch losses is limited by new section 91. Finally, the aforementioned active trade or business exception is repealed.

Sales by United States persons of CFC stock

If a domestic corporation sells or exchanges stock in a foreign corporation that it has held for one year or more, any amount received by the domestic corporation which is treated as a dividend for purposes of section 1248, is treated as a dividend for purposes of applying the rules of new section 245A with respect to the new 100-percent DRD. Thus, to the extent section 1248 treats an amount received as a dividend, such dividend may qualify for a DRD under section 245A if the requirements of section 245A are satisfied.[1668]

Sale of stock in a lower-tier CFC

If for any taxable year of a CFC beginning after December 31, 2017, an amount is treated as a dividend because of a sale or exchange by the CFC of stock in another foreign corporation held for a year or more,[1669] then: (i) the foreign-source portion of the dividend is treated as subpart F income of the selling CFC,[1670] (ii) a U.S. shareholder with respect to the selling CFC includes in gross income for the taxable year of the shareholder with or within which the taxable year of the CFC ends, an amount equal to the shareholder's *pro rata* share of the amount treated as subpart F income under (i), and (iii) the amount includible in the gross income of the United States shareholder under clause (ii) shall be treated as a divided from a specified 10-percent owned foreign corporation for purposes of applying section 245A.[1671]

[1667] Sec. 367(a)(3)(A) as in effect before the enactment of the Act.
[1668] Sec. 1248(j).
[1669] See sec. 964(e)(1).
[1670] See generally sec. 954(c)(1)(B).
[1671] A technical correction may be necessary to reflect this intent.

To the extent a dividend arising under section 964(e)(1) is a hybrid dividend, the tiered hybrid rules of section 245A(e)(2), rather than the rules of section 964(e)(4)(A), apply to the dividend.[1672]

Reduction in basis of certain foreign stock

A distribution from a foreign corporation eligible for a DRD could reduce the value of the foreign corporation, reducing built-in gain or increasing built-in loss in the stock of the foreign corporation. Therefore, solely for the purpose of determining a loss, a domestic corporate shareholder's adjusted basis in the stock of a specified 10-percent owned foreign corporation (as defined in section 245A) is reduced by an amount equal to the portion of any dividend received with respect to such stock from such foreign corporation that was not taxed by reason of the DRD allowable under section 245A in any taxable year of such domestic corporation.[1673] This rule applies in coordination with section 1059, such that any reduction in basis required pursuant to this provision will be disregarded to the extent the basis in the specified 10-percent owned foreign corporation's stock has already been reduced under section 1059.

In the case of a sale or exchange by a CFC of stock in another corporation in a taxable year of the selling CFC beginning after December 31, 2017, to which this provision applies if gain were recognized, rules similar to the rules of section 961(d) apply.[1674]

Inclusion of transferred loss amount in certain asset transfers

If a domestic corporation transfers substantially all of the assets of a foreign branch (within the meaning of section 367(a)(3)(C)) as in effect before the Act) to a specified 10-percent owned foreign corporation with respect to which it is a U.S. shareholder after the transfer, the domestic corporation includes in gross income an amount equal to the transferred loss amount, subject to certain limitations.[1675]

The transferred loss amount is, with respect to any transfer of substantially all of the assets of a foreign branch, the excess (if any) of: (1) the sum of the losses incurred by the foreign branch after December 31, 2017, and before the transfer, for which a deduction was allowed to the domestic corporation, over (2) the sum of any taxable income earned by the foreign branch after the loss incurred and any amount recognized under section 904(f)(3) on account of the transfer.[1676] The transferred loss amount is reduced (but not below zero) by the amount of gain recognized by the taxpayer (other than gain recognized by reason of an overall foreign loss recapture) on account of the transfer.[1677]

[1672] A technical correction may be necessary to reflect this intent.
[1673] Sec. 961(d).
[1674] Sec. 964(e)(4)(B).
[1675] Sec. 91(a).
[1676] Sec. 91(b).
[1677] Sec. 91(c). Sec. 14102(d)(4) of the Act, relating to transition rules, provides:"(4) Transition rule. The amount of gain taken into account under section 91(c) of the Internal Revenue Code of 1986, as added by this subsection, shall be reduced by the amount of gain which would be recognized under section 367(a)(3)(C) (determined without regard to the amendments made by subsection (e)) with respect to losses incurred before January 1, 2018."

Amounts included in gross income by reason of the provision are treated as derived from sources within the United States.[1678] Consistent with regulations or guidance that the Secretary of the Treasury shall prescribe, proper adjustments are made in the adjusted basis of the taxpayer's stock in the specified 10-percent owned foreign corporation to which the transfer is made, and in the transferee's adjusted basis in the property transferred, to reflect the amounts included in gross income under the provision.[1679]

The amount of gain taken into account under this provision is reduced by the amount of gain which would be recognized under section 367(a)(3)(C) as in effect before the date of the Act[1680] with respect to losses incurred before January 1, 2018.

To illustrate this provision assume that a U.S. multinational corporation ("U.S. Parent"), a calendar year taxpayer, incorporates its branch located in country X ("Incorporated Country X Branch") on December 31, 2018. Incorporated Country X Branch recognized $150 of losses during calendar year 2018 for which U.S. Parent took a deduction.

On December 31, 2018, Incorporated Country X Branch has tangible assets with built-in gain of $100, and U.S. Parent recognizes that $100 of gain under section 367(a)(1). Under section 91(a), U.S. Parent includes $50 in gross income ($150 of losses, reduced by $100 section 91(c) reduction amount, which in this case is the amount of gain recognized under section 367(a)(1)). However, if, for example, Incorporated Country X Branch also had $75 of pre-2018 branch losses, the $100 section 91(c) reduction amount would be reduced by $75 to $25. In this case, U.S. Parent would include $125 in gross income ($150 of losses, reduced by the $25 section 91(c) reduction amount).

Repeal of active trade or business exception under section 367

Section 367(a) is amended to provide that in connection with any exchange described in sections 332, 351, 354, 356, or 361, if a U.S. person transfers property used in the active conduct of a trade or business outside of the United States to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. That is, a transfer of property used in the active conduct of a trade or business outside of the United States by a U.S. corporation to a foreign corporation does not qualify for non-recognition of gain, notwithstanding that the transfer may quality for non-recognition of gain, in whole or part, under other provisions of the Code.

Effective Date

The provisions relating to sales or exchanges of CFC stock apply to sales or exchanges after December 31, 2017.

[1678] Sec. 91(d).

[1679] Sec. 91(e).

[1680] Determined without regard to the rule providing for proper adjustment of basis in the stock in the specified 10-percent owned foreign corporation to which the transfer is made.

The provision relating to reduction of basis in certain foreign stock for the purposes of determining a loss is effective for distributions made after December 31, 2017.

The provisions relating to transfer of loss amounts from foreign branches to certain foreign corporations and to the repeal of the active trade or business exception under section 367 apply to transfers after December 31, 2017.

C. Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation and Deemed Repatriation at Two-Tier Rate (sec. 14103 of the Act and secs. 78, 904, 907, and 965 of the Code)

Explanation of Provision

In general

As part of the transition from a deferral system with limitations to a system under which companies are eligible for a 100-percent dividends received deduction with respect to distributions of foreign earnings, the provision requires certain foreign corporations to include as subpart F income the untaxed and undistributed foreign earnings that were accumulated by those corporations in taxable years since 1986. The U.S. shareholders of those corporations are subject to tax ("transition tax") with respect to the shareholders' *pro rata* shares of such subpart F income. The transition tax ensures that undistributed foreign earnings that accrued before the effective date of the participation exemption system are subject to tax by the United States, allowing uniform applicability of the participation exemption with respect to post-enactment foreign earnings and profits of foreign subsidiaries.

The provision generally requires that, for the last taxable year beginning before January 1, 2018, any U.S. shareholder of a specified foreign corporation[1681] must include in income its *pro rata* share of the accumulated post-1986 deferred foreign income of the corporation. However, a portion of that *pro rata* share of foreign earnings is deductible. The deductible amount depends on the proportion of the deferred earnings that are held in cash or other assets, resulting in a reduced rate of tax applicable to the income includible under this provision. A corresponding portion of the credit for foreign taxes paid with respect to such income is disallowed, thus limiting the credit to the taxable portion of the included income. The separate foreign tax credit limitation rules of section 904 continue to apply, with coordinating rules. The transition tax generally may be paid over an eight-year period. Special rules are provided for S corporations and REITs.

Subpart F inclusion of deferred foreign income

The provision requires that certain pre-effective date foreign earnings be treated as subpart F income of a deferred foreign income corporation ("DFIC") in the last taxable year that begins before January 1, 2018. The increase in subpart F income of the

[1681] For purposes of this provision, a specified foreign corporation is any CFC and any foreign corporation that has at least one domestic corporation that is a U.S. shareholder. The term excludes PFICs that are not also CFCs.

DFIC required by this provision ("the section 965 inclusion") is the greater of two measurements of the accumulated post-1986 deferred foreign income of the corporation, i.e., the amount determined either as of November 2, 2017,[1682] or as of December 31, 2017 (the "measurement date(s)").

The transition tax applies to all U.S. shareholders of a DFIC, which is any specified foreign corporation with accumulated post-1986 deferred income that is greater than zero. Consistent with the operation of subpart F in general and of section 951 in particular, each U.S. shareholder of a DFIC must include in income the shareholder's *pro rata* share of the section 965 inclusion of the DFIC.

In determining whether a foreign corporation is a specified foreign corporation with respect to a U.S. shareholder, the shareholder must take into account the contemporaneous change in the operation of the constructive ownership rules,[1683] which are effective for the year of the transition tax. Taxpayers must determine whether they have constructive ownership in entities with respect to which they may not have previously had a reporting or tax obligation under the Code.

Scope of accumulated post-1986 deferred foreign income

To determine whether a specified foreign corporation is a DFIC, the U.S. shareholder must determine whether the corporation has accumulated post-1986 deferred foreign income greater than zero, based on the accumulated post-1986 deferred foreign income as of the measurement date. The earnings and profits taken into account for that measurement date include all post-1986 earnings and profits that are (1) not attributable to income that is effectively connected with the conduct of a trade or business in the United States and thus subject to current U.S. income tax, or (2) when distributed, not excludible from the gross income of a U.S. shareholder when distributed as previously taxed income under section 959.

Post-1986 earnings and profits are those earnings that accumulated in taxable years beginning after 1986 (including previously taxed earnings and profits), computed in accordance with sections 964(a) and 986, for all periods during which the corporation was a specified foreign corporation. Post-1986 earnings and profits are not reduced by distributions during the taxable year to which the transition tax applies. The post-1986 earnings and profits include earnings and profits described in sections 959(c)(1) and (2), but do not include earnings and profits that were accumulated by a foreign company prior to attaining its status as a specified foreign corporation.

The Secretary shall prescribe appropriate rules regarding the treatment of accumulated post-1986 foreign deferred income of specified foreign corporations that have shareholders who are not U.S. shareholders. Such rules may also include rules that are appropriate to implement the intent of the transition tax and the use of November 2, 2017, the date of introduction, as one of the meas-

[1682] H.R. 1, *Tax Cuts and Jobs Act*, 115th Cong., was introduced in the House of Representatives on November 2, 2017.

[1683] Prior to enactment of the Act, Section 958(b)(4) provided that the attribution rules of section 318 that would otherwise apply are inapplicable if the result would attribute stock held by a foreign person to a U.S. person. See, section 14213 of the Act and the description thereof, at subpart I.B.

urement dates in order to establish a floor for determining the post-1986 deferred foreign earnings and profits. For example, guidance may address the extent to which retroactive effective dates selected in entity classification elections filed after introduction of the Act will be permitted.[1684]

Deficits netted against accumulated post-1986 earnings and profits

A U.S. shareholder may reduce (but not below zero) its share of accumulated post-1986 earnings and profits from specified foreign corporations by the shareholder's share of deficits from other specified foreign corporations, including netting against deficits of another U.S. shareholder in a different U.S. ownership chain within the same U.S. affiliated group. The income inclusion required of a U.S. shareholder from DFICs under this transition rule is reduced by the portion of the aggregate foreign earnings and profits deficit allocated to that person by reason of that person's interest in an earnings and profits deficit foreign corporation ("E&P deficit foreign corporation"). An E&P deficit foreign corporation is any foreign corporation that is a specified foreign corporation with respect to the U.S. shareholder as of the date on which accumulated earnings and profits are measured for that corporation (November 2, 2017, or December 31, 2017, as the case may be) and which has a deficit in post-1986 earnings and profits as of that date.[1685] Accordingly, deficits that a foreign corporation accumulated prior to the U.S. shareholder acquisition of its interest in that corporation may be taken into account in determining the aggregate foreign earnings and profits deficit of a U.S. shareholder. The netting permitted by this rule is applied to the total earnings and profits of the specified foreign corporation, without regard to whether the earnings and profits and deficits were accumulated in the same income category for foreign tax credit limitation purposes.

For example, assume that a foreign corporation organized after December 31, 1986 has $100 of accumulated earnings and profits as of November 2, 2017, and December 31, 2017 (determined without diminution by reason of dividends distributed during the taxable year, other than dividends distributed to other specified foreign corporations), which consist of $120 general limitation earnings and profits and a $20 passive limitation deficit. Under generally applicable rules, if the $20 passive limitation deficit was a hovering deficit described in regulations, the foreign corporation's post-1986 earnings and profits would be $100, but foreign tax credits related to the hovering deficit would not be deemed paid by the U.S. shareholder, because the deemed paid credits are limited to the amount that is in proportion to the absorption of the deficit by current earnings in the same income category that gave rise to the deficit.[1686] Solely for purposes of calculating the amount of foreign income taxes deemed paid by the U.S. shareholder with respect to

[1684] See, Treas. Reg. sec. 301.7701–3(c), under which an election may specify an effective date up to 75 days prior to the date on which the election is filed.

[1685] It is possible that a specified foreign corporation is neither a DFIC nor an earnings and profits deficit foreign corporation, despite having post-1986 earnings and profits greater than zero or a deficit in accumulated post-1986 deferred foreign income.

[1686] See, Treas. Reg. sec. 1.367(b)–7(d)(2)(ii) (hovering deficit offset rule) and (iii) (foreign income taxes related to a hovering deficit).

an inclusion under section 965, Congress intends that a hovering deficit may be absorbed by current year earnings and profits and the foreign income taxes related to the hovering deficit may be added to the specified foreign corporation's post-1986 foreign income taxes in that separate category on a *pro rata* basis in the year of inclusion.

The U.S. shareholder aggregates its *pro rata* share of the foreign earnings and profits deficits of each E&P deficit foreign corporation and allocates such aggregate amount among the remaining specified foreign corporations. The aggregate foreign earnings and profits deficit is allocable to a specified foreign corporation in the same ratio as the U.S. shareholder's *pro rata* share of post-1986 deferred income of that corporation bears to the U.S. shareholder's *pro rata* share of accumulated post-1986 deferred foreign income from all deferred foreign income companies of such shareholder. The earnings and profits of the E&P deficit foreign corporation that are taken into account by a U.S. shareholder are increased at the foreign corporation level by the amount of the specified E&P deficit of such corporation that was used. Such increase does not apply for purposes of determining post-1986 undistributed earnings under section 902.[1687]

Example 1

To illustrate the ratio, assume that Z, a domestic corporation, is a U.S. shareholder with respect to each of four specified foreign corporations, two of which are earnings and profits deficit foreign corporations. Assume further the foreign companies have the following accumulated post-1986 deferred foreign income or foreign earnings and profits deficits as of November 2, 2017, and December 31, 2017:

Specified Foreign Corp.	Percentage Owned	Post-1986 Earnings and Profits (Deficit) USD	Pro rata Share
A	60%	($1,000)	($600)
B	10%	($200)	($20)
C	70%	$2,000	$1,400
D	100%	$1,000	$1,000

The aggregate foreign earnings and profits deficit of the U.S. shareholder is ($620), and the aggregate share of accumulated post-1986 deferred foreign income is $2,400. Thus, the portion of the aggregate foreign earnings and profits deficit allocable to foreign corporation C is ($362), that is, ($620) × 1400/2400. The remainder of the aggregate foreign earnings and profits deficit is allocable to foreign Corporation D. The U.S. shareholder has a net surplus of earnings and profits in the amount of $1,780.

Example 2

The intragroup netting among U.S. shareholders in an affiliated group in which there is at least one U.S. shareholder with a net earnings and profits surplus and another with a net earnings and profits deficit permits the net earnings and profits surplus share-

[1687] See section 965(b)(4)(B). A technical correction may be required to reflect this intent.

holder to reduce its net surplus by the shareholder's applicable share of aggregate unused earnings and profits deficit, based on the group's ownership percentage of the members. For example, a U.S. corporation may have two domestic subsidiaries, X and Y, in which it owns 100 percent and 80 percent, respectively. If X has a $1,000 net earnings and profits surplus, and Y has $1,000 net earnings and profits deficit, X is an earnings and profits net surplus shareholder, and Y is an earnings and profits net deficit shareholder. The net earnings and profits surplus of X may be reduced by the net earnings and profits deficit of Y to the extent of the group's ownership percentage in Y, which is 80 percent. The remaining net earnings and profits deficit of Y is unused. If the U.S. shareholder Z from Example 1 is also a wholly owned subsidiary of the same U.S. parent as X and Y, the group ownership percentage of Y is unchanged, and the surpluses of X and Z are reduced ratably by $800 of the net earnings and profits deficit of Y.

In taxable years beginning after 2017, amounts by which a U.S. shareholder's section 951 inclusion is reduced by aggregate earnings and profits deficits are considered as amounts included in the gross income of the U.S. shareholder. The shareholder's *pro rata* share of the earnings and profits of an E&P deficit foreign corporation that used qualified deficits to reduce its section 965 inclusion is increased by the amount of such deficit and attributed to the same activity to which the income was attributed.

Partial participation exemption deduction

A U.S. shareholder is allowed a deduction under section 965(c) of a portion of its *pro rata* share of the section 965 inclusion from all DFICs. The deductible portion is a sum of an amount equal to the 15.5-percent rate equivalent percentage of the portion of the shareholder's *pro rata* share of the inclusion amount that is the shareholder's aggregate cash position plus the eight-percent rate equivalent percentage of the portion of the inclusion that exceeds the aggregate cash position. By stating the permitted deduction in the form of a tax rate equivalent percentage rather than a flat rate of deduction, the provision ensures that all pre-effective date accumulated post-1986 deferred foreign income is subject to corporate tax at either an 8-percent rate or a 15.5-percent rate, without regard to the corporate tax rate that may be in effect at the time the shareholder is required to report the inclusion. For example, corporate U.S shareholders that use a fiscal year as their taxable year may not be required to include their *pro rata* share of the section 965 inclusions until a taxable year for which a corporate tax rate lower than that in effect for calendar year taxpayers for 2017 would apply. The structure of the allowable deduction ensures that amounts required to be included under sections 965 and 951 are generally subject to U.S. tax at either an 8-percent or 15.5 percent rate.

Aggregate cash position

The aggregate cash position of a U.S. shareholder is the shareholder's *pro rata* share of the earnings and profits attributable to cash assets of specified foreign corporations. It is the greater of the *pro rata* share of the cash position of all specified foreign corpora-

tions of the U.S. shareholder as of the last day of the last taxable year beginning before January 1, 2018, or the *pro rata* share of the average of the cash position of such corporations determined on the last day of each of the two taxable years ending immediately before November 9, 2017. If a specified foreign corporation does not exist on any particular cash measurement date, its cash position would be zero with respect to that date. For purposes of this computation, the cash position of certain noncorporate entities that would be treated as specified foreign corporations if they were foreign corporations is also included.

The cash position of a specified foreign corporation (or of an entity treated as such) consists of all cash, net accounts receivables, and the fair market value of the following enumerated categories of assets: personal property of a type that is actively traded on an established financial market (other than stock in the specified foreign corporation), government securities, certificates of deposit, commercial paper, foreign currency, and short-term obligations with a term of less than one year. In addition, the Secretary may identify other assets to be treated as cash assets if the Secretary determines that they are economically equivalent to the types of property enumerated in the statute.

Certain exclusions from aggregate cash position of a U.S. shareholder are specified in the provision. First, in limited circumstances, the aggregate cash position does not include net accounts receivable, short-term obligations, or property of a type actively traded on an established financial market (*e.g.*, publicly traded stock held by a specified foreign corporation.) This exception from inclusion in the aggregate cash position is limited to instances in which a U.S. shareholder can demonstrate that the value of such asset was taken into account as cash or cash equivalent by another specified foreign corporation with respect to which such shareholder is a U.S. shareholder.

Second, the aggregate cash position of a U.S. shareholder does not generally include the cash attributable to a direct ownership interest in a partnership. However, cash positions of certain noncorporate foreign entities are taken into account if such entities would be specified foreign corporations with respect to the U.S. shareholder if the entity were a foreign corporation. For example, if a U.S. shareholder owns a five-percent interest in a partnership, the balance of which is held by specified foreign corporations with respect to which such shareholder is a U.S. shareholder, the partnership is treated as a specified foreign corporation with respect to the U.S. shareholder, and the portion of its earnings held in cash or cash equivalent is includible in the aggregate cash position of the U.S. shareholder on a look-through basis. The Secretary may provide guidance for taking into account only the specified foreign corporations' share of the partnership's cash position, and not the five-percent interest directly owned by the U.S. shareholder.

The provision grants the Secretary authority to disregard transactions that the Secretary determines had the principal purpose of reducing the aggregate foreign cash position.

Special rules

The rate equivalent percentages are intended to ensure that deferred foreign income of U.S. shareholders is generally subject to comparable rates of tax, without regard to the type of U.S. person who is the shareholder or the different rates of income tax to which a taxpayer may be subject. Individuals who are U.S. shareholders, as well as the individual investors in U.S. shareholders that are pass-through entities, may achieve rate parity with corporate shareholders by electing application of corporate rates for the year under inclusion, under section 962. That section allows such individual U.S. shareholders to make the election for a specific taxable year, subject to regulations provided by the Secretary. Consistent with the goal of rate parity where possible, and to avoid duplicative tax on the amounts included in income under this provision, the entire amount of such inclusion, without reduction for the partial participation exemption deduction, is considered previously taxed income of the DFIC for purposes of subpart F.

Special rules complement the rules that generally govern basis adjustments for U.S. shareholders that are not entities organized under subchapter C.[1688] First, for partners in a partnership that is a U.S. shareholder of the DFIC, the increase in partnership income that is not taxed by reason of the partial dividends-received deduction available to the partner is treated as income not exempt from tax for purposes of determining the basis in an interest in a partnership.[1689] As a result, the partner's section 951 inclusion requires an adjustment to basis for the partner's distributive share of the inclusion. Upon actual distribution, basis is decreased by the amount of the distribution.

Similar rules apply to the determination of basis in stock of an S corporation.[1690] The general rules governing adjustments to basis and the accumulated adjustment account ("AAA") of such corporations require an increase in basis, with adjustments to the AAA in a manner similar to basis, with several exceptions.[1691] Among the exceptions is a rule that the AAA is not adjusted for tax-exempt income. The general rules require that both basis and the AAA increase by the taxable portion of the section 951 inclusion, *i.e.*, the inclusion less the partial participation exemption deduction. The special rule in section 965(f)(2) treats an amount equal to the partial participation exemption deduction as income that is tax-exempt and requires an increase in shareholder basis for this amount, but as income that is not tax-exempt for purposes of the AAA adjust-

[1688] Sec. 965(f)(2)(A).

[1689] Sec. 705(a)(1)(B).

[1690] Section 1361 defines an S corporation as a domestic small business corporation that has an election in effect for status as an S corporation, with fewer than 100 shareholders, none of whom are nonresident aliens, and all of whom are individuals, estates, trusts or certain exempt organizations.

[1691] Secs. 1367 and 1368. Under section 1367(a)(1), a shareholder's basis in an S corporation is increased by the amount included in income by the shareholder, including by reason of section 965. This amount will also increase the S corporation's AAA pursuant to section 1368(e)(1)(A). Under section 1367(a)(2), a shareholder's basis in an S corporation is reduced by deductions, including the partial participation exemption deduction. This amount also reduces the S corporation's AAA pursuant to section 1368(e)(1)(A). Thus, both shareholder basis and the S corporation's AAA are increased by the net amount of the inclusion under section 965 (*i.e.*, the amount included in income under Section 965(a)(1) less the amount allowed as a deduction under Section 965(c)).

ment.[1692] Thus, the entire section 951 inclusion increases both basis and the AAA. When subsequently distributed to the shareholder in the S corporation, a decrease in basis in the same amount is required.

Individual U.S. shareholders of a DFIC who do not make an election under section 962 may claim the partial participation exemption deduction in computing adjusted gross income, without regard to limitations that may apply to itemized deductions. The section 965(c) deduction is not treated as an itemized deduction for any purpose.[1693]

Foreign tax credits and the section 965(c) deduction

A portion of foreign income taxes deemed paid under section 960(a)(1) with respect to a U.S. shareholder's *pro rata* share of section 965 inclusions is creditable against the Federal income tax attributable to the inclusion. The portion that is attributable to the nontaxed portion of the deferred foreign income is neither creditable nor deductible. The disallowed portion of foreign taxes deemed paid is 55.7 percent of the foreign taxes deemed paid with respect to the inclusion attributable to the aggregate cash position plus 77.1 percent of the foreign taxes deemed paid with respect to the remaining portion of the section 965 inclusion.[1694] A similar portion of foreign taxes paid, accrued or deemed paid with respect to distributions of previously taxed earnings and profits that result from an inclusion under section 965(a) (including taxes imposed on distributions of previously taxed earnings and profits that are the result of section 965(a)) is neither creditable nor deductible. In addition, it is intended that no deduction or credit is allowed for taxes associated with earnings and profits that, by reason of section 965(b), are not included in income.[1695]

The provision coordinates the disallowance of foreign tax credits described above with the requirement[1696] that a domestic corporate shareholder is deemed to receive a dividend in an amount equal to foreign taxes it is deemed to have paid and for which it claimed a credit. Under the coordination rule, the foreign taxes deemed paid by a domestic corporation as a result of the inclusion are limited to the portion of those taxes in proportion to the taxable portion of the section 965 inclusion. The gross-up amount equals the total foreign income taxes multiplied by a fraction, the numerator of which is the taxable portion of the increased subpart F income under this provision and the denominator of which is the total increase in subpart F income under this provision.

A U.S. shareholder may elect,[1697] no later than with a timely filed return for the taxable year, not to apply net operating loss carryovers to reduce taxable income in that year below the amount

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[1692] Secs. 1367(a)(1)(A) and 1368(e)(1)(A).

[1693] A technical correction may be needed to reflect this intent. Filing instructions published for the 2018 filing season reflect this intent. See, Internal Revenue Service, "Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns," Appendix: Q&A2, available at https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns. See also, sec. 6, Notice 2018–26.

[1694] Other foreign tax credits used by a taxpayer against tax liability resulting from the deemed inclusion apply in full.

[1695] A technical correction may be needed to reflect this intent.

[1696] Sec. 78.

[1697] Sec. 965(n).

of the deemed repatriation. Depending on a taxpayer's circumstances, a possible effect of this election may be that the taxpayer offsets its U.S. tax in the transition tax year with a foreign tax credit that, had net operating losses reduced taxable income below the amount of the inclusion, would have been carried forward to future tax years to which the participation exemption regime applies. If the election is made, neither the pro rata share of the section 965 inclusion (as reduced by the section 965(c) deduction), nor the section 78 gross-up in the amount of any related deemed paid foreign tax credits is taken into account in computing the amount of the net operating loss incurred in, or the amount of the net operating loss deduction allowed in that year. Deductions, whether for current year expenses or for a net operating loss carryover, taken into account in the election year may not exceed gross income determined without regard to the transition inclusion and related section 78 gross-up.[1698]

Installment payments and special elections

Election to pay transition tax over eight years

A U.S. shareholder may elect to pay the net tax liability that results from the inclusion of a pro rata share of the section 965 inclusions in eight annual installments.[1699] The net tax liability eligible to be paid in installments is the excess of the U.S. shareholder's net income tax for the taxable year in which the section 965 inclusions are included in income over the taxpayer's net income tax for that year determined without regard to the inclusion of such earnings or any dividend received by a U.S. shareholder from a DFIC. Net income tax is defined as the regular tax liability less certain nonrefundable credits.[1700] Regular tax liability means regular tax as defined in section 26, which includes neither the minimum tax under section 59 nor the base erosion and anti-abuse tax of section 59A. As a result, neither the alternative minimum tax (if applicable in computing the tax liability without regard to the section 965 inclusions) nor the base erosion and anti-abuse tax is considered in determining the portion of the tax liability that is eligible to be paid over eight installments.[1701]

An election to pay tax in installments must be made by the due date for the tax return for the taxable year in which the pre-effective date undistributed CFC earnings are included in income. The Secretary has authority to prescribe the manner of making the

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[1698] A technical correction may be needed to reflect the intent. The reference in section 965(n)(1)(A) to "a net operating loss deduction under section 172" may be read to limit the election to a taxpayer's net operating loss carryforwards and carrybacks, but not allow losses in the year for which the election is made. However, any deductions that are deferred to preserve a net operating loss for the year may not also be deducted in the election year, so that the taxpayer's taxable income for the year cannot be less than the amount described in section 965(n)(2).

[1699] The amount due with each installment is a prescribed percentage of the net tax liability, as follows: Each of installments one through five equals eight percent of the net tax liability. The sixth and seventh installments increase to 15 percent and 20 percent, respectively. The eighth installment equals 25 percent.

[1700] The credits taken into account for purposes of determining the net tax liability are those described in sections 21 through 26 (nonrefundable personal credits), section 27 (taxes of foreign countries or territories of the United States), section 30A (Puerto Rican economic activity credit) sections 30B through 30D (related to fuel or motor vehicle), and sections 38 through 45S (certain business credits).

[1701] A technical correction may be needed to reflect the legislative intent.

election. The first installment must be paid on the due date (determined without regard to extensions) for the tax return for the taxable year of the income inclusion. Succeeding annual installments are due no later than the due dates (without extensions) for the income tax return of each succeeding year. If a deficiency is later determined with respect to the net tax liability, the additional tax due may be prorated among all installment payments in most circumstances. The portions of the deficiency prorated to an installment that was due before the deficiency was assessed must be paid upon notice and demand. The portion prorated to any remaining installment is payable with the timely payment of that installment payment, unless the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax, in which case the entire deficiency is payable upon notice and demand.

The timely payment of an installment does not incur interest. If a deficiency is determined that is attributable to an understatement of the net tax liability due under this provision, the deficiency is payable with underpayment interest for the period beginning on the date on which the net tax liability would have been due, without regard to an election to pay in installments, and ending with the payment of the deficiency. Furthermore, any amount of deficiency prorated to a remaining installment also bears interest on the deficiency, but not on the original installment amount.

The provision also includes an acceleration rule. If (1) there is a failure to pay timely any required installment, (2) there is a liquidation or sale of substantially all of the U.S. shareholder's assets (including in a bankruptcy case), (3) the U.S. shareholder ceases business, or (4) another similar circumstance arises, the unpaid portion of all remaining installments is due on the date of the event (or, in a title 11 bankruptcy case or similar proceeding, the day before the petition is filed).

Special rule for S corporations

A special rule permits deferral of the transition net tax liability for shareholders of a U.S. shareholder that is itself an S corporation and not subject to tax at the entity level. The S corporation is required to report on its income tax return for its last taxable year that begins before January 1, 2018, the amount that is includible in gross income by reason of this provision, as well as the amount of deduction that would be allowable, and provide a copy of such information to each shareholder. Any shareholder of the S corporation may elect to defer his or her portion of the net tax liability until the shareholder's taxable year in which a triggering event occurs. The election to defer the net tax liability is due not later than the due date for the shareholder's tax return for the taxable year that includes the close of the taxable year in which the S corporation reports the inclusion required by this provision.

Three types of events may trigger an end to deferral of the net tax liability. The first type of triggering event is a change in the status of the corporation as an S corporation. The second category includes liquidation or sale of substantially all corporate assets (including by reason of reorganization in bankruptcy or similar proceeding), termination of the company or end of business, or similar

event. The third type of triggering event is a transfer of shares of stock in the S corporation by the electing taxpayer, whether by sale, death, or otherwise, unless the transferee of the stock agrees with the Secretary to be liable for net tax liability in the same manner as the transferor. Partial transfers trigger the end of deferral only with respect to the portion of tax properly allocable to the portion of stock sold.

If a shareholder of an S corporation has elected deferral under the special rule for S corporation shareholders and a triggering event occurs, the S corporation and the electing shareholder are jointly and severally liable for any net tax liability and related interest or penalties. The period within which the IRS may collect such liability does not begin before the date of an event that triggers the end of the deferral. If an election to defer payment of the net tax liability is in effect for a shareholder, that shareholder must report the amount of the deferred net tax liability on each income tax return due during the period that the election is in effect. Failure to include that information with each income tax return will result in a penalty equal to five percent of the amount that should have been reported.

After a triggering event occurs, a shareholder of the S corporation may elect to pay the net tax liability in eight installments, subject to rules similar to those generally applicable to all U.S. shareholders, with certain exceptions. If the triggering event is a liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, the installment payment election is not available. Instead, the entire net tax liability is due upon notice and demand. The installment election is due with the timely return for the year in which the triggering event occurs. The first installment payment is required by the due date of the same return, determined without regard to extensions of time to file.

Special rules for REITs

Special rules are also provided to address instances in which the U.S. shareholder is a EIT. First, although the REIT must determine its *pro rata* share of the increase in subpart F income in accordance with the rules described above, the REIT is not required to take into account the section 951 inclusion for purposes of determining the REIT's amount of qualified REIT gross income.[1702] The section 951 inclusion is, however, taken into account for purposes of determining the income potentially required to be included in taxable income under section 857(b).

A REIT is generally permitted to deduct the portion of its income that is distributed to its shareholders as a dividend or qualifying

[1702] To qualify as a REIT, an entity must meet certain income requirements. A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate-related income. Sec. 856. In addition, a REIT is required to distribute at least 90 percent of REIT income (other than net capital gain) annually. Sec. 857. Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met to avoid an excise tax under section 4981.

liquidating distribution each year.[1703] The distributed income of the REIT is not taxed at the entity level; instead, it is taxed once, at the investor level. Requiring inclusion under this section could trigger a requirement that the REIT distribute an amount equal to 90 percent of that inclusion despite the fact that the REIT received no distribution from the DFIC.

To avoid requiring that any distribution requirement be satisfied in one year, a REIT may elect to defer a portion of the section 951 inclusion. Under a timely election, a REIT may instead take the amounts into income over a period of eight years. It must include eight percent in each of the five years beginning with the initial year in which the section 951 inclusion is determined, 15 percent in the sixth year, 20 percent in the seventh year and 25 percent in the eighth year. In each of those years, it may claim a partial dividends-received deduction in the applicable percentages in proportion to the amount included in each of the eight years. If a timely election is made by the REIT to defer inclusion, neither the REIT nor its investors may invoke the installment payment election.[1704]

In the event that a REIT liquidates, ceases to operate its business, or distributes substantially all its assets (or any other similar event occurs), any portion of the required inclusion not yet taken into income is accelerated and required to be included as gross income as of the day before the event.

Limitations on assessment extended

The provision establishes a minimum period of six years for assessment of the transition tax, or underpayments with respect to the transition tax, measured from the date on which the return initially reflecting the section 951 inclusion was filed. To the extent that such return was filed by a U.S. shareholder that is a domestic partnership, a commensurate extension of the period for making adjustments to a partnership return is intended.[1705] The provision does not operate to shorten any otherwise applicable limitations period that would provide a greater period for such adjustments or assessments.

Recapture from expatriated entities

The partial participation exemption deduction is subject to recapture if the U.S. shareholder that claimed the deduction becomes an expatriated entity at any point during the 10 years beginning on the date of enactment of the Act (December 22, 2017). An entity is subject to the recapture rule if it becomes an expatriated entity with respect to which a foreign corporation becomes a surrogate foreign corporation for the first time during the same 10-year period. For purposes of this rule, the terms expatriated entity and surrogate foreign corporation are given the same meaning as those terms are defined in section 7874(a)(2), except that a surrogate for-

[1703] Liquidating distributions are covered to the extent of earnings and profits, and are defined to include redemptions of stock that are treated by shareholders as a sale of stock under section 302. Secs. 857(b)(2)(B), 561, and 562(b).

[1704] Under section 965(m)(2)(B)(i)(III), a rule barring an electing trust from making an election to pay in installments refers to subsection (g), which deals with foreign tax credits, rather than subsection (h). A technical correction may be needed to reflect the correct cross-reference.

[1705] A technical correction may be needed to reflect the intent.

eign corporation that is treated as a domestic corporation under section 7874(b) is not within the scope of this recapture provision.

The recapture rule operates by increasing the tax in the year of expatriation. The income tax otherwise due in the year of expatriation is increased by an amount equal to 35 percent of the claimed partial participation exemption deduction. Although the amount due is computed by reference to the year in which the deemed subpart F income was originally reported and the deduction claimed, the additional tax arises and is assessed for the taxable year in which the U.S. shareholder becomes an expatriated entity. No credits are permitted to offset the additional tax due as a result of the recapture rule.

Regulatory authority

The provision specifies several areas for which regulatory action is expected to carry out the intent of the provision and to deter tax avoidance. With respect to the determination of cash position, the provision specifically authorizes the Secretary to identify other assets that are economically equivalent to the enumerated assets that are treated as cash. The provision also authorizes the Secretary to disregard transactions that are determined to have the principal purpose of reducing the aggregate foreign cash position. The specific grants of regulatory authority complement the Secretary's authority under the consolidated return provisions and allow him to determine proper application of this section on a consolidated basis for affiliated groups filing a consolidated return.

To avoid double-counting of earnings (or double noncounting) that may occur due to different measurement dates applicable to specified foreign corporations within an affiliated group or the timing of intragroup distributions, the Secretary is required to provide guidance to adjust the amount of post–1986 earnings and profits of a specified foreign corporation to ensure that a single item of a specified foreign corporation is taken into account only once in determining the income of a U.S. shareholder subject to this provision. For example, the Secretary may identify instances in which it is appropriate to adjust the amount of post–1986 earnings and profits of a specified foreign corporation to ensure that the earnings and profits of the specified foreign corporation are taken into account once. Such an adjustment may be necessary, for example, when there is a deductible payment (*e.g.*, interest or royalties) from one specified foreign corporation to another specified foreign corporation between measurement dates.

The grant of regulatory authority in the provision includes a nonexhaustive list of examples of areas in which the Secretary shall prescribe rules or guidance that are consistent with the intent of the statute and deter tax avoidance through use of entity classification elections and accounting method changes, among other possible strategies (*e.g.*, intragroup transactions such as distributions or liquidations).

The Secretary has proposed regulations pursuant to this provision.[1706]

[1706] See, Prop. Treas. Reg. sec. 1.965–1 *et seq*. Notice of Proposed Rulemaking, 83 FR 39514, August 9, 2018.

Effective Date

The provision is effective for the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to U.S. shareholders, for the taxable years in which or with which such taxable year of the foreign corporation ends.

SUBPART B—RULES RELATED TO PASSIVE AND MOBILE INCOME

A. Current Year Inclusion of Global Intangible Low-Taxed Income by U.S. Shareholders (sec. 14201 of the Act and sec. 78 and new secs. 951A and 960(d) of the Code)

Explanation of Provision

In general

Under the provision, a U.S. shareholder[1707] of any CFC must include in gross income for a taxable year its global intangible low-taxed income ("GILTI") in a manner generally similar to inclusions of subpart F income. GILTI means, with respect to any U.S. shareholder for the shareholder's taxable year, the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. The shareholder's net deemed tangible income return equals the excess (if any) of 10 percent of the aggregate of its *pro rata* share of the qualified business asset investment ("QBAI") of each CFC with respect to which it is a U.S. shareholder over certain interest expense. The interest expense that reduces a U.S. shareholder's net deemed tangible income return is the amount of interest expense taken into account in determining its net CFC tested income for the taxable year to the extent that the interest income attributable to such interest expense is not taken into account in determining the shareholder's net CFC tested income.

The formula for GILTI, which is calculated at the U.S. shareholder level, is:

$$GILTI = Net\ CFC\ Tested\ Income - [(10\% * QBAI) - Interest\ Expense]$$

where Interest Expense is defined and limited in the manner described above.[1708]

Although a GILTI inclusion is generally treated as a subpart F inclusion, GILTI is not subpart F income. Unlike subpart F income, GILTI is computed at the U.S.-shareholder level rather than the CFC level, with a U.S. shareholder allowed to offset tested income of its CFCs with tested loss of other CFCs in computing net CFC tested income. U.S. shareholders are not allowed certain other tax attributes of CFCs with tested loss—such as foreign tax credits and QBAI—when computing tax liability associated with GILTI. In addition, the foreign tax credit limitation is applied separately with respect to GILTI, and, in contrast with the general rules allowing carryovers and carrybacks of excess foreign tax credits, no

[1707] As determined under section 951A(e)(2), described below.

[1708] As the net deemed tangible income return cannot be less than zero, the formula assumes that interest expense does not exceed 10 percent of QBAI. Otherwise, GILTI equals net CFC tested income.

carryovers and carrybacks of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category.

Net CFC tested income

Net CFC tested income means, with respect to any U.S. shareholder, the excess of the aggregate of the shareholder's *pro rata* share of the tested income of each CFC with respect to which it is a U.S. shareholder over the aggregate of its *pro rata* share of the tested loss of each CFC with respect to which it is a U.S. shareholder.[1709] *Pro rata* shares are determined under subpart F principles (*i.e.*, the rules of section 951(a)(2) and the regulations thereunder).

The formula for net CFC tested income of the U.S. shareholder is:

$$\textit{Net CFC Tested Income} = \textit{Sum of CFC Tested Income} - \textit{Sum of CFC Tested Loss}$$

The tested income of a CFC is the excess (if any) of the gross income of the CFC determined without regard to certain amounts that are exceptions to tested income (referred to in this document as "gross tested income") over deductions (including taxes) properly allocable to such gross income. The exceptions to a CFC's tested income are: (1) any effectively connected income described in section 952(b); (2) any gross income taken into account in determining the CFC's subpart F income; (3) any gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under section 954(b)(4); (4) any dividend received from a related person (as defined in section 954(d)(3)); and (5) any foreign oil and gas extraction income (as defined in section 907(c)(1)).

The tested loss of a CFC means the excess (if any) of deductions (including taxes) properly allocable to the CFC's gross tested income over the amount of such gross income.

For purposes of computing deductions (including taxes) properly allocable to gross tested income, the deductions are allocated to such gross income following rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income).

Qualified business asset investment

QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is generally allowable under section 167.[1710] The adjusted basis in any property is determined by allocating the depreciation deduction with respect to the property ratably to each day during the period in the taxable year to which the depreciation relates, with depreciation deductions calculated using the alternative depreciation system under section 168(g) as in effect on the date of enactment of the Act, unless a later enacted law specifically and directly amends the definition of QBAI under section 951A.

[1709] Sec. 951A(c)(1).
[1710] Sec. 951A(d)(1).

Specified tangible property means any property used in the production of tested income.[1711] If such property was used in the production of both gross tested income and gross income that is not gross tested income (*i.e.*, dual-use property), the property is treated as specified tangible property in the same proportion that the amount of gross tested income produced with respect to the property bears to the total amount of gross income produced with respect to the property.[1712]

If a CFC holds an interest in a partnership at the close of the CFC's taxable year, the CFC takes into account its distributive share of the aggregate of the partnership's adjusted basis (determined as of such date in the hands of the partnership) in tangible property held by the partnership to the extent that the property is used in the trade or business of the partnership, is of a type with respect to which a deduction is allowable under section 167, and is used in the production of tested income (determined with respect to the CFC's distributive share of income with respect to the property). The CFC's distributive share of the adjusted basis of any property is the CFC's distributive share of income with respect to the property.

Coordination with subpart F

In contrast with subpart F income, which is a CFC amount, GILTI is a U.S.-shareholder amount. Nonetheless, GILTI inclusions are generally treated as subpart F inclusions.[1713] In particular, GILTI inclusions are treated in the same manner as amounts included as subpart F income for purposes of applying sections 168(h)(2)(B), 535(b)(10), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4).[1714] The Secretary may provide rules for treating GILTI inclusions as amounts included as subpart F income for other provisions of the Code in which the determination of subpart F income is required to be made at the CFC level.

The provision requires that the total amount of GILTI included by a U.S. shareholder be allocated across all CFCs with respect to which it is a U.S. shareholder. The portion of GILTI treated as being allocable to a CFC is zero for a CFC with no tested income and is, for a CFC with tested income, the portion of GILTI which bears the same ratio to the total amount of GILTI as the U.S. shareholder's *pro rata* amount of the tested income of the CFC bears to the aggregate amount of the U.S. shareholder's *pro rata* amount of the tested income of each CFC with respect to which it is a U.S. shareholder. For a CFC with tested income, the following formula expresses how to determine the portion of GILTI treated as being allocable to the CFC:

[1711] Sec. 951A(d)(2). Specified tangible property does not include property used in the production of tested loss, so that a CFC that has a tested loss in a taxable year does not have QBAI for such taxable year.

[1712] A technical correction may be needed to reflect this intent. For example, if a building produces $1,000 of gross tested income and $250 of gross subpart F income for a taxable year, then 80 percent ($1,000/$1,250) of a CFC's average adjusted basis in the building is included in QBAI for that taxable year.

[1713] Under Rev. Proc. 2018–48, amounts included in gross income by a REIT under sections 951(a)(1) (except by reason of section 965) and 951A(a), among other provisions in the Code, are treated as qualifying income for purposes of the gross income test under section 856(c)(2).

[1714] Sec. 951A(f)(1).

$$CFC's\ GILTI = GILTI * \left({Share\ of\ CFC's\ Tested\ Income} \middle/ {Share\ of\ Agg.CFC\ Tested\ Income} \right)$$

where *Share of CFC's Tested Income* is the U.S. shareholder's *pro rata* amount of the tested income of a CFC, *Share of Agg. CFC Tested Income* is the aggregate amount of the U.S. shareholder's *pro rata* amount of the tested income of each CFC with respect to which it is a U.S. shareholder, and GILTI is the total amount of GILTI included by the U.S. shareholder.

For purposes of the provision, a person is treated as a U.S. shareholder of a CFC for any taxable year of such person only if the person owns (within the meaning of section 958(a)) stock in the foreign corporation on the last day in the taxable year of the foreign corporation on which the foreign corporation is a CFC.[1715] A corporation is generally treated as a CFC for any taxable year if the corporation is a CFC at any time during the taxable year.

Deemed-paid credit for taxes properly attributable to tested income

For any amount of GILTI included in the gross income of a domestic corporation, the corporation is allowed a deemed-paid credit equal to 80 percent of the corporation's inclusion percentage multiplied by the aggregate (*i.e.*, sum of) tested foreign income taxes paid or accrued, with respect to tested income (but not tested loss), by each CFC with respect to which the domestic corporation is a U.S. shareholder.[1716] The inclusion percentage means, with respect to any domestic corporation, the ratio (expressed as a percentage) of such corporation's GILTI amount divided by the aggregate amount of its *pro rata* share of the tested income (but not tested loss) of each CFC with respect to which it is a U.S. shareholder (referred to as "aggregate tested income" in the formulas below). Tested foreign income taxes means, with respect to any domestic corporation that is a U.S. shareholder of a CFC, the foreign income taxes paid or accrued by the CFC that are properly attributable to the CFC's tested income (but not tested loss).[1717]

The deemed-paid credit with respect to a U.S. shareholder's GILTI inclusion can be expressed in the following formula:

$$Deemed\text{-}Paid\ Credit = 80\% * \frac{GILTI}{Aggregate\ Tested\ Income} * Aggregate\ Tested\ Foreign\ Income\ Taxes$$

The provision creates a separate foreign tax credit limitation for GILTI, with no carryforward or carryback available for excess credits.[1718] For purposes of determining the foreign tax credit limitation, GILTI is not general category income, and income that is both GILTI and passive category income is considered passive category income. As provided in section 14301 of the Act and amended sec-

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[1715] Sec. 951A(e)(2).

[1716] Sec. 960(d)(1). In addition, only 80 percent of foreign income taxes paid or accrued (or treated as paid or accrued) with respect to distributions out of income that was previously taxed as GILTI are creditable under section 901, and the amount not creditable is not deductible under section 901. A technical correction may be needed to reflect this intent.

[1717] Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).

[1718] Financial services income (sec. 904(d)(2)(C)(i)) is not treated as passive category income for foreign tax credit limitation purposes. A technical correction may be needed to reflect this intent. In addition, the carryback and carryover rules for foreign oil and gas taxes under section 907(f)(1) do not apply to taxes paid or accrued with respect to GILTI. A technical correction may be needed to reflect this intent.

tion 78, the taxes deemed to have been paid are treated as a dividend under section 78, determined by taking into account 100 percent of the product of the inclusion percentage and aggregate tested foreign income taxes (instead of 80 percent in the determination of the deemed-paid credit). For foreign tax credit limitation purposes, the section 78 gross-up amount attributable to a GILTI inclusion is assigned to the basket to which the related foreign taxes deemed paid were allocated.[1719]

The section 78 gross-up amount can be expressed in the following formula:

$$Section\ 78\ Gross\text{-}Up = 100\% * \frac{GILTI}{Aggregate\ Tested\ Income} * Aggregate\ Tested\ Foreign\ Income\ Taxes$$

Regulatory authority to address abuse

Congress intends that non-economic transactions intended to affect tax attributes of CFCs and their U.S. shareholders (including amounts of tested income and tested loss, tested foreign income taxes, net deemed tangible income return, and QBAI) to minimize tax under this provision be disregarded. One area of concern for Congress is certain planning related to QBAI and the transition to the participation exemption system created by the Act. The Secretary is expected to prescribe regulations to address transactions undertaken to increase a CFC's QBAI that occur after the measurement date of post-1986 earnings and profits under amended section 965, but before the first taxable year for which new section 951A applies.

The Secretary has proposed regulations pursuant to this provision.[1720]

Examples

The following examples illustrate how GILTI is calculated for domestic corporations and allocated across CFCs. The examples are highly stylized and are not meant to represent actual taxpayer scenarios. These examples account for the 50-percent deduction for GILTI available to domestic corporations under new section 250 (described in section 14202 of the Act) for taxable years beginning after December 31, 2017, and before January 1, 2026.[1721]

Example 1: Two Wholly Owned CFCs, Each with Tested Income

Assume a domestic corporation, USCo, wholly owns two CFCs, CFC1 and CFC2, and has no expenses or other sources of income. These are the only CFCs with respect to which USCo is a U.S. shareholder. The following table includes more information about CFC1 and CFC2. Assume that their foreign sales income are items of gross income included in the computation of tested income, and that CFC1 and CFC2 each allocate all of their expenses to their

[1719] A technical correction may be needed to reflect this intent.

[1720] See Prop. Treas. Reg. sec. 1.951–1 *et seq.* Notice of Proposed Rulemaking, 83 FR 51072, October 10, 2018.

[1721] For taxable years after December 31, 2025, the deduction for GILTI and the GILTI-attributable section 78 gross-up amount is reduced to 37.5 percent. The examples assume that the deduction is 50 percent and therefore assume that the calculations are being performed with respect to a taxable year of a domestic corporation beginning after December 31, 2017, and before January 1, 2026.

foreign sales income. Also assume that CFC1 and CFC2 each face a uniform tax rate across all their sources of income.

FACTS FOR EXAMPLE 1

	CFC1	CFC2
Gross Income:		
Foreign Sales Income	$300	$2,000
Subpart F Income	$100	$0
Oil Extraction Income	$600	$0
Expenses:		
Operating Expenses	$200	$300
Net Income	$800	$1,700
Foreign Tax Rate	20 percent	5 percent
QBAI	$500	$0

CFC-level calculations of tested income

CFC1 earns foreign sales income of $300 and has deductions of $220 ($20 of taxes plus $200 of operating expenses) allocable to its foreign sales income. The subpart F income and oil extraction income are not included in tested income. Therefore, it has tested income of $80 ($300 − $220) and tested foreign income tax of $20 (20 percent * [$300 − $200]). CFC1 has QBAI of $500.

CFC2 earns foreign sales income of $2,000 and has deductions of $385 ($85 of taxes plus $300 of operating expenses) allocable to its foreign sales income. Therefore, it has tested income of $1,615 ($2,000 − $385) and tested foreign income tax of $85 (5 percent * [$2,000 − $300]). CFC2 has QBAI of $0.

U.S.-shareholder-level calculation of GILTI and U.S. tax liability

USCo has net CFC tested income of $1,695, which is the sum of CFC1's tested income of $80 and CFC2's tested income of $1,615. Its *pro rata* share of QBAI is $500 ([100 percent * $500] + [100 percent * $0]). Therefore, USCo's GILTI = $1,695 − (10 percent * $500) = $1,645.

USCo is allowed a deemed-paid credit equal to 80 percent of its inclusion percentage multiplied by the aggregate tested foreign income taxes paid or accrued by CFC1 and CFC2. Its inclusion percentage is 97.05 percent (GILTI/Aggregate Tested Income = $1,645/$1,695). With respect to USCo, the aggregate tested foreign income taxes paid or accrued by CFC1 and CFC2 is $105 ($20 + $85). Therefore, USCo's deemed-paid credit is 80 percent * 97.05 percent * $105 = $81.52.

USCo includes 100 percent of its GILTI and section 78 gross-up amount in gross income, or $1,746.90 ($1,645 + $101.90).[1722] It is allowed a deduction for 50 percent of this amount, or $873.45, resulting in U.S. taxable income of $873.45. The tentative U.S. tax owed on this income is the U.S. corporate tax rate of 21 percent applied to USCo's taxable income amount of $873.45, or $183.42.

The residual U.S. tax paid by USCo on its GILTI is its tentative U.S. tax of $183.42 less its deemed-paid credit of $81.52, or $101.90.

[1722] The section 78 gross-up amount = 100 percent * 97.05 percent * $105 = $101.90.

Allocation of GILTI across CFCs

USCo's GILTI amount is allocated across each CFC with respect to which it is a U.S. shareholder based on the percentage of its *pro rata* share of the tested income of all CFCs that is accounted for by each CFC. The portion of USCo's GILTI amount of $1,645 treated as being with respect to CFC1 equals $77.64 ($1,645 * [$80/$1,695]). The portion of USCo's GILTI amount that is treated as being with respect to CFC2 is the remainder, or $1,567.36 ($1,645 * [$1,615/$1,695]).

Example 2: Variant of Example 1, With Tested Loss

Example 2 generally has the same facts as Example 1, except that CFC2 has foreign sales income of $360. Assume that CFC2 still pays foreign taxes of $85 with respect to its foreign sales income. Thus, CFC2 has foreign sales income of $360 and deductions of $385 ($85 of taxes plus $300 of operating expenses) allocable to its foreign sales income. Therefore, it has tested loss of $25 ($360 − $385). Because CFC2 has a tested loss, the foreign income taxes paid by CFC2 are not tested foreign income taxes.

As in Example 1, CFC1 has tested income of $80 and tested foreign income tax of $20.

U.S.-shareholder-level calculation of GILTI and U.S. liability

USCo has net CFC tested income of $55, which is CFC1's tested income of $80 less CFC2's tested loss of $25. Its *pro rata* share of QBAI is $500 ([100 percent * $500] + [100 percent * $0]).[1723] Therefore, USCo's GILTI = $55 − (10 percent * $500) = $5.

USCo is allowed a deemed-paid credit equal to 80 percent of its inclusion percentage multiplied by the aggregate tested foreign income taxes paid or accrued by CFC1 and CFC2. Its inclusion percentage is 6.25 percent (GILTI/Aggregate Tested Income = $5/$80). With respect to USCo, the aggregate tested foreign income taxes paid or accrued by CFC1 and CFC2 is $20. Therefore, USCo's deemed-paid credit is 80 percent * 6.25 percent * $20 = $1.

USCo includes 100 percent of its GILTI and section 78 gross-up amount in gross income, or $6.25 ($5 + $1.25).[1724] It is allowed a deduction for 50 percent of this amount, or $3.13, resulting in U.S. taxable income of $3.12 ($6.25 − $3.13). The tentative U.S. tax owed on this income is the U.S. corporate tax rate of 21 percent applied to USCo's taxable income amount, or $0.66.

The residual U.S. tax paid by USCo on its GILTI is its tentative U.S. tax of $0.66 less its deemed-paid credit of $1, or $0. The amount of USCo's deemed-paid credit that is unused, $0.34, may not be carried back or carried forward.

Allocation of GILTI across CFCs

Because only CFC1 has tested income among each CFC with respect to which USCo is a U.S. shareholder, all of USCo's GILTI of $5 is allocated to CFC1.

[1723] Note that a CFC that has a tested loss in a taxable year (such as CFC2 in Example 2) does not have QBAI for such taxable year.

[1724] The section 78 gross-up amount = 100 percent * 6.25 percent * $20 = $1.25.

Example 3: Multiple U.S. Shareholders and CFCs

Example 3 illustrates how GILTI is calculated when there are multiple U.S. shareholders of one CFC, and each U.S. shareholder wholly owns another CFC.

Consider two domestic corporations, US1 and US2. US1 wholly owns CFC1 and owns 75 percent of the shares in CFC2. US2 wholly owns CFC3 and owns 25 percent of the shares in CFC2. Neither US1 nor US2 have expenses or other sources of income or own shares in other CFCs besides the ones described.

Additional facts for Example 3 are described below. Assume that gross income from foreign sales is included in the computation of tested income for each CFC.

FACTS FOR EXAMPLE 3

	CFC1	CFC2	CFC3
Gross Income:			
Foreign Sales Income	$1,500	$2,000	$700
Expenses:			
Operating Expenses	$200	$300	$800
Net Income	$1,300	$1,700	−$100
Foreign Tax Rate	10 percent	5 percent	15 percent
QBAI	$500	$1,000	$0

CFC-level calculations of tested income

CFC1 earns foreign sales income of $1,500, pays foreign income tax of $130 (10 percent * $1,300), and has deductions of $330 ($130 of taxes plus $200 of expenses) allocable to its foreign sales income. Therefore, it has tested income of $1,170 ($1,500 − $330) and tested foreign income tax of $130. CFC1 has QBAI of $500.

CFC2 earns foreign sales income of $2,000, pays foreign income tax of $85 (5 percent * $1,700), and has deductions of $385 ($85 of taxes plus $300 of expenses) allocable to its foreign sales income. Therefore, it has tested income of $1,615 ($2,000 − $385) and tested foreign income tax of $85. CFC2 has QBAI of $1,000.

CFC3 earns foreign sales income of $700, pays no foreign income tax, and has deductions of $800 allocable to its foreign sales income. Therefore, it has tested loss of $100. Because CFC3 has tested loss, it has no QBAI.

U.S.-shareholder-level calculation of GILTI and U.S. tax liability

US1's GILTI and U.S. tax liability

US1 has net CFC tested income of $2,381.25, which is the sum of CFC1's tested income of $1,170 and US1's *pro rata* share (75 percent) of CFC2's tested income of $1,615 (or $1,211.25). US1 has aggregate tested foreign income tax of $193.75, which is the sum of CFC1's tested foreign income tax of $130 and US1's *pro rata* share of CFC2's tested foreign income tax of $85 (or $63.75). Its *pro rata* share of QBAI is $1,250 ([100 percent * $500] + [75 percent * $1,000]). Therefore, US1's GILTI = $2,381.25 − (10 percent * $1,250) = $2,256.25.

US1 is allowed a deemed-paid credit equal to 80 percent of its inclusion percentage multiplied by the aggregate tested foreign in-

come taxes paid or accrued by CFC1 and CFC2. Its inclusion percentage is 94.8 percent (GILTI/Aggregate Tested Income = $2,256.25/$2,381.25). The aggregate tested foreign income taxes paid or accrued by CFC1 and CFC2 with respect to US1 is $193.75. Therefore, US1's deemed-paid credit is 80 percent * 94.8 percent * $193.75 = $146.94.

US1 includes 100 percent of its GILTI and section 78 gross-up amount in gross income, or $2,439.93 ($2,256.25 + $183.68).[1725] It is allowed a deduction of 50 percent of this amount, or $1,219.97, resulting in U.S. taxable income of $1,219.96 ($2,439.93 − $1,219.97). The tentative U.S. tax owed on this income is the U.S. corporate tax rate of 21 percent applied to US1's taxable income of $1,219.96, or $256.19.

The residual U.S. tax paid by US1 on its GILTI is its tentative U.S. tax of $256.19 less its deemed-paid credit of $146.94, or $109.25.

US2's GILTI and U.S. tax liability

US2 has net CFC tested income of $303.75, which is its *pro rata* share of CFC2's tested income ($403.75 = 25 percent * $1,615) less the $100 in tested loss of CFC3. US2 has aggregate tested foreign income tax of $21.25, which is 25 percent of CFC2's tested foreign income tax of $85. Because CFC3 has a tested loss, it has no tested foreign income tax and no QBAI. US2's *pro rata* share of QBAI is $250 ([25 percent * $1,000] + [100 percent * $0]). Therefore, US2's GILTI = $303.75 − (10 percent * $250) = $278.75.

US2 is allowed a deemed-paid credit equal to 80 percent of its inclusion percentage multiplied by its aggregate tested foreign income taxes. Its inclusion percentage is 69 percent (GILTI/Aggregate Tested Income = $278.75/$403.75). US2's *pro rata* share of CFC2's tested foreign income tax is $21.25 (25 percent * $85). Therefore, US2's deemed-paid credit is 80 percent * 69 percent * $21.25 = $11.73.

US2 includes 100 percent of its GILTI and section 78 gross-up amount in gross income, or $293.41 ($278.75 + $14.66).[1726] It is allowed a deduction for 50 percent of this amount, or $146.71, resulting in U.S. taxable income of $146.70 ($293.41 − $146.71). The tentative U.S. tax owed on this income is the U.S. corporate tax rate of 21 percent applied to US2's taxable income of $146.70, or $30.81.

The residual U.S. tax paid by US2 on its GILTI is its tentative U.S. tax of $30.81 less its deemed-paid credit of $11.73, or $19.08.

Allocation of GILTI across CFCs

US1 has $2,256.25 of GILTI to be allocated across each of its CFCs with tested income. Its *pro rata* share of the aggregate tested income of each CFC with respect to which it is a U.S. shareholder is $2,381.25, with its *pro rata* share of CFC1's tested income accounting for 49.1 percent ($1,170/$2,381.25) and its *pro rata* share of CFC2's tested income accounting for the remaining 50.9 percent. Therefore, the amount of US1's GILTI allocated to CFC1 is

[1725] The section 78 gross-up amount = 100 percent * 94.8 percent * $193.75 = $183.68.
[1726] The section 78 gross-up amount = 100 percent * 69 percent * $21.25 = $14.66.

$1,107.82 (49.1 percent * $2,256.25), while the remainder of $1,148.43 is allocated to CFC2.

US2 has $278.75 of GILTI to allocate across each CFC with tested income with respect to which it is a U.S. shareholder. Since CFC3 has a tested loss, all of US2's GILTI of $278.25 is allocated to CFC2.

As a result, the amount of GILTI allocated to each CFC by both US1 and US2 is as follows: $1,107.82 for CFC1, $1,426.68 for CFC2, and $0 for CFC3.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

B. Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income (sec. 14202 of the Act and new sec. 250 of the Code)

Explanation of Provision

In general

New section 250 allows a domestic corporation a 37.5-percent deduction for its foreign-derived intangible income ("FDII") and a 50-percent deduction on the sum of its GILTI and the amount treated as a dividend received by the corporation under section 78 that is attributable to its GILTI (referred to in this document as the "GILTI-attributable section 78 gross-up amount").[1727] FDII is a corporation's deemed intangible income multiplied by the percentage of its deduction eligible income that is derived from serving foreign markets. A corporation's deemed intangible income equals the excess (if any) of its deduction eligible income over a 10-percent return on its qualified business asset investment ("QBAI"). The formula for FDII can be expressed as the following:

$$FDII = [Deduction\ Eligible\ Income - (10\% \times QBAI)] \times \frac{Foreign\text{-}Derived\ Deduction\ Eligible\ Income}{Deduction\ Eligible\ Income}$$

Note that, for purposes of determining FDII, deemed intangible income is calculated on a formulaic basis and not on an item-of-in-

[1727] The section 250 deduction is only available to C corporations that are neither RICs nor REITs.

An S corporation's taxable income is computed in the same manner as an individual (sec. 1363(b)) so that deductions allowable only to corporations, including the section 250 deduction, do not apply. See Report by the House Committee on Ways and Means to accompany H.R. 6055, Subchapter S Revision Act of 1982, H. Rep. No. 97–826, p. 14; and Report by the Senate Committee on Finance to accompany H.R. 6055, Subchapter S Revision Act of 1982, S. Rep. 97–640, p. 15.

The Code provides that deductions for corporations provided in part VIII of subchapter B, which include the section 250 deduction, do not apply in computing RIC taxable income (sec. 852(b)(2)(C)) or REIT taxable income (sec. 857(b)(2)(A)). Therefore, the section 250 deduction is not available for RICs or REITs.

In general, it is intended that the Secretary may provide that the section 250 deduction be treated as exempting the deducted income from tax. However, the section 250 deduction would not give rise to an increase in a domestic corporate partner's basis in a domestic partnership under section 705(a)(1)(B) because the deduction is allowed at the domestic corporate partner level.

In addition, the section 250 deduction is computed after applying the limitation on the deduction for business interest (sec. 163(j)) and the limitation on the deduction for NOLs (sec. 172).

come basis. Although a factual inquiry is made to determine which components of a corporation's overall income are derived from serving foreign markets, no factual inquiry is made to determine whether deemed intangible income is derived from serving foreign markets.

Deduction for FDII and GILTI

In the case of domestic corporations for taxable years beginning after December 31, 2017, and before January 1, 2026, the provision generally allows as a deduction an amount equal to the sum of 37.5 percent of the corporation's FDII plus 50 percent of the sum of its GILTI (if any) and GILTI-attributable section 78 gross-up amount. For taxable years beginning after December 31, 2025, the deduction for FDII is reduced to 21.875 percent and the deduction for GILTI is reduced to 37.5 percent.[1728] As a result, for taxable years beginning after December 31, 2017, and before January 1, 2026, the effective U.S. tax rate (*i.e.*, taking into account the effect of the deduction) on FDII is 13.125 percent and the effective U.S. tax rate on GILTI is 10.5 percent.[1729] For taxable years beginning after December 31, 2025, the effective U.S. tax rate on FDII rises to 16.406 percent and the effective U.S. tax rate on GILTI rises to 13.125 percent.

The Secretary is authorized to prescribe regulations or other guidance as may be necessary or appropriate to carry out this provision.[1730]

Deduction eligible income

A domestic corporation's FDII is its deemed intangible income multiplied by the percentage of its deduction eligible income that is foreign-derived.[1731] While deemed intangible income and foreign-derived deduction eligible income are calculated separately, the starting point for each calculation is a corporation's deduction eligible income.

Deduction eligible income means, with respect to any domestic corporation, the excess (if any) of the gross income of the corporation determined without regard to certain amounts that exceptions to deduction eligible income (referred to in this document as "gross deduction eligible income") over deductions (including taxes) properly allocable to such gross income.[1732] The exceptions to deduction eligible income are: (1) any subpart F income included in the gross income of the corporation under 951(a)(1); (2) any GILTI of the corporation; (3) any financial services income (as defined in section 904(d)(2)(D)) of the corporation; (4) any dividend received from a CFC with respect to which the corporation is a U.S. shareholder; (5) any domestic oil and gas extraction income of the corporation; (6) any foreign branch income (as defined in new section 904(d)(2)(J)) of the corporation; (7) any income received or accrued

[1728] Sec. 250(a)(2)(B)(3).

[1729] Due to the reduction in the effective U.S. tax rate resulting from the deduction for FDII and GILTI, the Secretary is expected to provide, as appropriate, regulations or other guidance similar to that under amended section 965 with respect to the determination of gain or loss under section 986(c).

[1730] Sec. 250(c).

[1731] Sec. 250(b)(1).

[1732] Sec. 250(b)(3)(A).

that is of a kind that would be foreign personal holding company income (as defined in section 954(c));[1733] and any amount included in gross income of the corporation under section 1293.[1734]

Deemed intangible income

The domestic corporation's deemed intangible income means the excess (if any) of its deduction eligible income over its deemed tangible income return.[1735] The deemed tangible income return means, with respect to any corporation, an amount equal to 10 percent of the corporation's QBAI. Deemed intangible income can be calculated as follows:[1736]

$$Deemed\ Intangible\ Income = Deduction\ Eligible\ Income - (10\% \times QBAI)$$

Qualified business asset investment

For purposes of computing its FDII, a domestic corporation's QBAI is the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is allowable under section 167.[1737] The adjusted basis in any property must be determined using the alternative depreciation system under section 168(g) as in effect on the date of enactment of the Act, unless a later enacted law specifically and directly amends the definition of QBAI for purposes of computing FDII.

Specified tangible property means any tangible property used in the production of deduction eligible income.[1738] If such property was used in the production of gross deduction eligible income and income that is not gross deduction eligible income (*i.e.*, dual-use property), the property is treated as specified tangible property in the same proportion that the amount of gross deduction eligible income produced with respect to the property bears to the total amount of gross income produced with respect to the property.[1739] In other words, the percentage of a domestic corporation's adjusted basis in dual-use property that is included in QBAI equals the gross deduction eligible income produced with respect to the property divided by the total gross income produced with respect to the property.

Foreign-derived deduction eligible income

Foreign-derived deduction eligible income means, with respect to a taxpayer for its taxable year, any deduction eligible income of the

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[1733] A technical correction may be needed to reflect this intent.

[1734] A technical correction may be needed to reflect this intent.

[1735] Sec. 250(b)(2).

[1736] If the quantity in this formula is negative, deemed intangible income is zero.

[1737] The definition of QBAI for purposes of computing FDII relies on the definition of QBAI for purposes of computing GILTI under section 951A(d), determined by substituting "deduction eligible income" for "tested income" in section 951A(d)(2) and without regard to whether the corporation is a controlled foreign corporation. Sec. 250(b)(2)(B).

[1738] The adjusted basis in any tangible depreciable property held by a foreign branch is generally not included in QBAI for purposes of computing FDII because foreign branch income is excluded from gross deduction eligible income.

[1739] A technical correction may be needed to reflect this intent. For example, if a building is used in the production of $1,000 of total gross income for a taxable year, $250 of which was gross domestic oil and gas extraction income and the remaining $750 of which was gross deduction eligible income, then 75 percent of a domestic corporation's average adjusted basis in the building is included in QBAI for that taxable year.

taxpayer that is derived in connection with (1) property that is sold by the taxpayer to any person who is not a U.S. person[1740] and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use[1741] or (2) services provided by the taxpayer that the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States.[1742]

Foreign use means any use, consumption, or disposition that is not within the United States.[1743] Special rules for determining foreign use apply to transactions that involve property or services provided to domestic intermediaries or to certain related parties.[1744]

For purposes of determining foreign-derived intangible income, the terms "sold," "sells"', and "sale" include any lease, license, exchange, or other disposition.[1745]

Property or services provided to domestic intermediaries[1746]

If a taxpayer sells property to another person (other than a related party) for further manufacture or modification within the United States, the property is generally not treated as sold for a foreign use even if such other person subsequently utilizes such property for foreign use.[1747] Deduction eligible income derived in connection with services provided to another person (other than a related party) located within the United States is not treated as foreign-derived deduction eligible income, even if the other person uses the services in providing services the income from which is considered foreign-derived deduction eligible income.

Special rules with respect to certain related party transactions[1748]

If property is sold to a related foreign party, the sale is not treated as for a foreign use unless (1) the property is ultimately sold by a related party to (or used by a related party in connection with property that is sold to or in connection with the provision of services to) another person who is an unrelated party who is not a U.S. person and (2) the taxpayer establishes to the satisfaction of the Secretary that such property is for a foreign use. Income derived in connection with services provided to a related party who is not located in the United States is not treated as foreign-derived deduction eligible income unless the taxpayer establishes to the satisfaction of the Secretary that such service is not substantially simi-

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[1740] If property is sold by the taxpayer to a person who is not a U.S. person, but the Federal government facilitates the transaction purely as an intermediary (*e.g.*, for certain foreign military sales), income derived from the sale of such property may be treated as foreign-derived deduction eligible income if the other requirements are met. A technical correction may be needed to reflect this intent.

[1741] If property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use.

[1742] Sec. 250(b)(4).

[1743] Sec. 250(b)(5)(A).

[1744] Secs. 250(b)(5)(B) and (C).

[1745] Sec. 250(b)(5)(E).

[1746] Sec. 250(b)(5)(B).

[1747] In other words, the fact that a component is included in property that is eventually sold for a foreign use is insufficient for the sale of the component to be considered for a foreign use.

[1748] Sec. 250(b)(5)(C).

lar to services provided by the related party to persons located within the United States.[1749]

Related party

For purposes of determining foreign use, a related party means any member of an affiliated group as defined in section 1504(a) determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears and without regard to sections 1504(b)(2) and 1504(b)(3).[1750] Any person (other than a corporation) is treated as a member of the affiliated group if the person is controlled by members of the group (including any entity treated as a member of the group by reason of this sentence) or controls any member, with control being determined under the rules of section 954(d)(3).

Taxable income limitation

If the sum of a domestic corporation's FDII, GILTI, and GILTI-attributable section 78 gross-up amounts exceeds its taxable income determined without regard to this provision, then the amount of FDII, GILTI, and GILTI-attributable section 78 gross-up for which a deduction is allowed is reduced (but not below zero) by an amount determined by such excess.[1751] The reduction in the amount of FDII for which a deduction is allowed equals such excess multiplied by a percentage equal to the corporation's FDII divided by the sum of its FDII, GILTI, and GILTI-attributable section 78 gross-up amounts. The reduction in the sum of the corporation's GILTI and GILTI-attributable section 78 gross-up amounts for which a deduction is allowed equals the remainder of such excess.[1752]

Illustration of effective tax rates on FDII and GILTI

This section provides an algebraic illustration of effective tax rates on FDII and GILTI and shows how the effective tax rates on FDII and GILTI may align. For simplicity, the illustration assumes, among other things, that the taxable income limitation is not binding, that the CFCs relevant to the calculations each have tested income, and that the domestic corporation has no expenses.[1753] If these assumptions do not hold, the effective tax rates on FDII and GILTI may not align and the results below may change.

As a result of the deduction, and with respect to domestic corporations, the effective tax rate on FDII is 13.125 percent and the effective U.S. tax rate on GILTI is 10.5 percent for taxable years

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[1749] A clerical correction may be needed to reflect this intent.

[1750] Sec. 250(b)(5)(D).

[1751] Technical corrections may be needed to reflect this intent.

[1752] For example, consider a domestic corporation with $1,250 of FDII, $650 of GILTI, and $100 of GILTI-attributable section 78 gross-up, and taxable income (determined without regard to this provision) of $1,500. The sum of the corporation's FDII, GILTI, and GILTI-attributable section 78 gross-up amounts is $2,000, which exceeds $1,500 by $500. For purposes of this provision, the amount of FDII for which a deduction is allowed is reduced by $500 multiplied by $1,250/$2,000, or $312.50. The sum of the amount of GILTI and GILTI-attributable section 78 gross-up amounts for which a deduction is allowed is reduced by the remainder of the excess, or $187.50 ($500 * $750/$2,000).

[1753] As under the law prior to enactment of the Act, U.S. shareholders are required to allocate expenses to foreign-source income for foreign tax credit limitation purposes based on principles applicable prior to the enactment of the Act.

beginning after December 31, 2017, and before January 1, 2026. Since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed by a domestic corporation is 13.125 percent.[1754] If the foreign tax rate on GILTI is zero percent, then the U.S. residual tax rate on GILTI is 10.5 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 13.125 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5 percent and 13.125 percent. At foreign tax rates greater than or equal to 13.125 percent, there is no residual U.S. tax owed on GILTI, so that the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.

For domestic corporations in taxable years beginning after December 31, 2025, the effective tax rate on FDII rises to 16.406 percent and the effective U.S. tax rate on GILTI rises to 13.125 percent. The minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed by a domestic corporation rises to 16.406 percent.[1755]

Example of FDII calculation

This example illustrates how the deduction for FDII is calculated. Calculations related to GILTI can be found in the explanation of section 14201 of the Act.

Consider USCo, a domestic corporation which has $5,000 of gross deduction eligible income and $2,000 of deductions allocable to that gross income. These are USCo's only items of income and deductions, so that all its gross income is gross deduction eligible income and all of its deductions are allocable to its gross deduction eligible income.

USCo's deduction eligible income is its gross deduction eligible income less deductions allocable to that income, or $5,000 – $2,000 = $3,000. In this particular example, USCo's deduction eligible income equals its taxable income. Assume that USCo has established to the satisfaction of the Secretary that $1,200 of its deduction eligible income is foreign-derived, and that USCo has $10,000 of QBAI.

USCo's deemed intangible income equals its deduction eligible income minus a 10 percent return on its QBAI, or $3,000 – (10 percent * $10,000) = $2,000.

USCo's FDII is its deemed intangible income multiplied by the percentage of its deduction eligible income that is foreign-derived, or $2,000 * ($1,200/$3,000) = $800. USCo is allowed a deduction of 37.5 percent on its FDII of $800, or $300.

[1754] The effective GILTI rate of 10.5 percent divided by 80 percent equals 13.125 percent. If the foreign tax rate on a particular amount of GILTI is 13.125 percent, and domestic corporations are allowed a credit equal to 80 percent of foreign taxes paid, then the foreign tax rate, after accounting for the 80-percent haircut, on this amount of GILTI equals 10.5 percent (13.125 percent * 80 percent), which equals the effective GILTI rate of 10.5 percent. Therefore, no U.S. residual tax is owed.

[1755] Under the assumptions in this illustration of effective tax rates, if the foreign tax rate on GILTI is zero percent, then the U.S. residual tax rate on GILTI is 13.125 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 16.406 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 13.125 percent and 16.406 percent. At foreign tax rates greater than or equal to 16.406 percent, there is no residual U.S. tax on GILTI, and the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.

USCo's taxable income, less the deduction for FDII, is $3,000 — $300 = $2,700. Under a 21-percent corporate tax rate, USCo's tax liability is $567 (21 percent * $2,700). Therefore, the deduction for FDII has reduced the effective tax rate on USCo's pre-deduction taxable income of $3,000 from 21 percent to 18.9 percent ($567/$3,000).[1756]

Effective Date

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

C. Repeal of Treatment of Foreign Base Company Oil Related Income as Subpart F Income (sec. 14211 of the Act and sec. 954(a) of the Code)

Explanation of Provision

The provision eliminates foreign base company oil related income as a category of foreign base company income.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

D. Repeal of Inclusion Based on Withdrawal of Previously Excluded Subpart F Income from Qualified Investment (sec. 14212 of the Act and sec. 955 of the Code)

Explanation of Provision

Background on prior law

In 1975, foreign base company shipping income was added as a category of subpart F income for taxable years beginning after 1975. Foreign base company shipping income was income derived from the use of an aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, the sale or other disposition of any such aircraft or vessel, and certain space or ocean activities (*e.g.,* leasing of satellites for use in space). A reinvestment exception permitted a CFC to defer inclusion of foreign base company shipping income to the extent that it was reinvested during the taxable year in certain qualified shipping investments.[1757] Subsequent net decreases in qualified shipping investments were considered subpart F income, to the extent of previously excluded subpart F income. In the Tax Reform Act of 1986,[1758] the reinvestment exception was repealed, but for-

[1756] USCo's effective tax rate is not reduced by the full amount of the deduction (*i.e.,* from 21 percent to 13.125 percent, or 7.875 percentage points). This is because only a portion (66.7 percent) of USCo's deduction eligible income is deemed intangible income, and only a portion (40 percent) of USCo's deduction eligible income is foreign-derived. In this particular example, the rate reduction of 2.1 percentage points equals 7.875 percentage points * 66.7 percent * 40 percent.

[1757] The qualified shipping investments were described in former section 954(b)(2).

[1758] Pub. L. No. 99–514 (October 22, 1986).

eign base company shipping income that was previously deferred by reason of the reinvestment exception remained deferred until a net decrease in such qualified investments triggered an inclusion required by section 955. For taxable years beginning after 2004, foreign base company shipping income is no longer subpart F income. However, to the extent that foreign base company shipping income deferred before 1987 was withdrawn from qualified investments, it remained subject to inclusion under section 955.

Repeal of section 955

The provision repeals section 955. As a result, a U.S. shareholder in a CFC that invested its previously excluded subpart F income in qualified foreign base company shipping operations is no longer required to include in income a *pro rata* share of the previously excluded subpart F income when the CFC decreases such investments.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders within which or with which such taxable years of foreign corporations end.

E. Modification of Stock Attribution Rules for Determining Status as a Controlled Foreign Corporation (sec. 14213 of the Act and secs. 318 and 958 of the Code)

Explanation of Provision

Background on prior law

The ownership attribution rules for determining constructive ownership of corporate stock are modified for purposes of determining U.S. shareholder status. Prior to the Act, stock owned by a foreign person, regardless of the ownership threshold, was not attributed to U.S. persons, including domestic corporations, through so-called downward attribution from a parent to its subsidiary.[1759] As a result, a wholly-owned domestic subsidiary of a foreign corporation was not treated as owning stock in other foreign corporations owned by the foreign parent.[1760] In a common example, a new foreign parent, or another non-CFC foreign affiliate, could transfer property to a CFC in exchange for stock representing at least 50 percent of the voting power and value of the CFC. Such transactions "de-control" the CFC, thus converting former CFCs to non-CFCs, despite continuous ownership by the U.S. shareholders, and avoiding the application of subpart F provisions.

Change to the modification of stock attribution rules

The provision amends the ownership attribution rules by repealing the paragraph that precluded downward attribution of stock owned by a foreign person to a U.S. person. As a result, certain stock of a foreign corporation owned by a foreign person is attrib-

[1759] Secs. 318 and former 958(b)(4). Specifically, section 958(b)(4) provided that section 318(a)(3) did not apply to treat a U.S. person as owning stock owned by a foreign person.
[1760] Sec. 958(b)(4); Treas. Reg. sec. 1.958–2(d)(1)(iii).

uted to a related U.S. person owned by the foreign person for purposes of determining whether the related U.S. person is a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. In other words, the provision requires "downward attribution" from a foreign person to a related U.S. person in circumstances in which prior law did not. Congress intended to render ineffective certain transactions among related persons that are used as a means of avoiding the subpart F provisions, including the "de-control" transactions described above.[1761] The *pro rata* share of a CFC's subpart F income that a U.S. 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.

Effective Date

The provision is effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of such foreign corporations and for the taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

F. Modification of Definition of United States Shareholder (sec. 14214 of the Act and sec. 951 of the Code)

Explanation of Provision

U.S. shareholders of a CFC must include in their gross income certain types of income and investments of the CFC that otherwise would not be currently taxable to them under general tax rules. The Act expands the definition of a U.S. shareholder under section 951(b) to include not only (as under prior law) a U.S. person who owns 10 percent of the voting stock of a foreign corporation, but also any U.S. person who owns 10 percent or more of the total value of shares of all classes of stock of a foreign corporation. This expanded definition of a U.S. shareholder applies for all purposes of the Code.[1762]

Section 1248 provides special rules for taxing U.S. shareholders (and certain former U.S. shareholders) of a CFC upon the disposition of stock in the CFC. These rules are designed to insure that any gain recognized on the disposition of CFC stock is taxed as ordinary income (rather than as capital gain) to the U.S. shareholders to the extent of earnings and profits of the CFC that had not previously been subject to U.S. taxation under subpart F.[1763] Accordingly, section 1248(a)(2) should require ownership of at least

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[1761] A technical correction may be necessary to reflect the intent expressed by Congress. See, Committee Report, *Reconciliation Recommendations Pursuant to H. Con. Res. 71,* S. Prt. 115–20, December 2017, p. 378, as reprinted on the website of the Senate Budget Committee, available at https://www.budget.senate.gov/taxreform, (the Committee did not intend "to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is a related person (within the meaning of section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4)") and Conference Report to accompany H.R. 1, H.R. Report 115–466, December 15, 2017, pp. 633–634.

[1762] For purposes of determining U.S. shareholder status, stock owned directly, indirectly and constructively is taken into account. See sec. 958. However, U.S. shareholders are subject to taxation under subpart F only to the extent of their direct and indirect ownership. Sec. 951(a).

[1763] See S. Rep. No. 1881, 87th Cong., 2d Sess. 107 (1962).

10 percent of the value or voting stock of the CFC during periods in which the expanded definition of U.S. shareholder under section 951(b) applies.[1764]

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

G. Elimination of Requirement that Corporation Must Be Controlled for 30 Days Before Subpart F Inclusions Apply (sec. 14215 of the Act and sec. 951(a)(1) of the Code)

Explanation of Provision

The provision eliminates the requirement that a corporation must be a CFC for an uninterrupted period of 30 days in a taxable year before a U.S. shareholder is required to include its *pro rata* share of the subpart F income of the foreign corporation. Instead, a U.S. shareholder is required to include its *pro rata* share of the subpart F income of a foreign corporation that is a CFC at any time during any taxable year (assuming the stock ownership requirements of section 951(a)(1) are satisfied with respect to the shareholder).

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

H. Limitations on Income Shifting Through Intangible Property Transfers (sec. 14221 of the Act and secs. 367 and 482 of the Code)

Explanation of Provision

Background on prior law

Profits from transfers of intangible property between related taxpayers generally are allocated to each related taxpayer by reference to the amount of profit that a similarly situated taxpayer would realize in similar transactions with unrelated parties.[1765] A U.S. person may transfer intangible property to a related person (typically, a foreign affiliate) in one of four ways.[1766] Whether for purposes of

[1764] A technical correction may be necessary to reflect this intent.

[1765] See discussion of intercompany transfers in the summary of Prior Law above.

[1766] The four methods are an outright transfer of the intangible property; a license of the intangible property, in which the U.S. person transfers less than all substantial rights in the intangible property to the foreign affiliate; the provision of a service by the U.S. person to the foreign affiliate using the intangible property, rather than a direct transfer of the property; and finally, a transfer by the U.S. person of intangible property through a qualified cost-sharing arrangement with one or more foreign affiliates, under which the participants make resources available and contribute funds (through a combination of cash and existing intangible property rights) toward the joint development of a new marketable product or service. The method of transfer may determine whether the applicable section is section 482 or section 367(d). Special

determining gain recognition under section 367(d) or determining whether profits should be reallocated under section 482, the definition of intangible property was found in the former section 936(h)(3)(B).[1767] That provision defined intangible property to include the several enumerated categories, including "any similar item."[1768] Recurring definitional and methodological issues have arisen in controversies with respect to the identification and appropriate valuation of intangible property transferred in related party transactions.[1769]

Extensive guidance promulgated under section 482 with respect to intangibles provide guidance on how to determine whether the intangibles transferred should be valued collectively or separately. The interrelation of intangible assets that are transferred in one or more contemporaneous transactions may produce synergies that increase the value of the assets if viewed in the aggregate, compared to the sum of values assigned if assets are valued asset-by-asset. If a valuation method fails to take into account such synergies, it may not reach an arm's length result.[1770]

The regulations also establish a realistic alternative principle that underlies the evaluation of all transfer pricing methodologies for a transfer of intangibles. In determining the income attributable to a taxpayer that participated in a specific transfer of intangibles, the method of valuation chosen must yield results consistent with the economic results from alternative arrangements that were realistically available to that taxpayer. The degree of consistency between anticipated benefits from the transactions under the chosen pricing method and the anticipated benefits of a realistic alternative to the transaction indicates the reliability and appropriateness of the valuation.[1771] This principle is predicated on the notion that a taxpayer enters into a particular transaction only if none of its realistic alternatives is economically preferable to the transaction under consideration.

Revisions to definition of intangible property

The provision revises the definition of intangible property. First, it adds any goodwill (both foreign and domestic), going concern value and workforce in place to the list of specific property within the scope of the definition. The residual category of "any similar

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rules may apply in the case of a U.S. taxpayer's transfer or property to a partnership with related foreign partners under sections 704(c) and 721(c) and related regulations.

[1767] Sec. 936(h)(3)(B). The operative definition of intangible property, as amended by the Act, was moved to section 367(d) as a conforming amendment to the repeal of section 936 as deadwood, in the Consolidated Appropriations Act 2018. See, Pub. L. No. 115–141, Division U, Title IV, at sec. 401(d)(1)(C) (the repeal of section 936) and sec. 401(d)(1)(D)(viii)(I) (definition of intangible property added to section 367(d)) (March 23, 2018).

[1768] Prior to amendment, subparagraph (B) of section 936(h)(3) and its concluding flush language read as follows: The term "intangible property means any—(i) patent, invention, formula, process, design, pattern or know-how; (ii) copyright and literary, musical or artistic composition; (iii) trademark, trade name or brand name; (iv) franchise, license or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data; or (vi) any similar item, which has substantial value independent of any individual.

[1769] *Veritas v. Commissioner*, 133 T.C. No. 14 (December 10, 2009), (including goodwill and going concern value within the definition would "expand" the regulatory definition in effect for the tax year before the Court), non-acq., IRB 2010–49 (December 6, 2010). *Amazon v. Commissioner,* 148 T.C. No. 8 (2017) (holding that "workforce in place, going concern value, goodwill, and what trial witnesses described as 'growth options' and corporate 'resources' or 'opportunities'" all fell outside the definition under prior law).

[1770] See Treas. Reg. secs. 1.482–1(f)(2), 1.482–4(c)(1) and 1.482–1T (sunset September 14, 2018).

[1771] See Treas. Reg. sec. 1.482–7(g)(2)(iii) and Exs. (1), (2) and (3), thereunder.

item" is replaced by "any item the value of which is not attributable to tangible property or the services of any individual" and flush language at the end of the former subparagraph is removed, thus clarifying that neither source nor amount of value is relevant to determining whether property in one of the other enumerated categories of intangible property is within the scope of the definition.

Codification of valuation guidance

The provision also clarifies the authority of the Secretary to specify the method to be used to determine the value of intangible property that is transferred. It does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property. In particular, the provision amends section 482 and expands the grant of regulatory authority under section 367 to make clear that the IRS may require the use of aggregate basis valuation and may apply the realistic alternative principle in valuation of intangibles transferred in either outbound restructuring of U.S. operations or intercompany pricing allocations.[1772]

The provision requires the use of the aggregate basis valuation method in cases in which multiple intangible properties are transferred in one or more related transactions if the Secretary determines that the result of the aggregation method is a more reliable measure of the income properly allocable to a taxpayer. This approach is consistent with Tax Court decisions in cases outside of the section 482 context, where collections of multiple, related intangible assets were viewed by the Tax Court in the aggregate.[1773] Finally, it is also consistent with the cost-sharing regulations.[1774]

The provision codifies application of the realistic alternative principle to determine valuation of transferred intangible property. As a result, the IRS may require that an arm's-length price be determined by reference to a transaction (for example, the U.S. owner of intangible property such as a patent uses it to manufacture a product) that is different from the transaction that was actually completed (the U.S. owner of that same intangible property licenses the manufacturing rights to a foreign affiliate and then buys the resulting product from the licensee).

Effective Date

The provision applies to transfers in taxable years beginning after December 31, 2017. No inference is intended with respect to application of section 936(h)(3)(B) or the authority of the Secretary

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[1772] Secs. 367(d) and 482.

[1773] See, *e.g., Kraft Foods Co. v. Commissioner,* 21 T.C. 513 (1954) (thirty-one related patents must be valued as a group and the useful life for depreciation should be based on the average of the patents' useful lives); *Standard Conveyor Co. v. Commissioner,* 25 B.T.A. 281, p. 283 (1932) ("[I]t is evident that it is impossible to value these seven patents separately. Their value, as in the case of many groups of patents representing improvements on the prior art, appears largely to consist of their combination."); *Massey-Ferguson, Inc. v. Commissioner,* 59 T.C. 220 (1972) (taxpayer who abandoned a distribution network of contracts with separate distributorships was entitled to an abandonment loss for the entire network in the taxable year during which the last of the contracts was terminated because that was the year in which the entire intangible value was lost).

[1774] See Treas. Reg. sec. 1.482–7(g)(2)(iv) (if multiple transactions in connection with a cost-sharing arrangement involve platform, operating and other contributions of resources, capabilities or rights that are reasonably anticipated to be interrelated, then determination of the arm's-length charge for platform contribution transactions and other transactions on an aggregate basis may provide the most reliable measure of an arm's-length result).

to provide by regulation for such application with respect to taxable years beginning before January 1, 2018.

I. Certain Related Party Amounts Paid or Accrued in Hybrid Transactions or With Hybrid Entities (sec. 14222 of the Act and sec. 267A of the Code)

Explanation of Provision

In general

The provision denies a deduction for any disqualified related party amount that is paid or accrued pursuant to a hybrid transaction or that is paid by or to a hybrid entity. A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes or in which such related party is subject to tax, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country. A disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under subpart F. In general, a related party is any person that controls, or is controlled by, the taxpayer, with control being direct or indirect ownership of more than 50 percent of the vote, value, or beneficial interests of the relevant person.

Hybrid transactions

A hybrid transaction is any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for Federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or in which the recipient is subject to tax.

Hybrid entities

A hybrid entity is any entity which is either: (1) treated as fiscally transparent for Federal income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or in which the entity is subject to tax, or (2) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or in which the entity is subject to tax but not so treated for Federal income tax purposes.

Regulatory authority

The Secretary has broad authority to issue regulations or other guidance as may be necessary or appropriate to carry out the purposes of the provision, including by issuing regulations or other guidance providing: (1) rules for treating certain conduit arrangements which involve a hybrid transaction or hybrid entity as subject to the provision; (2) rules for applying this provision to branches (domestic or foreign) or domestic entities, even if such branches or entities do not meet the statutory definition of a hybrid

entity;[1775] (3) rules for applying this provision to certain structured transactions; (4) rules for denying all or a portion of a deduction claimed for an interest or a royalty payment that, as a result of the hybrid transaction or entity, is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25 percent; (5) rules for denying all of a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system which provides for the exclusion or deduction of a substantial portion of such amount; (6) rules for determining the tax residence of a foreign entity if the foreign entity is otherwise considered a resident of more than one country or of no country; (7) exceptions to the general rule set forth in the provision with respect to (A) cases in which the disqualified related party amount is taxed under the laws of a foreign country other than the country of which the related party is a resident for tax purposes, and (B) other cases which the Secretary determines do not present a risk of eroding the Federal tax base; and (8) requirements for record keeping and information in addition to any requirements imposed by section 6038A.

The Secretary's authority includes addressing overly broad or under-inclusive application of this provision. An example of an under-inclusive application of provision may involve an imported mismatch arrangement (*i.e.*, an arrangement where deductible payments made through an intermediary payee are not taxable on ultimate receipt). To illustrate this type of arrangement, assume that a foreign multinational corporation ("Foreign Parent") resident in country X has a foreign subsidiary in country Y ("Foreign Sub"), which in turn wholly owns a U.S. corporation ("U.S. Sub"). Foreign Parent capitalizes Foreign Sub with cash in exchange for a hybrid instrument that is treated as debt for country Y purposes, but as equity for country X purposes. Foreign Sub then lends the cash to U.S. Sub in exchange for a note on which interest paid is deductible. The result is a deduction for interest in the United States, and an inclusion (of interest income) offset by a deductible payment on

[1775] For example, Treasury may issue guidance that addresses certain disregarded branch structures or diverted branch payments. Unlike hybrid mismatches, branch mismatches could arise when the ordinary rules for allocating income and expenditure between a branch and head office result in a portion of the taxpayer's net income escaping tax in both the branch and residence jurisdictions.

A simple example illustrates a disregarded branch structure. Assume a foreign multinational corporation ("Foreign Parent") resident in country X has a U.S. subsidiary ("U.S. Sub") and forms a separate financing branch in the United States ("U.S. Branch") which lacks sufficient presence in the United States to be subject to Federal income tax. Foreign Parent lends money to U.S. Sub through U.S. Branch. Country X exempts or excludes the interest paid by U.S. Sub to U.S. Branch from taxation on the grounds that it is attributable to a foreign branch. U.S. Branch's interest income is not, however, taxed in the United States because U.S. Branch does not have sufficient presence in the United States for its interest to be subject to tax there. Thus, the result of this disregarded branch structure is a deduction for the interest paid by U.S. Sub to U.S. Branch, with no corresponding income inclusion for Foreign Parent in either country X or the United States.

A diverted branch payment has the same structure and outcome as a payment to a disregarded branch. The mismatch arises, however, not because of conflict in the characterization of the branch, but rather as a result of a difference between the laws of the residence and branch jurisdictions in the attribution of the payments to the branch. For example, consider the same facts as above, except that now the United States treats U.S. Branch as subject to Federal income tax. A mismatch may still arise if U.S. Branch treats the interest payment as made directly to the Foreign Parent head office in country X, while the Foreign Parent head office treats the payment as made to U.S. Branch.

the hybrid instrument by Foreign Sub in country Y. Furthermore, the payment on the hybrid instrument made by Foreign Sub to Foreign Parent may not be includible to Foreign Parent in country X if such payment is treated as a distribution on equity that is exempt from taxation in country X.

A similar example might involve a hybrid entity. Using the same facts as above, assume Foreign Parent and a country X subsidiary ("Foreign X Sub") form a financing company in country Y that is treated as a partnership for country Y purposes and as a corporation for country X purposes ("Reverse Hybrid"). Reverse Hybrid lends cash to U.S. Sub in exchange for a note on which interest paid is deductible. Interest income of Reverse Hybrid is not includible to Foreign Parent and Foreign Sub in country X. Furthermore, country Y does not impose tax on interest income of Reverse Hybrid. The result is a deduction for interest in the United States with no corresponding income inclusion in either country X or Y.

An example of an overly broad application of this provision may involve a debt issuance that is primarily targeted and sold to a tax-exempt domestic investor base, but a minor portion of which is acquired by unrelated persons who benefit from hybrid treatment in their countries of residence. Such a debt issuance should not be considered a structured transaction because the hybrid treatment is unrelated to the tax-exempt status of the domestic investor base. Treasury may also issue guidance identifying circumstances under which the hybrid nature of a transaction or entity is deemed to be unrelated to the application of a preferential tax regime. For example, assume Foreign Parent from country X wholly owns U.S. Sub, which wholly owns an entity that is disregarded for U.S. tax purposes ("DRE"). DRE pays a royalty directly to Foreign Parent. Several years after the formation of DRE, country X implements a preferential tax regime under which royalties paid by DRE to Foreign Parent are subject to a reduced rate of tax. Under these facts, Treasury could determine that the hybrid nature of DRE is unrelated to the application of country X's preferential regime.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

J. Shareholders of Surrogate Foreign Corporations Not Eligible for Reduced Rate on Dividends (sec. 14223 of the Act and sec. 1(h)(11)(C)(iii) of the Code)

Explanation of Provision

The provision states that dividends from certain surrogate foreign corporations are excluded from qualified dividend income within the meaning of section 1(h)(11)(B) and are ineligible to be taxed as net capital gains. As a result, individual shareholders in such corporations cannot claim the reduced rate on dividends. The term surrogate foreign corporation is given the same meaning as in section 7874 and generally refers to a foreign corporation that is a surrogate for a domestic entity that migrated its tax home from the United States to a foreign jurisdiction pursuant to a plan

or series of related transactions completed after March 4, 2003.[1776] However, this provision applies only to those companies that first become surrogate foreign corporations after date of enactment.

Effective Date

The provision is effective for dividends received after the date of enactment (December 22, 2017).

SUBPART C—MODIFICATIONS RELATED TO FOREIGN TAX CREDIT SYSTEM

A. Repeal of Section 902 Indirect Foreign Tax Credits; Determination of Section 960 Credit on Current Year Basis (sec. 14301 of the Act and secs. 902, 960, and 78 of the Code)

Explanation of Provision

Background on prior law

The United States allows a foreign tax credit for foreign taxes paid on income derived from direct operations (conducted, *e.g.*, through a branch office) or passive investments in a foreign country. Under prior law, the United States also allowed a credit with respect to dividends received from foreign subsidiary corporations out of earnings that had been subject to foreign taxes.[1777] The latter credit is called a deemed-paid credit or an indirect credit.

The United States also provides a deemed-paid credit with respect to any income inclusion under subpart F.[1778] Under prior law, the deemed-paid credit is limited to the amount of foreign income taxes[1779] that would have been deemed paid if the inclusion were treated as a dividend.

Section 78 requires that a domestic corporation claiming a deemed-paid credit include, as additional dividend income, an amount equal to the foreign taxes deemed paid. This section 78 "gross-up" ensures that the full amount of the earnings on which the foreign taxes were paid are included in taxable income and reflected in the calculation of the foreign tax credit limitation under section 904.[1780]

Repeal of section 902

The provision repeals the deemed-paid credit under section 902 with respect to dividends received by a domestic corporation that

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[1776] Under section 7874(a)(2)(B), a foreign-incorporated entity is a surrogate foreign corporation if, pursuant to a plan, (1) the foreign entity acquired substantially all properties held by a domestic corporation (or properties constituting a trade or business of a domestic partnership); (2) at least 60 percent but less than 80 percent (by vote or value) of the stock of the foreign entity after the transaction is held by the former shareholders of the domestic corporation (by reason of the stock they had held in the domestic corporation), and (3) the foreign corporation, 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.

[1777] Sec. 902.

[1778] Sec. 960.

[1779] Foreign income taxes under the provision include income, war profits, or excess profits taxes paid or accrued by the CFC to any foreign country or possession of the United States.

[1780] The separate foreign tax credit limitations are discussed in greater detail in the explanation of section 14302 of the Act.

owns 10 percent or more of the voting stock of a foreign corporation.

Modification and expansion of section 960

The provision retains but modifies the deemed-paid credit rules under section 960. The deemed-paid credit under section 960(a) is limited to the amount of foreign income taxes properly attributable to a subpart F inclusion. The provision eliminates the need for computing and tracking cumulative tax pools. In addition to modifying the rules with respect to deemed-paid foreign tax credits attributable to subpart F inclusions, the provision further expands the deemed-paid credit rules to a portion of the foreign income taxes properly attributable to GILTI inclusions.[1781]

The provision also provides rules applicable to foreign taxes attributable to distributions from previously taxed earnings and profits, including distributions made through tiered CFCs. These rules allow foreign tax credits under section 960 in the year the previously taxed income is distributed to a corporation that is a U.S. shareholder of the CFC. For example, if a U.S. shareholder excludes any part of a distribution received from a lower-tier CFC through a chain of CFCs as previously taxed income, the U.S. shareholder will be deemed to have paid any withholding or other taxes paid by an upper-tier CFC that are properly attributable to distributions of the previously taxed income by the lower-tier CFC. A credit is allowed under section 901 only for 80 percent of the foreign income taxes imposed with respect to previously taxed earnings and profits attributable to GILTI and no credit is allowed for any taxes paid or accrued (or treated as paid or accrued) with respect to distributions of previously taxed amounts described in section 965(b)(4)(A).[1782]

Furthermore, the provision does not allow a credit for taxes that are not attributable to actual distributions of previously taxed earnings and profits. For example, no credit is allowed for taxes related to earnings and profits that were not included in income by reason of section 965(b) (reduction in amounts included in gross income of U.S. shareholders of specified foreign corporations with deficits of earnings and profits), or for the portion of taxes not allowed as a deemed paid credit for taxes properly attributable to tested income by reason of the inclusion percentage or 80 percent multiplicand in section 960(d)(1).[1783]

The Secretary is granted authority under the provision to provide regulations and other guidance as may be necessary and appropriate to carry out the purposes of this provision. Under such rules, taxes are not attributable to an item of subpart F income if the base upon which the tax was imposed does not include the item of subpart F income. For example, if foreign law exempts a certain type of income from its tax base, no deemed-paid credit results from the inclusion of such income as subpart F. Tax imposed on income that is not included in subpart F income is not considered attributable to subpart F income.

[1781] New section 960(d) is discussed in greater detail in the explanation of section 14201 of the Act.

[1782] A technical correction may be necessary to reflect this intent.

[1783] A technical correction may be necessary to reflect this intent.

Extension of section 78

The provision extends the existing language of section 78, which treats the gross up as a dividend to the domestic corporation, to new section 245A (*i.e.*, the deemed dividend does not receive the benefit of the participation exemption).[1784] The provision further revises new section 250(a)(1)(B) to apply the section 250 deduction to the section 78 gross-up with respect to a section 951A inclusion.[1785] The section 78 gross-up amount attributable to a GILTI inclusion is considered GILTI for foreign tax credit limitation purposes.[1786]

Other rules

The provision also allows deemed-paid credits to reduce the U.S. tax on an inclusion of income of a qualified electing fund (as defined in section 1295) consistent with prior law. Further, the provision preserves the prior-law suspension of taxes and credits until related income is taken into account under section 909 for all taxpayers that claim foreign tax credits, including shareholders of qualified electing funds.

The Treasury Department has issued proposed regulations addressing these provisions.[1787]

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

B. Separate Foreign Tax Credit Limitation Basket for Foreign Branch Income (sec. 14302 of the Act and sec. 904 of the Code)

Explanation of Provision

Background on prior law

Under prior law, the amount of allowable foreign tax credits is limited to the amount of U.S. tax attributable to foreign-source net income, with separate limitations for passive category income, general category income, and income that is resourced under applicable treaties.[1788] For each category (or "basket") of foreign-source income, the maximum amount of foreign tax credits equals the same proportion of the overall U.S. tax liability (as determined without regard to foreign tax credits) that the amount of foreign-source in-

[1784] A technical correction to the effective date of the changes to section 78 may be necessary to reflect the intent that fiscal-year taxpayers are not eligible to claim the benefit of the participation exemption for section 78 gross-ups made in taxable years beginning before December 31, 2017. A technical correction to section 78 may also be necessary to reflect the intent to allow previously taxed income from lower-tier CFCs that give rise to deemed paid credits under section 960(b) to be distributed without additional U.S. taxation. Furthermore, a technical correction may be necessary to reflect the intent that the section 78 gross-up amount attributable to a GILTI inclusion should be assigned to the basket to which the taxes relate for foreign tax credit limitation purposes.

[1785] New section 250 is discussed in greater detail in the explanation of section 14202 of the Act.

[1786] A technical correction may be necessary to reflect this intent.

[1787] REG–105600–18, November 28, 2018, available at https://www.irs.gov/pub/irs-drop/reg-105600-18.pdf.

[1788] See sec. 904(d).

come in the relevant basket bears to the U.S. taxpayer's worldwide income.

A domestic corporation may operate in a foreign country through an actual foreign branch, or may own a foreign entity that is classified as a disregarded entity and treated as a foreign branch for U.S. tax purposes. All income of a foreign branch is included in the taxable income of the domestic corporation, regardless of whether any amounts are remitted to the United States in the year earned. Foreign taxes imposed on the foreign branch income may be claimed as credits against any U.S. tax liability. Furthermore, the losses of a foreign branch reduce the taxable income of such domestic corporation. Dual consolidated loss rules under section 1503(d), however, provide that such losses cannot be used currently if the losses can also be used by a foreign subsidiary to reduce its income under foreign law.

Separate foreign tax credit limitation basket for foreign branch income

In addition to the separate limitation categories for passive income, general income, and, for taxable years beginning after December 31, 2017, amounts includible in gross income under section 951A (*i.e.,* GILTI), the provision provides that the foreign tax credit limitation is applied separately to foreign branch income.[1789] As a result, the U.S. tax on foreign branch income can be reduced only by credits for taxes paid by foreign branches of a U.S. person, and any excess credits for foreign income taxes paid by a U.S. person's foreign branches cannot be used to reduce U.S. tax on other foreign-source income.[1790]

Foreign branch income means the business profits of a U.S. person[1791] which are attributable to one or more qualified business units[1792] ("QBUs"') in one or more foreign countries. Under the provision, business profits of a QBU are determined under rules established by the Secretary. Business profits of a QBU, however, do not include any income that is passive category income. Financial services income attributable to a QBU shall not be treated as passive category income.[1793]

Like the passive and general foreign tax credit separate limitation categories, the separate limitation category for foreign branch income is intended to prevent so-called "cross-crediting" of foreign tax paid with respect to foreign-source income in one limitation category (here, foreign branch income) against U.S. tax imposed on income in another limitation category (*e.g.,* general limitation category income). Like the other separate limitation categories, the foreign branch income limitation allows blending of foreign tax credits for foreign taxes imposed on different income streams within the same category (*e.g.,* income from two or more foreign branches). For an example of a restriction created by the provision,

[1789] Sec. 904(d)(1)(B). Clerical corrections may be necessary to reflect the intent to add two new foreign tax credit limitation categories (*i.e.,* GILTI and foreign branch income) to section 904(d)(1). For example, the cross-reference in section 904(d)(2)(H)(i) to section 904(d)(1)(B) (foreign branch income) should be changed to section 904(d)(1)(D) (general category income).

[1790] Pursuant to section 904(c), excess credits can be carried back one year and forward 10 years.

[1791] Sec. 904(d)(2)(J)(i).

[1792] As defined in section 989(a).

[1793] A technical correction may be necessary to reflect this intent.

assume that a U.S. taxpayer receives foreign-source royalty income that has been subject to little or no foreign tax and that is in the general limitation category. Assume the U.S. taxpayer also has manufacturing sales income in one or more foreign branches that has been subject to foreign tax at a rate higher than the applicable U.S. tax rate. If the U.S. taxpayer has foreign tax credits related to foreign tax paid on its foreign branch manufacturing sales income in excess of the separate foreign branch limitation amount, the taxpayer is not permitted to use those excess foreign tax credits to offset residual U.S. tax on the foreign-source royalty income in the general limitation category. If, by contrast, the royalty income were instead derived by another foreign branch ("Foreign Branch 2") subject to little foreign tax, the taxpayer would be permitted to take into account foreign tax attributable to, and foreign income derived by, the high-tax foreign branch in the same foreign tax credit limitation computation as foreign tax attributable to, and foreign income derived by, Foreign Branch 2.

Effective Dates

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

C. Source of Income from Sales of Inventory Determined Solely on Basis of Production Activities (sec. 14303 of the Act and sec. 863(b) of the Code)

Explanation of Provision

Background on prior law

Income from the sale of inventory is generally sourced based on where title to the property and risk of loss pass to the purchaser (the "title passage" rule).[1794] For example, income from the sale of inventory where title passes outside the United States generally is foreign-source income. Income from production activity, conversely, is generally sourced where the taxpayer's production assets are located.[1795]

Prior law sourced gross income from the sale of inventory manufactured or produced within and sold without the United States, or vice versa, by attributing some gross income from the sale to the production activity and the remainder to sales activity. While not the only sourcing method provided in the applicable regulations under section 863(b), a commonly used approach under prior law was the "50/50 method," under which gross income was apportioned one-half to production activity and one-half to sales activity. Where inventory was produced in the United States and sold outside the United States, or vice versa, the 50/50 method resulted in 50 percent of the income being treated as U.S. source and 50 percent as foreign source. This general rule is modified where a sale of personal property made by a nonresident was attributable to its office or fixed place of business in the United States.[1796] In those cases, all of the income is U.S. source except in the case of inven-

[1794] Secs. 861(a)(6), 862(a)(6), and 865(b); *see also* Treas. Reg. sec. 1.861-7.
[1795] Treas. Reg. sec. 1.863-3(c)(1)(i)(A).
[1796] Sec. 865(e)(2).

tory sold for use, disposition, or consumption outside the United States if a foreign office or other fixed place of business of the nonresident materially participated in the sale.[1797]

As a general matter, if sales income is treated as foreign source, the U.S. tax on such sales income generally can be reduced by excess foreign tax credits on other business income in the same foreign tax credit basket.

Changes to section 863(b)

The provision overrides the general title passage rule and the 50/50 method and provides that gains, profits, and income from the sale or exchange of inventory property that is either (1) produced (in whole or in part) inside the United States and then sold or exchanged outside the United States or (2) produced (in whole or part) outside the United States and then sold or exchanged inside the United States, is allocated and apportioned solely on the basis of the location of production activity.[1798] For example, income derived from the sale of inventory property outside the United States is sourced wholly within the United States if the property was produced entirely in the United States, even if title passage occurred elsewhere. Likewise, income derived from inventory property sold in the United States, but produced entirely in another country, has a foreign source even if title passage occurs in the United States. If inventory property is produced partly in, and partly outside, the United States, the income derived from its sale is sourced partly in the United States regardless of where title to the property passes.

Effective Date

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

D. Election to Increase Percentage of Domestic Taxable Income Offset by Overall Domestic Loss Treated as Foreign Source (sec. 14304 of the Act and sec. 904(g) of the Code)

Explanation of Provision

Background on prior law

If a taxpayer has an overall domestic loss ("ODL") for any taxable year beginning after 2006, then in a succeeding taxable year an amount of the taxpayer's U.S.-source income equal to the lesser of (1) 50 percent of the taxpayer's U.S.-source income or (2) the amount of the ODL (to the extent not recharacterized under this ODL rule in prior taxable years) is treated as foreign-source income (the "ODL recapture rule").[1799]

[1797] *Ibid.*

[1798] The provision does not modify section 865(e)(2). Furthermore, the rule addressing sales of inventory property purchased in the United States and sold in a U.S. possession was not changed by the Act.

[1799] Sec. 904(g)(1). Any U.S.-source income recharacterized under the ODL rules is allocated among and increases the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the prior ODLs.

An ODL means any domestic loss to the extent it offsets foreign-source taxable income for the current taxable year or for any preceding taxable year by reason of a loss carryback.[1880]

Election to increase percentage of domestic taxable income offset by ODL

For any pre-2018 unused ODL taken into account under the ODL recapture rule in an applicable taxable year, the provision allows a taxpayer to elect to have the ODL recapture rule applied by substituting for the 50-percent limitation a limitation with a percentage greater than 50 percent but not more than 100 percent.[1801] The term pre-2018 unused ODL means any ODL which: (1) arises in a qualified taxable year[1802] beginning before January 1, 2018, and (2) has not been used under the general rule set forth in section 904(g)(1).[1803] The term "applicable taxable year" means any taxable year of the taxpayer beginning after December 31, 2017, and before January 1, 2028.

For example, assume that a taxpayer has a $100 pre-2018 unused ODL. In its 2019 taxable year, taxpayer earns $75 of U.S.-source income and $100 of foreign-source income, resulting in $175 of total taxable income. For purposes of taking into account its $100 pre-2018 unused ODL under the ODL recapture rule, the taxpayer may elect to increase the percentage of U.S.-source income treated as foreign source to a percentage greater than 50 percent but not more than 100 percent for purposes of determining the foreign tax credit limitation under section 904 for its 2019 taxable year, meaning that, in this case, up to $75 of U.S.-source income may be recharacterized as foreign-source.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

[1800] Sec. 904(g)(2)(A). For this purpose, a domestic loss means the amount by which the U.S.-source gross income for the taxable year is exceeded by the sum of the deductions properly apportioned or allocated thereto, determined without regard to any loss for any taxable year unless the taxpayer elected the use of the foreign tax credit for such taxable year. Sec. 904(g)(2)(B).

[1801] Sec. 904(g)(5)(A).

[1802] For this purpose, qualified taxable year means any taxable year for which the taxpayer elected the use of the foreign tax credit. Sec. 904(g)(2)(C).

[1803] Sec. 904(g)(5)(B).

PART II—INBOUND TRANSACTIONS

A. Base Erosion and Anti-Abuse Tax (sec. 14401 of the Act and sec. 6038A and new sec. 59A of the Code)

Explanation of Provision

In general

Section 59A of the Act imposes a tax on certain corporate taxpayers in addition to any other regular tax liability the taxpayer may have. Several new terms are defined to effectuate this tax. These terms and the mechanics of this base erosion and anti-abuse additional tax are explained in more detail below.

Liability for this additional tax is generally limited to those taxpayers with substantial gross receipts and is determined, in part, by the extent to which the taxpayer has made deductible payments to foreign related parties. Taxpayers potentially liable for this additional tax have three-year average gross receipts in excess of $500 million and a "base erosion percentage" exceeding a specified threshold. The base erosion percentage is generally determined by dividing "base erosion tax benefits" by the amount of deductions allowable to the taxpayer for the taxable year.

The taxpayer's additional tax is computed by comparing the taxpayer's "modified taxable income" to the taxpayer's regular tax liability (as defined in section 26(b)) after the regular tax liability has been reduced by certain credits against tax. Modified taxable income is the taxpayer's regular taxable income increased by any base erosion tax benefit with respect to any "base erosion payment" and an adjustment for the taxpayer's NOL deduction, if any. The taxpayer has an additional tax liability equal to the difference between 10 percent of the taxpayer's modified taxable income and the taxpayer's regular tax liability after adjustment has been made to account for certain credits against the taxpayer's regular tax liability. Special rules apply in the case of banks and securities dealers. Special rules also apply in the case of the taxpayer's taxable year beginning in 2018 and for taxable years beginning after December 31, 2025.

Applicable taxpayer

In general

With respect to any taxable year, an applicable taxpayer is a taxpayer: (1) which is a corporation other than a RIC, a REIT, or an S corporation; (2) which has average annual gross receipts of at least $500 million over the three preceding taxable years; and (3) which has a base erosion percentage for the taxable year of three

percent or higher.[1804] All persons treated as a single employer under section 52(a) are aggregated and treated as one person for purposes of applying the $500 million gross receipts test and determining the base erosion percentage, except that in applying section 1563 for purposes of section 52, the exception for foreign corporations under section 1563(b)(2)(C) is disregarded.

Gross receipts test and foreign persons

A foreign person's gross receipts are generally taken into account for purposes of applying the $500 million gross receipts test only if they are taken into account in determining income effectively connected with the conduct of a U.S. trade or business.[1805] In other words, if the foreign person has a foreign branch, gross receipts of that foreign branch are generally not taken into account in the $500 million gross receipts test. In contrast, the gross receipts of the foreign branch of a U.S. person are generally taken into account in the $500 million gross receipts test. In cases where the gross receipts of a taxpayer that is a foreign person are aggregated with the gross receipts of any U.S. person, the gross receipts from all sources of those U.S. persons are included in the aggregation with the foreign person's gross receipts in applying the $500 million gross receipts test to determine whether the foreign person is an applicable taxpayer. For example, if the gross receipts of a taxpayer that is a foreign person are aggregated with the gross receipts of a U.S. person with a foreign branch, gross receipts of that foreign branch are generally taken into account for purposes of applying the $500 million gross receipts test to the foreign person.

Base erosion payment

In general

A base erosion payment is generally any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable under Chapter 1.[1806]

A base erosion payment includes any amount paid or accrued by the taxpayer to a foreign related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation). A base erosion payment also includes any premium or other consideration paid or accrued by the taxpayer to a foreign related party for any reinsurance payments that are taken into account under sections 803(a)(1)(B) or 832(b)(4)(A).

Base erosion payments do not generally include any amount that constitutes a reduction in gross receipts, including payments for cost of goods sold. However, base erosion payments include any amount that constitutes a reduction in gross receipts of the taxpayer that is paid or accrued by the taxpayer with respect to: (1) a surrogate foreign corporation that is a related party of the taxpayer, but only if the person first became a surrogate foreign corporation after November 9, 2017, or (2) a foreign person that is a

[1804] Sec. 59A(e).
[1805] Sec. 59A(e)(2)(A).
[1806] Sec. 59A(d)(1). Chapter 1 encompasses section 1 through section 1400Z–2 of the Code.

member of the same expanded affiliated group[1807] as the surrogate foreign corporation. A surrogate foreign corporation has the meaning given in section 7874(a)(2)(B) but does not include a foreign corporation treated as a domestic corporation under section 7874(b).

Foreign persons and related parties

For purposes of section 59A, a foreign person is generally any person who is not a U.S. person within the meaning of section 7701(a)(30).[1808]

In addition, for purposes of section 59A, a related party is, with respect to the taxpayer, any 25-percent owner of the taxpayer; any person who is related (within the meaning of sections 267(b) or 707(b)(1)) to the taxpayer or any 25-percent owner of the taxpayer; and any other person who is related (within the meaning of section 482) to the taxpayer.[1809]

Base erosion payment exceptions

Certain payments for services[1810]

A base erosion payment does not include any amount paid or accrued by a taxpayer for services if (1) such services meet the requirements for eligibility for use of the services cost method under section 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure) and (2) such amount constitutes the total services cost with no markup component.

Qualified derivative payments

A base erosion payment does not include any qualified derivative payment.[1811] A qualified derivative payment is any payment made by a taxpayer pursuant to a derivative with respect to which the taxpayer: (1) recognizes gain or loss as if such derivative were sold for its fair market value on the last business day of the taxable year (and such additional times as are required by the Code or by the taxpayer's method of accounting), (2) treats any gain or loss so recognized as ordinary, and (3) treats the character of all items of income, deduction, gain or loss with respect to a payment pursuant to the derivative as ordinary.

No payment is treated as a qualified derivative payment for any taxable year unless the taxpayer includes as part of the reporting requirements under section 6038A(b)(2)[1812] information identifying the payments to be treated as qualified derivative payments for the taxable year and any other information that the Secretary deter-

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[1807] The definition of expanded affiliated group follows the definition in section 7874(c)(1), under which an expanded affiliated group is an affiliated group as defined in section 1504(a) but without regard to the exception for foreign corporations and applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears.

[1808] Secs. 59A(g), citing 6038A(c)(3). Under section 6038A(c)(3), any individual who is a citizen of any possession of the United States (but is not otherwise a U.S. citizen) and who is not a U.S. resident is not treated as a U.S. person.

[1809] Sec. 59A(g). The 25-percent ownership threshold is determined by vote or value. In addition, section 318 applies in determining who is a related party except that (1) the threshold for attribution of corporate stock ownership under section 318(a)(2)(C) is reduced from 50 percent to 10 percent and (2) the rules of section 318(a)(3) are not applied so as to consider a U.S. person as owning stock that is owned by a person who is not a U.S. person.

[1810] Sec. 59A(d)(5).

[1811] Sec. 59A(h).

[1812] A clerical correction may be needed to reflect this intent.

mines is necessary to carry out the exception for qualified derivative payments.[1813]

The exception for qualified derivative payments does not apply if (1) a payment with respect to a derivative is in substance, or is disguising, the kind of payment that would be treated as a base erosion payment if it were not made pursuant to a derivative, including any interest, royalty, or service payment, (or any other payment subject to this provision) or, (2) in the case of a contract which has derivative and nonderivative components, the payment is properly allocable to the nonderivative component.

For purposes of determining whether a base erosion payment is a qualified derivative payment, the term "derivative" means any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following: (1) any share of stock of a corporation,[1814] (2) any evidence of indebtedness, (3) any commodity that is actively traded, (4) any currency, (5) any rate, price, amount, index, formula, or algorithm.[1815] A derivative does not include any item described in (1) through (5) above or any insurance, annuity, or endowment contract issued by an insurance company to which subchapter L applies (or issued by any foreign corporation to which such subchapter would apply if such foreign corporation were a domestic corporation).

Base erosion tax benefit

A base erosion tax benefit generally reflects the reduction in taxable income arising from the associated base erosion payment.

A base erosion tax benefit is: (1) any deduction allowed under Chapter 1 for the taxable year with respect to a base erosion payment; (2) in the case of a base erosion payment with respect to the purchase of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation), any deduction allowed under Chapter 1 for depreciation or amortization in lieu of depreciation with respect to the property acquired with such payment; (3) any reduction under section 803(a)(1)(B) in the gross amount of premiums and other consideration arising out of indemnity insurance and any deduction under section 832(b)(4)(A) from the amount of gross premiums paid for reinsurance; and (4) in the case of a base erosion payment the amount of which constitutes a reduction in gross receipts, any reduction in gross receipts with respect to such payment.[1816]

In the case of a taxpayer to which new section 163(j) applies to limit a taxpayer's interest deduction for the taxable year, the reduction in the amount of interest for which a deduction is allowed by reason of section 163(j) is treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to related parties.[1817]

[1813] Sec. 59A(h)(2)(B).

[1814] Except as otherwise provided by the Secretary, American depository receipts and similar instruments with respect to shares of stock in foreign corporations are treated as shares of stock in such foreign corporations.

[1815] Sec. 59A(h)(4)(A).

[1816] Sec. 59A(c)(2).

[1817] Sec. 59A(c)(3).

Any base erosion tax benefit attributable to any base erosion payment on which tax is imposed by section 871 or 881, and with respect to which tax has been deducted and withheld under section 1441 or 1442, is generally not taken into account in computing modified taxable income or the base erosion percentage. However, in computing modified taxable income, the portion (if any) not taken into account is determined under rules similar to the rules under former section 163(j)(5)(B).[1818] For example, if the withholding tax rate on a particular base erosion payment is reduced by two-thirds from the regular rate of 30 percent to 10 percent (so that the payment is subject to withholding at one-third of the regular withholding tax rate), then the base erosion tax benefit attributable to the base erosion payment is reduced by one-third for purposes of calculating modified taxable income.

Base erosion percentage

For purposes of calculating modified taxable income, and determining whether a taxpayer is an applicable taxpayer and subject to the base erosion and anti-abuse additional tax, the base erosion percentage means, for any taxable year, the percentage equal to the aggregate amount of base erosion tax benefits of the taxpayer for the taxable year divided by the sum of: (1) the aggregate amount of the deductions allowable to the taxpayer under Chapter 1 for the taxable year and (2) the amount of other base erosion tax benefits to the extent they are not included in (1).[1819] The denominator for the base erosion percentage is computed without regard to any deduction allowed under sections 172, 245A, or 250 and any deduction for amounts reflecting service payments, or qualified derivative payments, that are excluded as base erosion payments.

Modified taxable income of applicable taxpayers

An applicable taxpayer's modified taxable income is its taxable income for the taxable year increased by (1) any base erosion tax benefit with respect to any base erosion payment and (2) the base erosion percentage of any NOL deduction allowed under section 172 for such taxable year.[1820]

Calculation of tax liability

Under the base erosion and anti-abuse additional tax, applicable taxpayers are required to pay a tax equal to the base erosion minimum tax amount for the taxable year in addition to any other regular tax liability they may have.[1821] The base erosion minimum tax amount equals the excess, if any, of 10 percent of modified taxable income over the amount of regular tax liability reduced (but not below zero) by the sum of a certain amount of Chapter 1 credits. Specifically, the amount of regular tax liability is reduced (and the base erosion minimum tax amount increased) by all Chapter 1

[1818] As in effect before the date of enactment of the Act. Sec. 59A(c)(2)(B)(ii).
[1819] Sec. 59A(d)(4)
[1820] Sec. 59A(c)(1).
[1821] Sec. 59A(a).

credits except for the research credit[1822] and a certain portion of applicable section 38 credits.

Applicable section 38 credits[1823] are credits allowed under section 38 for the taxable year that are properly allocable to the low-income housing credit,[1824] the renewable energy production credit,[1825] and the energy investment credit.[1826] In general, no more than 80 percent of the amount of applicable section 38 credits for a taxable year can be used to reduce an applicable taxpayer's base erosion minimum tax liability, and in no case can applicable section 38 credits reduce the taxpayer's base erosion minimum tax liability by more than 80 percent.[1827]

Special rules

Special rules for a taxable year beginning in 2018 and for taxable years beginning after December 31, 2025

For a taxable year beginning in 2018, the 10-percent rate on modified taxable income is reduced to five percent.[1828] For taxable years beginning after December 31, 2025, the 10-percent rate on modified taxable income is increased to 12.5 percent, and the amount of regular tax liability is reduced (and the base erosion minimum tax amount is therefore increased) by the sum of all the taxpayer's Chapter 1 credits for the taxable year, when computing the base erosion minimum tax amount.[1829]

Special rules for banks and securities dealers

An applicable taxpayer that is a member of an affiliated group that includes a bank (as defined in section 581) or securities dealer registered[1830] under section 15(a) of the Securities Exchange Act of 1934 is subject to a tax rate on its modified taxable income that is one-percentage point higher than the generally applicable tax rate (*e.g.*, six percent instead of five percent for a taxable year beginning in 2018).[1831] In addition, for purposes of determining whether they are applicable taxpayers, banks and securities dealers are subject to a two-percent base erosion percentage threshold (rather than three percent).[1832]

Information reporting requirements

The provision introduces additional information reporting requirements with respect to certain foreign-owned corporations under section 6038A.[1833] The provision authorizes the Secretary to prescribe additional reporting requirements under section 6038A relating to: (1) the name, principal place of business, and the country or countries of organization or residence of each person which is a related party to the reporting corporation and had any trans-

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[1822] Sec. 41(a).
[1823] Sec. 59A(b)(4).
[1824] Sec. 42(a).
[1825] Sec. 45(a).
[1826] Sec. 48.
[1827] Sec. 59A(b)(1)(B)(i)(II)
[1828] Sec. 59A(b)(1)(A).
[1829] Sec. 59A(b)(2).
[1830] A clerical correction may be needed to reflect this intent.
[1831] Sec. 59A(b)(3).
[1832] Sec. 59A(e)(1)(C).
[1833] Sec. 6038A(b).

action with the reporting corporation during its taxable year; (2) the manner of relation between the reporting corporation and each person referred to in (1); and (3) transactions between the reporting corporation and each related foreign person.

In addition, for purposes of information reporting under sections 6038A and 6038C, if the reporting corporation or the foreign corporation to which section 6038C applies is an applicable taxpayer under this provision, the taxpayer is required to report (1) such information as the Secretary finds necessary to determine the base erosion minimum tax amount, base erosion payments, and base erosion tax benefits of the taxpayer for the taxable year and (2) any other information as the Secretary determines is necessary.[1834]

The penalties for failure to furnish information or maintain records under sections 6038A(d)(1) and (2) are both increased to $25,000.

Regulations

New section 59A(i) authorizes the Secretary to prescribe such regulations or other guidance necessary or appropriate to carry out the provisions section 59A, including regulations providing for such adjustments to the application of this provision necessary to prevent avoidance of the provision, including through (1) the use of unrelated persons, conduit transactions, or other intermediaries, or (2) transactions or arrangements designed in whole or in part to (A) characterize payments otherwise subject to this provision as payments not subject to this provision or (B) substitute payments not subject to this provision for payments otherwise subject to this provision. In addition, the Secretary is authorized to prescribe such regulations or other guidance necessary or appropriate for purposes of applying the exception for qualified derivative payments, including rules to prevent avoidance.[1835]

Examples

The following examples illustrate components of the base erosion minimum tax calculation. Example 1 presents the base facts for all of the examples and shows how the base erosion percentage and base erosion minimum tax amount are calculated when the taxpayer has neither an NOL deduction nor any allowed credit. Example 2 shows how modified taxable income is computed when the taxpayer has an NOL deduction. Examples 3 through 5 illustrate the different effects that the research credit, applicable section 38 credits, and other Chapter 1 credits have on the calculation of the base erosion minimum tax amount. Example 6 shows how the calculation operates for taxable years beginning after December 31, 2025.

Example 1: Base Case

Assume USCo, a domestic C corporation that is neither a RIC nor a REIT, has gross receipts of $600,000,000 for its 2019 tax year and an average of $500,000,000 in gross receipts for the prior three taxable years. USCo is not a bank or securities dealer. USCo is a

[1834] Sec. 6038A(b)(2).
[1835] A clerical correction may be needed to reflect this intent.

calendar-year taxpayer. It has no other sources of income and no foreign operations, and is wholly-owned by a foreign corporation (which has no other U.S. operations). For 2019 it pays its employees $100,000,000 in salary (all of which is deductible) and makes $50,000,000 in interest payments and $250,000,000 in royalty payments to its foreign parent. USCo has carried over no NOLs into 2019. Also, for 2019, assume that USCo has made no payments reflected in cost of goods sold, has no other expenses, and has no credits available to reduce its regular tax liability. All calculations in these examples are for USCo's 2019 tax year.

Base erosion percentage

USCo has base erosion payments, and base erosion tax benefits, of $300,000,000 ($50,000,000 + $250,000,000). Its base erosion percentage equals its base erosion tax benefits of $300,000,000 divided by its $400,000,000 in overall deductible payments, or 75 percent. USCo is therefore an applicable taxpayer and subject to the base erosion minimum tax because it is a C corporation that is not a RIC or REIT and has met the gross receipts and base erosion percentage thresholds for being an applicable taxpayer.

Base erosion minimum tax

USCo has taxable income of $200,000,000 ($600,000,000 – $400,000,000). At a 21-percent corporate tax rate, USCo's regular tax liability is $42,000,000.

USCo's modified taxable income is its taxable income determined without regard to its $300,000,000 in base erosion tax benefits, or $500,000,000.

USCO's base erosion minimum tax liability equals 10 percent of its modified taxable income less its amount of regular tax liability, or $50,000,000 – $42,000,000 = $8,000,000. USCo is required to pay its base erosion minimum tax liability of $8,000,000 in addition to its regular tax liability of $42,000,000 for a total tax liability of $50,000,000.

Example 2: Variant of Example 1 with NOL Deduction

Assume the same facts as Example 1, except that USCo has an NOL deduction (originating from a loss in tax year 2018) in tax year 2019 of $100,000,000. For simplicity, also assume that USCo's base erosion percentage for tax year 2018 is the same as that for tax year 2019, or 75 percent.

With the $100,000,000 NOL, USCo has taxable income of $100,000,000 ($600,000,000 – $400,000,000 – $100,000,000). At a 21-percent corporate tax rate, USCo's regular tax liability is $21,000,000.

USCo's modified taxable income is its taxable income determined without regard to its $300,000,000 in base erosion tax benefits and the base erosion percentage of its NOL deduction allowed under section 172 for tax year 2019, or $100,000,000 + $300,000,000 + (75 percent * $100,000,000) = $475,000,000.

USCo's base erosion minimum tax liability equals 10 percent of its modified taxable income less its amount of regular tax liability adjusted by credits, or $47,500,000 – $21,000,000 = $26,500,000. USCo is required to pay its base erosion minimum tax liability of

$26,500,000 in addition to its regular tax liability of $21,000,000 for a total tax liability of $47,500,000. Relative to the scenario in Example 1, USCo's $100,000,000 NOL reduces its regular tax liability by $21,000,000 but increases its base erosion minimum tax liability by $18,500,000, resulting in a tax savings of $2,500,000 (or 2.5 percent of its NOL amount).

Example 3: Variant of Example 2 with Foreign Tax Credit

Assume the same facts as Example 2, except that USCo is allowed a section 901 foreign tax credit of $8,000,000 for 2019.

As in Example 2, USCo has regular tax liability of $21,000,000 and modified taxable income of $475,000,000.

For purposes of the base erosion minimum tax calculation, USCo is required to reduce the amount of its regular tax liability by the excess of all allowable Chapter 1 credits ($8,000,000) over the sum of its research credit ($0) and a certain portion of applicable section 38 credits ($0).[1836] In particular, USCo's base erosion minimum tax liability equals 10 percent of its modified taxable income less its amount of regular tax liability adjusted by credits, or $47,500,000 – {$21,000,000–[$8,000,000–($0 + $0)]} = $34,500,000.

USCo is required to pay its base erosion minimum tax liability of $34,500,000 in addition to its regular tax liability of $21,000,000 for a total tax liability, prior to allowed credits, of $55,500,000. USCo's total tax liability after allowed credits is $47,500,000 ($55,500,000 – $8,000,000).

Example 4: Variant of Example 3 with Research Credit

Assume the same facts as Example 3, except that USCo is also allowed a section 41 research credit of $5,000,000 for 2019.

As in Example 2, USCo has regular tax liability of $21,000,000 and modified taxable income of $475,000,000.

For purposes of the base erosion minimum tax calculation, USCo is required to reduce the amount of its regular tax liability by the excess of all allowable Chapter 1 credits ($8,000,000 + $5,000,000) over the sum of its research credit ($5,000,000) and a certain portion of applicable section 38 credits ($0).[1837] In particular, USCo's base erosion minimum tax liability equals 10 percent of its modified taxable income less its amount of regular tax liability adjusted by credits, or $47,500,000 – {$21,000,000 – [($8,000,000 + $5,000,000) – ($5,000,000 + $0)]} = $34,500,000.

USCo is required to pay its base erosion minimum tax liability of $34,500,000 in addition to its regular tax liability of $21,000,000 for a total tax liability, prior to allowed credits, of $55,500,000. USCo's total tax liability after allowed credits is $42,500,000 ($55,500,000 – $8,000,000 – $5,000,000). While USCo's total post-credit tax liability is $47,500,000 in Example 3, USCo's total post-credit tax liability is $42,500,000 in Example 4.

[1836] Sec. 59A(b)(1)(B)(ii)(I).
[1837] *Ibid.*

Example 5: Variant of Example 4 with an Applicable Section 38 Credit

Assume the same facts as in Example 4, except that USCo is allowed a section 42 low-income housing credit of $6,000,000.

As in Example 4, USCo has regular tax liability of $21,000,000 and modified taxable income of $475,000,000.

For purposes of the base erosion minimum tax calculation, USCo is required to reduce the amount of its regular tax liability by the excess of all allowable Chapter 1 credits ($8,000,000 + $5,000,000 + $6,000,000) over the sum of the full amount of its research credit ($5,000,000) and a certain portion of applicable section 38 credits (80 percent * $6,000,000 = $4,800,000). In particular, USCo's base erosion minimum tax liability equals 10 percent of its modified taxable income less its amount of regular tax liability adjusted by credits, or $47,500,000 − {$21,000,000 − [($8,000,000 + $5,000,000 + $6,000,000) − ($5,000,000 + (80 percent * $6,000,000))]} = $35,700,000.

The portion is $4,800,000 because no more than 80 percent of the amount of applicable section 38 credits for a taxable year can be used to reduce USCo's base erosion minimum tax liability, and in no case can applicable section 38 credits reduce USCo's base erosion minimum tax liability by more than 80 percent.[1838] Without regard to the special rule for applicable section 38 credits, USCo's base erosion minimum tax liability would be $40,500,000 ($47,500,000 − $21,000,000 + ($8,000,000 + $6,000,000)). Applicable section 38 credits cannot be used to reduce the base erosion minimum tax liability by more than 80 percent of this amount, or $32,400,000 (80 percent * $40,500,000). For purposes of computing its base erosion minimum tax liability, USCo's applicable section 38 credit adjustment to its Chapter 1 credit amount is the lesser of $32,400,000 or $4,800,000. Therefore, the applicable section 38 credit adjustment is $4,800,000.

USCo is required to pay its base erosion minimum tax liability of $35,700,000 in addition to its regular tax liability of $21,000,000 for a total tax liability, prior to allowed credits, of $56,700,000. USCo's total tax liability after allowed credits is $37,700,000 ($56,700,000 − $8,000,000 − $5,000,000 − $6,000,000). While USCo's total post-credit tax liability is $42,500,000 in Example 4, USCo's total post-credit tax liability is $37,700,000 in Example 5.

Example 6: Variant of Example 5 for Tax Year 2026

Assume the same facts as in Example 5, except that the figures for tax year 2019 are for tax year 2026.

As in Example 5, USCo has regular tax liability of $21,000,000 and modified taxable income of $475,000,000.

When computing the base erosion minimum tax amount for taxable years beginning after December 31, 2025, the 10-percent tax rate on modified taxable income is increased to 12.5 percent, and the amount of regular tax liability is reduced by the sum of all the taxpayer's Chapter 1 credits for the taxable year. As a result, USCo's base erosion liability for 2026 equals 12.5 percent of its modified taxable income less its amount of regular tax liability (re-

[1838] Sec. 59A(b)(1)(B)(ii)(II).

duced by the sum of all Chapter 1 credits), or (12.5 percent * $475,000,000) − [$21,000,000 − ($8,000,000 + $5,000,000 + $6,000,000] = $59,375,000 − $2,000,000 = $57,375,000. USCo's total post-credit tax liability is $57,375,000 + $21,000,000 − $19,000,000 = $59,375,000, so that, in effect, USCo is unable to utilize any of its allowed Chapter 1 credits to reduce its total tax liability.[1839]

Effective Date

The provision applies to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.

[1839] To see this, note that, if USCo had no allowed Chapter 1 credits, its regular tax liability is $21,000,000 and its base erosion minimum tax amount equals $59,375,000 − $21,000,000 = $38,375,000, so that its total tax liability equals $21,000,000 + $38,375,000 = $59,375,000.

PART III—OTHER PROVISIONS

A. Restriction on Insurance Business Exception to the Passive Foreign Investment Company Rules (sec. 14501 of the Act and sec. 1297 of the Code)

Prior Law

Passive foreign investment companies and insurance

Under the PFIC regime, passive income is any income which is of a kind that would be foreign personal holding company income, including dividends, interest, royalties, rents, and certain gains on the sale or exchange of property, commodities, or foreign currency. However, among other exceptions, passive income does not include any income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.[1840] In applying the insurance exception, the IRS analyzes whether risks assumed under contracts issued by a foreign company organized as an insurer are truly insurance risks, whether the risks are limited under the terms of the contracts, and the status of the company as an insurance company.[1841]

Explanation of Provision

The provision modifies the requirements for a corporation the income of which is not included in passive income for purposes of the PFIC rules. The provision replaces the test based on whether a corporation is predominantly engaged in an insurance business with a test based on the corporation's insurance liabilities.[1842] The requirement that the foreign corporation would be subject to tax under subchapter L if it were a domestic corporation is retained.

[1840] Sec. 1297(b)(2)(B).

[1841] Notice 2003–34, 2003–C.B. 1 990, June 9, 2003. See also, Prop. Treas. Reg. sec. 1.1297–4, 26 CFR Part 1, REG–108214–15, April 24, 2015.

[1842] Treasury regulations proposed in 2015 have taken a different approach that is based on the prior statutory rule. Prop. Treas. Reg. sec. 1.1297–4, 26 CFR Part 1, REG–108214–15, April 24, 2015. The proposed regulations provide that "the term insurance business means the business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with those investment activities and administrative services that are required to support or are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation." The proposed regulations provide that an investment activity is an activity producing foreign personal holding company income, and that is "required to support or [is] substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation to the extent that income from the activities is earned from assets held by the foreign corporation to meet obligations under the contracts." The preamble to the proposed regulations specifically requests comments on the proposed regulations "with regard to how to determine the portion of a foreign insurance company's assets that are held to meet obligations under insurance contracts issued or reinsured by the company," for example, if the assets "do not exceed a specified percentage of the corporation's total insurance liabilities for the year." *Ibid*.

Under the provision, passive income for purposes of the PFIC rules does not include income derived in the active conduct of an insurance business by a corporation (1) that would be subject to tax under subchapter L if it were a domestic corporation; and (2) the applicable insurance liabilities of which constitute more than 25 percent of its total assets as reported on the company's applicable financial statement for the last year ending with or within the taxable year.

For the purpose of the provision's exception from passive income, applicable insurance liabilities mean, with respect to any property and casualty or life insurance business (1) loss and loss adjustment expenses, (2) reserves (other than deficiency, contingency, or unearned premium reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks. This includes loss reserves for property and casualty, life, and health insurance contracts and annuity contracts. Unearned premium reserves with respect to any type of risk are not treated as applicable insurance liabilities for purposes of the provision. For purposes of the provision, the amount of any applicable insurance liability may not exceed the lesser of such amount (1) as reported to the applicable insurance regulatory body in the applicable financial statement (or, if less, the amount required by applicable law or regulation), or (2) as determined under regulations prescribed by the Secretary.

An applicable financial statement is a statement for financial reporting purposes that (1) is made on the basis of generally accepted accounting principles, (2) is made on the basis of international financial reporting standards, but only if there is no statement made on the basis of generally accepted accounting principles, or (3) except as otherwise provided by the Secretary in regulations, is the annual statement required to be filed with the applicable insurance regulatory body, but only if there is no statement made on either of the foregoing bases. Unless otherwise provided in regulations, it is intended that generally accepted accounting principles means U.S. GAAP.

The applicable insurance regulatory body means, with respect to any insurance business, the entity established by law to license, authorize, or regulate such insurance business and to which the applicable financial statement is provided. For example, in the United States, the applicable insurance regulatory body is the State insurance regulator to which the corporation provides its annual statement.

If a corporation fails to qualify solely because its applicable insurance liabilities constitute 25 percent or less of its total assets, a United States person who owns stock of the corporation may elect in such manner as the Secretary prescribes to treat the stock as stock of a qualifying insurance corporation if (1) the corporation's applicable insurance liabilities constitute at least 10 percent of its total assets, and (2) based on the applicable facts and circumstances, the corporation is predominantly engaged in an insurance business, and its failure to qualify under the 25 percent threshold is due solely to runoff-related or rating-related circumstances involving such insurance business.

Facts and circumstances that tend to show the firm may not be predominantly engaged in an insurance business include a small number of insured risks with low likelihood but large potential costs; workers focused to a greater degree on investment activities than underwriting activities; and low loss exposure. Additional relevant facts for determining whether the firm is predominantly engaged in an insurance business include: claims payment patterns for the current and prior years; the firm's loss exposure as calculated for a regulator such as the SEC or for a rating agency, or if those are not calculated, for internal pricing purposes; the percentage of gross receipts constituting premiums for the current and prior years; and the number and size of insurance contracts issued or taken on through reinsurance by the firm. The fact that a firm has been holding itself out as an insurer for a long period is not determinative either way.

Runoff-related or rating-related circumstances include, for example, the fact that the company is in runoff, that is, it is not taking on new insurance business (and consequently has little or no premium income), and is using its remaining assets to pay off claims with respect to pre-existing insurance risks on its books. Such circumstances also include, for example, the application to the company of specific requirements with respect to capital and surplus relating to insurance liabilities imposed by a rating agency as a condition of obtaining a rating necessary to write new insurance business for the current year.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

B. Repeal of Fair Market Value Method of Interest Expense Apportionment (sec. 14502 of the Act and sec. 864 of the Code)

Explanation of Provision

The provision prohibits members of an affiliated group from allocating and apportioning interest expense on the basis of either gross income or the fair market value of assets for purposes of the income and expense sourcing provisions of the Code.[1843] Instead, the members must allocate and apportion interest expense based on the adjusted tax basis of assets.

Effective Date

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

[1843] Section 864(e) provides that members of an affiliated group must allocate and apportion interest expense of each member as if all members of such group were a single corporation. An affiliated group is an affiliated group within the meaning of section 1504, with exceptions that take into account a foreign corporation if it is owned 80-percent owned by affiliated members and if more than 50 percent of its gross income is effectively connected with the conduct of a trade or business in the United States.

APPENDIX: TECHNICAL EXPLANATION OF MODIFICATION OF DEDUCTION FOR QUALIFIED BUSINESS INCOME OF A COOPERATIVE AND ITS PATRONS (ENACTED MARCH 23, 2018, PUB. L. NO. 115–141)

Below is Part B of the Technical Explanation of the revenue provisions of the House amendment to the Senate amendment to H.R. 1625 (Rules Committee Print 115–66), as introduced in the House on March 21, 2018. Part B describes modifications to section 199A. The Technical Explanation, prepared by the staff of the Joint Committee on Taxation, was published online at *www.jct.gov* as: Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the House Amendment to the Senate Amendment to H.R. 1625 (Rules Committee Print 115–66),* (JCX–6–18), March 22, 2018, pages 5–28. H.R. 1625 was enacted on March 23, 2018, as Pub. L. No. 115–141.[1844]

Modification of Deduction for Qualified Business Income of a Cooperative and Its Patrons

Prior Law

1. Treatment of taxpayers with domestic production activities income

In general

Former section 199[1845] provides a deduction from taxable income (or, in the case of an individual, adjusted gross income[1846]) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income (determined without regard to the section 199 deduction) for the taxable year.[1847] The amount of the deduction for a taxable year is limited to 50 percent of the W–2 wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.[1848] W–2 wages are the total wages subject to wage withholding,[1849] elective deferrals,[1850] and deferred compensation[1851] paid by the taxpayer with respect to employment of its employees during the calendar year ending during the taxable year of the taxpayer.[1852] W–2 wages do not include any

[1844] The section 199A modification is contained in Pub. L. No 115–141, the Consolidated Appropriations Act, 2018, Division T, sec. 101.

[1845] Section 199 was repealed by Pub. L. No. 115–97, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, for taxable years beginning after December 31, 2017. All references to former section 199 in this document refer to section 199 as in effect before its repeal.

[1846] For this purpose, adjusted gross income is determined after application of sections 86, 135, 137, 219, 221, 222, and 469, and without regard to the section 199 deduction. Sec. 199(d)(2).

[1847] Sec. 199(a).

[1848] Sec. 199(b).

[1849] Defined in sec. 3401(a).

[1850] Within the meaning of sec. 402(g)(3).

[1851] Deferred compensation includes compensation deferred under section 457, as well as the amount of any designated Roth contributions (as defined in section 402A).

[1852] Sec. 199(b). In the case of a taxpayer with a short taxable year that does not contain a calendar year ending during such short taxable year, the following amounts are treated as the W–2 wages of the taxpayer for the short taxable year: (1) wages paid during the short taxable year to employees of the qualified trade or business; (2) elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the qualified trade or business; and (3) compensation actually deferred under section 457 during the short taxable

Continued

amount that is not properly allocable to domestic production gross receipts as a qualified item of deduction.[1853] In addition, W–2 wages do not include any amount that was not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.[1854]

In the case of oil related qualified production activities income, the deduction is reduced by three percent of the least of the taxpayer's oil related qualified production activities income, qualified production activities income, or taxable income (determined without regard to the section 199 deduction) for the taxable year.[1855] For this purpose, oil related qualified production activities income for any taxable year is the portion of qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof[1856] during the taxable year.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the cost of goods sold that are allocable to those receipts;[1857] and (2) other expenses, losses, or deductions which are properly allocable to those receipts.[1858] Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property[1859] that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States;[1860] (2) any sale, exchange, or

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year with respect to employees of the qualified trade or business. Amounts that are treated as W–2 wages for a taxable year are not treated as W–2 wages of any other taxable year. See Treas. Reg. sec. 1.199–2(b). In addition, in the case of a taxpayer who is an individual with otherwise qualified production activities income from sources within the commonwealth of Puerto Rico, if all the income for the taxable year is taxable under section 1 (income tax rates for individuals), the determination of W–2 wages with respect to the taxpayer's trade or business conducted in Puerto Rico is made without regard to any exclusion under the wage withholding rules (as provided in section 3401(a)(8)) for remuneration paid for services in Puerto Rico. See sec. 199(d)(8)(B).

[1853] Sec. 199(b)(2)(B).

[1854] Sec. 199(b)(2)(C).

[1855] Sec. 199(d)(9).

[1856] Within the meaning of sec. 927(a)(2)(C) as in effect before its repeal.

[1857] For this purpose, any item or service brought into the United States is treated as acquired by purchase, and its cost is treated as not less than its value immediately after it entered the United States. A similar rule applies in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts. In addition, for any property exported by the taxpayer for further manufacture, the increase in cost or adjusted basis may not exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture. See sec. 199(c)(3)(A) and (B).

[1858] Sec. 199(c)(1). In computing qualified production activities income, the domestic production activities deduction itself is not an allocable deduction. Sec. 199(c)(1)(B)(ii). See Treas. Reg. secs. 1.199–1 through 1.199–9 where the Secretary has prescribed rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining qualified production activities income.

[1859] Qualifying production property generally includes any tangible personal property, computer software, and sound recordings. Sec. 199(c)(5).

[1860] When used in the Code in a geographical sense, the term "United States" generally includes only the States and the District of Columbia. Sec. 7701(a)(9). A special rule for determining domestic production gross receipts, however, provides that for taxable years beginning after December 31, 2005, and before January 1, 2018, in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term "United States" includes the Commonwealth of Puerto Rico, but only if all of the taxpayer's Puerto Rico-sourced gross receipts are taxable under the Federal income tax for individuals or corporations for such taxable year. Sec. 199(d)(8)(A) and (C). In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico. Sec. 199(d)(8)(B).

other disposition, or any lease, rental, or license, of any qualified film[1861] produced by the taxpayer; (3) any sale, exchange, or other disposition, or any lease, rental, or license, of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States by the taxpayer for the construction of real property in the United States.[1862]

Domestic production gross receipts do not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.[1863] In addition, domestic production gross receipts do not include gross receipts which are derived from (1) the sale of food and beverages prepared by the taxpayer at a retail establishment, (2) the transmission or distribution of electricity, natural gas, or potable water, or (3) the lease, rental, license, sale, exchange, or other disposition of land.[1864]

Special rules

All members of an expanded affiliated group[1865] are treated as a single corporation and the deduction is allocated among the members of the expanded affiliated group in proportion to each member's respective amount, if any, of qualified production activities income. In addition, for purposes of determining domestic production gross receipts, if all of the interests in the capital and profits of a partnership are owned by members of a single expanded affiliated group at all times during the taxable year of such partnership, the partnership and all members of such group are treated as a single taxpayer during such period.[1866]

For a tax-exempt taxpayer subject to tax on its unrelated business taxable income by section 511, the section 199 deduction is determined by substituting unrelated business taxable income for taxable income where applicable.[1867]

The section 199 deduction is determined by only taking into account items that are attributable to the actual conduct of a trade or business.[1868]

[1861] Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers. Sec. 199(c)(6).

[1862] Sec. 199(c)(4)(A).

[1863] Sec. 199(c)(7). For this purpose, a person is treated as related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 are made without regard to section 1563(b).

[1864] Sec. 199(c)(4)(B).

[1865] For this purpose, an expanded affiliated group is an affiliated group as defined in section 1504(a) determined (i) by substituting "more than 50 percent" for "more than 80 percent" each place it appears, and (ii) without regard to paragraphs (2) and (4) of section 1504(b). See sec. 199(d)(4)(B).

[1866] Sec. 199(d)(4)(D).

[1867] Sec. 199(d)(7).

[1868] Sec. 199(d)(5).

Partnerships and S corporations

With regard to the domestic production activities income of a partnership or S corporation, the deduction is determined at the partner or shareholder level. Each partner or shareholder generally takes into account such person's allocable share of the components of the calculation (including domestic production gross receipts; the cost of goods sold allocable to such receipts; and other expenses, losses, or deductions allocable to such receipts) from the partnership or S corporation, as well as any items relating to the partner or shareholder's own qualified production activities income, if any.[1869]

In applying the wage limitation, each partner or shareholder is treated as having been allocated wages from the partnership or S corporation in an amount that is equal to such person's allocable share of W–2 wages.[1870]

Specified agricultural and horticultural cooperatives

In general

With regard to specified agricultural and horticultural cooperatives, section 199 provides the same treatment of qualified production activities income derived from agricultural or horticultural products that are manufactured, produced, grown, or extracted by such cooperatives,[1871] as it provides for qualified production activities income of other taxpayers, including non-specified cooperatives (*i.e.,* the cooperative may claim a deduction for qualified production activities income). The cooperative is treated as having manufactured, produced, grown, or extracted in whole or significant part any qualifying production property marketed by the cooperative if such items were manufactured, produced, grown, or extracted in whole or significant part by its patrons.[1872] In addition, the cooperative is treated as having manufactured, produced, grown, or extracted agricultural products with respect to which the cooperative performs storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural products, provided the products are consumed in connection with or incorporated into the manufacturing, production, growth, or extraction of qualifying production property (whether or not by the cooperative).[1873] Finally, for purposes of determining the cooperative's section 199 deduction, qualified production activities income and taxable income are determined without regard to any deduction allowable under section 1382(b) and (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions) for the taxable year.[1874]

[1869] Sec. 199(d)(1)(A).

[1870] In the case of a trust or estate, the components of the calculation are apportioned between (and among) the beneficiaries and the fiduciary. See sec. 199(d)(1)(B) and Treas. Reg. sec. 1.199–5(d) and (e).

[1871] For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative. See Treas. Reg. sec. 1.199–6(f).

[1872] Sec. 199(d)(3)(D) and Treas. Reg. sec. 1.199–6(d).

[1873] See Treas. Reg. sec. 1.199–3(e)(1).

[1874] See sec. 199(d)(3)(C) and Treas. Reg. sec. 1.199–6(c).

Definition of a specified agricultural or horticultural cooperative

A specified agricultural or horticultural cooperative is an organization to which part I of subchapter T applies that is engaged in (a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or (b) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted.[1875]

Allocation of the cooperative's deduction to patrons

Any patron that receives a qualified payment from a specified agricultural or horticultural cooperative is allowed as a deduction for the taxable year in which such payment is received an amount equal to the portion of the cooperative's deduction for qualified production activities income that is (i) allowed with respect to the portion of the qualified production activities income to which such payment is attributable, and (ii) identified by the cooperative in a written notice mailed to the patron during the payment period described in section 1382(d).[1876] A qualified payment is any amount that (i) is described in paragraph (1) or (3) of section 1385(a) (*i.e.,* patronage dividends and per-unit retain allocations), (ii) is received by an eligible patron from a specified agricultural or horticultural cooperative, and (iii) is attributable to qualified production activities income with respect to which a deduction is allowed to such cooperative.[1877]

The cooperative cannot reduce its income under section 1382 for any deduction allowable to its patrons under this rule (*i.e.,* the cooperative must reduce its deductions allowed for certain payments to its patrons in an amount equal to the section 199 deduction allocated to its patrons).[1878]

Present Law

1. Treatment of taxpayers other than corporations

In general

Individual income tax rates

To determine regular tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status (*i.e.,* single, head of household, married filing jointly, or married filing sep-

[1875] Sec. 199(d)(3)(F). For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative. See Treas. Reg. sec. 1.199–6(f).

[1876] Sec. 199(d)(3)(A) and Treas. Reg. sec. 1.199–6(a). The written notice must be mailed by the cooperative to it patrons no later than the 15th day of the ninth month following the close of the taxable year. The cooperative must report the amount of the patron's section 199 deduction on Form 1099–PATR, "Taxable Distributions Received From Cooperatives," issued to the patron. Treas. Reg. sec. 1.199–6(g).

[1877] Sec. 199(d)(3)(E). For this purpose, patronage dividends and per-unit retain allocations include any advances on patronage and per-unit retains paid in money during the taxable year. Treas. Reg. sec. 1.199–6(e).

[1878] Sec. 199(d)(3)(B) and Treas. Reg. sec. 1.199–6(b).

arately). For 2018, the regular individual income tax rate schedule provides rates of 10, 12, 22, 24, 32, 35, and 37 percent.

Partnerships

Partnerships generally are treated for Federal income tax purposes as pass-through entities not subject to tax at the entity level.[1879] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account by the partners in computing their income tax liability (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners).[1880] A partner's deduction for partnership losses is limited to the partner's adjusted basis in its partnership interest.[1881] Losses not allowed as a result of that limitation generally are carried forward to the next year. A partner's adjusted basis in the partnership interest generally equals the sum of (1) the partner's capital contributions to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) the partner's distributive share of losses allowed as a deduction and certain nondeductible expenditures, and (2) any partnership distributions to the partner.[1882] Partners generally may receive distributions of partnership property without recognition of gain or loss, subject to some exceptions.[1882]

Partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect.[1884] In general, an allocation has substantial economic effect to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.[1885]

State laws of every State provide for limited liability companies[1886] ("LLCs"), which are neither partnerships nor corporations under applicable State law, but which are generally treated as partnerships for Federal tax purposes.[1887]

A publicly traded partnership generally is treated as a corporation for Federal tax purposes.[1888] For this purpose, a publicly trad-

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[1879] Sec. 701.

[1880] Sec. 702(a).

[1881] Sec. 704(d). In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by partnership deductions (sections 469 and 465). These limitations do not apply to corporate partners (except certain closely-held corporations) and may not be important to individual partners who have partner-level passive income from other investments.

[1882] Sec. 705.

[1883] Sec. 731. Gain or loss may nevertheless be recognized, for example, on the distribution of money or marketable securities, distributions with respect to contributed property, or in the case of disproportionate distributions (which can result in ordinary income).

[1884] Sec. 704(b)(2).

[1885] Treas. Reg. sec. 1.704–1(b)(2).

[1886] The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute, though the tax treatment of LLCs for State tax purposes may differ.

[1887] Any domestic nonpublicly traded unincorporated entity with two or more members generally is treated as a partnership for federal income tax purposes, while any single-member domestic unincorporated entity generally is treated as disregarded for Federal income tax purposes (*i.e.*, treated as not separate from its owner). Instead of the applicable default treatment, however, an LLC may elect to be treated as a corporation for Federal income tax purposes. Treas. Reg. sec. 301.7701–3 (known as the "check-the-box" regulations).

[1888] Sec. 7704(a).

ed 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).[1889]

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.[1890]

S corporations

For Federal income tax purposes, an S corporation[1891] generally is not subject to tax at the corporate level.[1892] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation are taken into account by the S corporation shareholders in computing their income tax liabilities (based on the S corporation's method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in its S corporation stock and the indebtedness of the S corporation to such shareholder. Losses not allowed as a result of that limitation generally are carried forward to the next year. A shareholder's adjusted basis in the S corporation stock generally equals the sum of (1) the shareholder's capital contributions to the S corporation and (2) the shareholder's pro rata share of S corporation income, less (1) the shareholder's pro rata share of losses allowed as a deduction and certain nondeductible expenditures, and (2) any S corporation distributions to the shareholder.[1893]

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

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one

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[1889] Sec. 7704(b).

[1890] Sec. 7704(c)(2). Qualifying income is defined to include interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Sec. 7704(d). Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of certain fuel mixtures, alternative fuel, alcohol fuel, or biodiesel fuel. Qualifying income also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) where a principal activity of the partnership is the buying and selling of such commodities, futures, options, or forward contracts. However, the exception for partnerships with qualifying income does not apply to any partnership resembling a mutual fund (*i.e.*, that would be described in section 851(a) if it were a domestic corporation), which includes a corporation registered under the Investment Company Act of 1940 (Pub. L. No. 76–768 (1940)) as a management company or unit investment trust. Sec. 7704(c)(3).

[1891] An S corporation is so named because its Federal tax treatment is governed by subchapter S of the Code.

[1892] Secs. 1363 and 1366.

[1893] Sec. 1367. If any amount that would reduce the adjusted basis of a shareholder's S corporation stock exceeds the amount that would reduce that basis to zero, the excess is applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder. If, after a reduction in the basis of such indebtedness, there is an event that would increase the adjusted basis of the shareholder's S corporation stock, such increase is instead first applied to restore the reduction in the basis of the shareholder's indebtedness. Sec. 1367(b)(2).

class of stock.[1894] Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders of an S corporation.

Sole proprietorships

Unlike a C corporation, partnership, or S corporation, a business conducted as a sole proprietorship is not treated as an entity distinct from its owner for Federal income tax purposes.[1895] Rather, the business owner is taxed directly on business income, and files Schedule C (sole proprietorships generally), Schedule E (rental real estate and royalties), or Schedule F (farms) with his or her individual tax return. Furthermore, transfer of a sole proprietorship is treated as a transfer of each individual asset of the business. Nonetheless, a sole proprietorship is treated as an entity separate from its owner for employment tax purposes,[1896] for certain excise taxes,[1897] and certain information reporting requirements.[1898]

Taxpayers other than corporations with qualified business income

For taxable years beginning after December 31, 2017, and before January 1, 2026, an individual taxpayer generally may deduct 20 percent of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 20 percent of aggregate qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income.[1899] Limitations based on W–2 wages and capital investment phase in above a threshold amount of taxable income.[1900] A disallowance of the deduction on income of specified service trades or businesses also phases in above the threshold amount of taxable income.

Qualified business income

In general

Qualified business income is determined for each qualified trade or business of the taxpayer. For any taxable year, qualified business income means the net amount of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business of the taxpayer. The determination of qualified items of income, gain, deduction, and loss takes into account such items only to the extent included or allowed in the determination of taxable income for the year.

Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the

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[1894] Sec. 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. Sec. 1361(c)(1).

[1895] A single-member unincorporated entity is disregarded for Federal income tax purposes, unless its owner elects to be treated as a C corporation. Treas. Reg. sec. 301.7701–3(b)(1)(ii). Sole proprietorships often are conducted through legal entities for nontax reasons. While sole proprietorships generally may have no more than one owner, a married couple that files a joint return and jointly owns and operates a business may elect to have that business treated as a sole proprietorship under section 761(f).

[1896] Treas. Reg. sec. 301.7701–2(c)(2)(iv).

[1897] Treas. Reg. sec. 301.7701–2(c)(2)(v).

[1898] Treas. Reg. sec. 301.7701–2(c)(2)(vi).

[1899] Sec. 199A. Eligible taxpayers also include fiduciaries and beneficiaries of trusts and estates with qualified business income.

[1900] For this purpose, taxable income is computed without regard to the 20-percent deduction. Sec. 199A(e)(1).

conduct of a trade or business within the United States.[1901] In the case of an individual with qualified business income from sources within the commonwealth of Puerto Rico, if all such income for the taxable year is taxable under section 1 (income tax rates for individuals), then the term "United States" is considered to include Puerto Rico for purposes of determining the individual's qualified business income.[1902]

Certain items are not qualified items of income, gain, deduction, or loss.[1903] Specifically, qualified items of income, gain, deduction, and loss do not include (1) any item taken into account in determining net capital gain or net capital loss, (2) dividends, income equivalent to a dividend, or payments in lieu of dividends, (3) interest income other than that which is properly allocable to a trade or business, (4) the excess of gain over loss from commodities transactions other than (i) those entered into in the normal course of the trade or business or (ii) with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business, (5) the excess of foreign currency gains over foreign currency losses from section 988 transactions other than transactions directly related to the business needs of the business activity, (6) net income from notional principal contracts other than clearly identified hedging transactions that are treated as ordinary (*i.e.,* not treated as capital assets), and (7) any amount received from an annuity that is not received in connection with the trade or business. Qualified items do not include any item of deduction or loss properly allocable to any of the preceding items.

If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, then such loss is carried forward and in the next taxable year is treated as a loss from a qualified trade or business.[1904] Any deduction that would otherwise be allowed in a subsequent taxable year with respect to the taxpayer's qualified trades or businesses is reduced by 20 percent of any carryover qualified business loss.

Reasonable compensation and guaranteed payments

Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer.[1905] Similarly, qualified business income does not include any guaranteed payment for services rendered with respect to the trade or business,[1906] and, to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner, acting other than in his or her capacity as a partner, for services.[1907]

[1901] For this purpose, section 864(c) is applied by substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation," each place they appear. Sec. 199A(c)(3)(A).

[1902] Sec. 199A(f)(1)(C).

[1903] See sec. 199A(c)(3)(B).

[1904] Sec. 199A(c)(2).

[1905] Sec. 199A(c)(4).

[1906] Described in sec. 707(c).

[1907] Described in sec. 707(a).

Qualified trade or business

A qualified trade or business means any trade or business other than a specified service trade or business and other than the trade or business of performing services as an employee.[1908]

Specified service trade or business

A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.[1909] For this purpose a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities (section 475(c)(2) and (e)(2), respectively).

The exclusion from the definition of a qualified trade or business for specified service trades or businesses phases in for a taxpayer with taxable income in excess of a threshold amount. The threshold amount is $157,500 (200 percent of that amount, or $315,000, in the case of a joint return) (together, the "threshold amount"), adjusted for inflation in taxable years beginning after 2018.[1910] The exclusion from the definition of a qualified trade or business for specified service trades or businesses is fully phased in for a taxpayer with taxable income in excess of the threshold amount plus $50,000 ($100,000 in the case of a joint return).[1911]

Tentative deductible amount for a qualified trade or business

In general

For a taxpayer with taxable income below the threshold amount, the deductible amount for each qualified trade or business is equal to 20 percent of the qualified business income with respect to the trade or business.[1912] For a taxpayer with taxable income above the threshold, the taxpayer is allowed a deductible amount for each qualified trade or business equal to the lesser of (1) 20 percent of the qualified business income with respect to such trade or business, or (2) the greater of (a) 50 percent of the W–2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the W–2 wages paid with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property of the qualified trade or business.[1913]

[1908] Sec. 199A(d)(1).
[1909] Sec. 199A(d)(2).
[1910] Sec. 199A(e)(2).
[1911] See sec. 199A(d)(3).
[1912] Sec. 199A(b)(3).
[1913] Sec. 199A(b)(2).

Limitations based on W–2 wages and capital

The wage and capital limitations phase in for a taxpayer with taxable income in excess of the threshold amount.[1914] The wage and capital limitations apply fully for a taxpayer with taxable income in excess of the threshold amount plus $50,000 ($100,000 in the case of a joint return).

W–2 wages are the total wages subject to wage withholding,[1915] elective deferrals,[1916] and deferred compensation[1917] paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the taxable year of the taxpayer.[1918] In the case of a taxpayer who is an individual with otherwise qualified business income from sources within the commonwealth of Puerto Rico, if all the income for the taxable year is taxable under section 1 (income tax rates for individuals), the determination of W–2 wages with respect to the taxpayer's trade or business conducted in Puerto Rico is made without regard to any exclusion under the wage withholding rules[1919] for remuneration paid for services in Puerto Rico. W–2 wages do not include any amount that is not properly allocable to qualified business income as a qualified item of deduction.[1920] In addition, W–2 wages do not include any amount that was not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.[1921]

Qualified property means tangible property of a character subject to depreciation under section 167 that is held by, and available for use in, the qualified trade or business at the close of the taxable year, which is used at any point during the taxable year in the production of qualified business income, and for which the depreciable period has not ended before the close of the taxable year.[1922] The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (a) the date that is 10 years after the date the property is first placed in service, or (b) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (determined without regard to section 168(g)).

[1914] See sec. 199A(b)(3)(B).

[1915] Defined in sec. 3401(a).

[1916] Within the meaning of sec. 402(g)(3).

[1917] Deferred compensation includes compensation deferred under section 457, as well as the amount of any designated Roth contributions (as defined in section 402A).

[1918] Sec. 199A(b)(4). In the case of a taxpayer with a short taxable year that does not contain a calendar year ending during such short taxable year, the following amounts are treated as the W–2 wages of the taxpayer for the short taxable year: (1) wages paid during the short taxable year to employees of the qualified trade or business; (2) elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the qualified trade or business; and (3) compensation actually deferred under section 457 during the short taxable year with respect to employees of the qualified trade or business. Amounts that are treated as W–2 wages for a taxable year are not treated as W–2 wages of any other taxable year. See Conference Report to accompany H.R. 1, Tax Cuts and Jobs Act, H.R. Rep. No. 115–466, December 15, 2017, p. 217.

[1919] As provided in sec. 3401(a)(8).

[1920] Sec. 199A(b)(4)(B).

[1921] Sec. 199A(b)(4)(C).

[1922] Sec. 199A(b)(6).

Partnerships and S corporations

In the case of a partnership or S corporation, the section 199A deduction is determined at the partner or shareholder level. Each partner in a partnership takes into account the partner's allocable share of each qualified item of income, gain, deduction, and loss, and is treated as having W–2 wages and unadjusted basis of qualified property for the taxable year equal to the partner's allocable share of W–2 wages and unadjusted basis of qualified property of the partnership. The partner's allocable share of W–2 wages and unadjusted basis of qualified property are required to be determined in the same manner as the partner's allocable share of wage expenses and depreciation, respectively. Similarly, each shareholder of an S corporation takes into account the shareholder's pro rata share of each qualified item of income, gain, deduction, and loss of the S corporation, and is treated as having W–2 wages and unadjusted basis of qualified property for the taxable year equal to the shareholder's pro rata share of W–2 wages and unadjusted basis of qualified property of the S corporation.

Qualified REIT dividends, cooperative dividends, and publicly traded partnership income

A deduction is allowed for 20 percent of the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income for the taxable year.[1923]

Qualified REIT dividends do not include any portion of a dividend received from a REIT that is a capital gain dividend[1924] or a qualified dividend.[1925]

A qualified cooperative dividend means any patronage dividend,[1926] per-unit retain allocation,[1927] qualified written notice of allocation,[1928] or any other similar amount, provided such amount is includible in gross income and is received from either (1) a tax-exempt organization described in section 501(c)(12)[1929] or a taxable or tax-exempt cooperative that is described in section 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the Code in 1962.[1930]

Qualified publicly traded partnership income means (with respect to any qualified trade or business of the taxpayer) the sum of (a) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss of the partnership from a publicly traded partnership not treated as a corporation,[1931] and (b) gain recognized by the taxpayer on disposition of

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[1923] See sec. 199A(a) and (b).
[1924] Defined in sec. 857(b)(3).
[1925] Defined in sec. 1(h)(11). See sec. 199A(e)(3).
[1926] Defined in sec. 1388(a).
[1927] Defined in sec. 1388(f).
[1928] Defined in sec. 1388(c).
[1929] Organizations described in section 501(c)(12) are benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses. Sec. 501(c)(12)(A).
[1930] Sec. 199A(e)(4).
[1931] Such items must be effectively connected with a U.S. trade or business, be included or allowed in determining taxable income for the taxable year, and not constitute excepted enumer-

its interest in such partnership that is treated as ordinary income (for example, by reason of section 751).[1932]

Determination of the taxpayer's deduction

The taxpayer's deduction for qualified business income for the taxable year is equal to the sum of (1) the lesser of (a) the combined qualified business income amount for the taxable year, or (b) an amount equal to 20 percent of taxable income (reduced by any net capital gain[1933] and qualified cooperative dividends), plus (2) the lesser of (a) 20 percent of qualified cooperative dividends, or (b) taxable income (reduced by net capital gain). This sum may not exceed the taxpayer's taxable income for the taxable year (reduced by net capital gain).[1934] The combined qualified business income amount for the taxable year is the sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer and 20 percent of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income.[1935]

The taxpayer's deduction for qualified business income is not allowed in computing adjusted gross income; instead, the deduction is allowed in computing taxable income.[1936] The deduction is available to both individuals who do itemize their deductions and individuals who do not itemize their deductions.[1937]

2. Treatment of cooperatives and their patrons

In general

Certain corporations are eligible to be treated as cooperatives and taxed under the special rules of subchapter T of the Code.[1938] In general, the subchapter T rules apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, most tax-exempt organizations, and certain utilities).

For Federal income tax purposes, a cooperative subject to the cooperative tax rules of subchapter T generally computes its income as if it were a taxable corporation, except that, in determining its taxable income, the cooperative does not take into account amounts paid for the taxable year as (1) patronage dividends, to the extent paid in money, qualified written notices of allocation,[1939] or other property (except nonqualified written notices of allocation)[1940] with respect to patronage occurring during such taxable year, and (2) per-unit retain allocations, to the extent paid in money, qualified per-unit retain certificates,[1941] or other property (except non-

ated investment-type income. Such items do not include the taxpayer's reasonable compensation, guaranteed payments for services, or (to the extent provided in regulations) section 707(a) payments for services.

[1932] Sec. 199A(e)(5).
[1933] Defined in sec. 1(h).
[1934] Sec. 199A(a).
[1935] Sec. 199A(b)(1).
[1936] Sec. 62(a).
[1937] Sec. 63(b) and (d).
[1938] Secs. 1381–1388.
[1939] As defined in sec. 1388(c).
[1940] As defined in sec. 1388(d).
[1941] As defined in sec. 1388(h).

qualified per-unit retain certificates)[1942] with respect to marketing occurring during such taxable year.[1943]

Patronage dividends are amounts paid to a patron (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation of the cooperative to pay such amount that existed before the cooperative received the amount so paid, and (3) which are determined by reference to the net earnings of the cooperative from business done with or for its patrons.[1944] Per-unit retain allocations are allocations to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron.[1945]

Because a patron of a cooperative that receives patronage dividends or per-unit retain allocations generally must include such amounts in gross income,[1946] excluding patronage dividends and per-unit retain allocations paid by the cooperative from the cooperative's taxable income in effect allows the cooperative to be a conduit with respect to profits derived from transactions with its patrons.

Specified agricultural or horticultural cooperatives with qualified business income

For taxable years beginning after December 31, 2017, and before January 1, 2026, a deduction is allowed to any specified agricultural or horticultural cooperative equal to the lesser of (a) 20 percent of the excess (if any) of the cooperative's gross income over the qualified cooperative dividends paid during the taxable year for the taxable year, or (b) the greater of 50 percent of the W–2 wages paid by the cooperative with respect to its trade or business or the sum of 25 percent of the W–2 wages of the cooperative with respect to its trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of qualified property of the cooperative.[1947] The cooperative's section 199A(g) deduction may not exceed its taxable income[1948] for the taxable year.

A specified agricultural or horticultural cooperative is an organization to which part I of subchapter T applies that is engaged in (a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, (b) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted, or (c) the provision of supplies, equipment, or services to farmers or organizations described in the foregoing.

[1942] As defined in sec. 1388(i).

[1943] Sec. 1382(b)(1) and (3). In determining its taxable income, the cooperative also does not take into account amounts paid in money or other property in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred, or in redemption of a nonqualified per-unit retain certificate which was paid as a per-unit retain allocation during the payment period for the taxable year during which the marketing occurred. Sec. 1382(b)(2) and (4).

[1944] Sec. 1388(a).

[1945] Sec. 1388(f).

[1946] Sec. 1385(a)(1) and (3).

[1947] Sec. 199A(g).

[1948] For this purpose, taxable income is computed without regard to the cooperative's deduction under section 199A(g).

Explanation of Provision

1. Treatment of specified agricultural or horticultural cooperatives

Deduction for qualified production activities income

The provision modifies the deduction for qualified business income of a specified agricultural or horticultural cooperative under section 199A(g) to instead provide a deduction for qualified production activities income of a specified agricultural or horticultural cooperative that is similar to the deduction for qualified production activities income under former section 199.

The provision provides a deduction from taxable income that is equal to nine percent of the lesser of the cooperative's qualified production activities income or taxable income (determined without regard to the cooperative's section 199A(g) deduction and any deduction allowable under section 1382(b) and (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions)) for the taxable year. The amount of the deduction for a taxable year is limited to 50 percent of the W–2 wages paid by the cooperative during the calendar year that ends in such taxable year. For this purpose, W–2 wages are determined in the same manner as under the other provisions of section 199A, except that such wages do not include any amount that is not properly allocable to domestic production gross receipts.[1949]

In the case of oil related qualified production activities income, the provision provides that the section 199A(g) deduction is reduced by three percent of the least of the cooperative's oil related qualified production activities income, qualified production activities income, or taxable income (determined without regard to the cooperative's section 199A(g) deduction and any deduction allowable under section 1382(b) and (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions)) for the taxable year. For this purpose, oil related qualified production activities income for any taxable year is the portion of qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof[1950] during the taxable year.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the cost of goods sold that are allocable to such receipts;[1951] and (2) other expenses, losses, or deductions that are properly allocable to such receipts.[1952] Domestic production gross receipts generally are gross

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[1949] Under the proposal, because Puerto Rico is not treated as part of the United States for purposes of determining domestic production gross receipts under section 199A(g), W–2 wages do not include any remuneration paid for services in Puerto Rico.

[1950] Within the meaning of section 927(a)(2)(C) as in effect before its repeal.

[1951] For this purpose, any item or service brought into the United States is treated as acquired by purchase, and its cost is treated as not less than its value immediately after it entered the United States. A similar rule applies in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts. In addition, for any property exported by the cooperative for further manufacture, the increase in cost or adjusted basis may not exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture.

[1952] In computing qualified production activities income, the section 199A(g) deduction itself is not an allocable deduction. As under former section 199, the cooperative's qualified production

Continued

receipts of the cooperative that are derived from any lease, rental, license, sale, exchange, or other disposition of any agricultural or horticultural product[1953] that was manufactured, produced, grown, or extracted by the cooperative in whole or in significant part within the United States.[1954] The cooperative is treated as having manufactured, produced, grown, or extracted in whole or significant part any agricultural or horticultural products marketed by the cooperative if such items were manufactured, produced, grown, or extracted in whole or significant part by its patrons.

Domestic production gross receipts do not include any gross receipts of the cooperative derived from property leased, licensed, or rented by the taxpayer for use by any related person.[1955] In addition, domestic production gross receipts do not include gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of land.

Definition of specified agricultural or horticultural cooperative

The provision limits the definition of specified agricultural or horticultural cooperative to organizations to which part I of subchapter T applies that (1) manufacture, produce, grow, or extract in whole or significant part any agricultural or horticultural product, or (2) market any agricultural or horticultural product that their patrons have so manufactured, produced, grown, or extracted in whole or significant part.[1956] The definition no longer includes a cooperative solely engaged in the provision of supplies, equipment, or services to farmers or other specified agricultural or horticultural cooperatives.

Special rules

All members of an expanded affiliated group[1957] are treated as a single corporation and the deduction is allocated among the members of the expanded affiliated group in proportion to each member's respective amount, if any, of qualified production activities income. In addition, for purposes of determining domestic production

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activities income is determined without regard to any deduction allowable under section 1382(b) and (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions). See Treas. Reg. sec. 1.199–6(c).

[1953] Consistent with former section 199, it is intended that agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative. See Treas. Reg. sec. 1.199–6(f).

[1954] Consistent with former section 199, it is intended that domestic production gross receipts include gross receipts of a cooperative derived from any sale, exchange, or other disposition of agricultural products with respect to which the cooperative performs storage, handling, or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth, or extraction of agricultural or horticultural products (whether or not by the cooperative). See Treas. Reg. sec. 1.199–3(e)(1).

[1955] For this purpose, a person is treated as related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 are made without regard to section 1563(b).

[1956] Consistent with former section 199, it is intended that agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative. See Treas. Reg. sec. 1.199–6(f).

[1957] For this purpose, an expanded affiliated group is an affiliated group as defined in section 1504(a) determined (i) by substituting "more than 50 percent" for "more than 80 percent" each place it appears, and (ii) without regard to paragraphs (2) and (4) of section 1504(b).

gross receipts, if all of the interests in the capital and profits of a partnership are owned by members of a single expanded affiliated group at all times during the taxable year of such partnership, the partnership and all members of such group are treated as a single taxpayer during such period.

In the case of a specified agricultural or horticultural cooperative that is a partner in a partnership, rules similar to the rules applicable to a partner in a partnership under section 199A(f)(1) apply.

For a tax-exempt cooperative subject to tax on its unrelated business taxable income by section 511, the provision is applied by substituting unrelated business taxable income for taxable income where applicable.

The section 199A(g) deduction is determined by only taking into account items that are attributable to the actual conduct of a trade or business.

Allocation of the cooperative's deduction to patrons

The provision provides that an eligible patron that receives a qualified payment from a specified agricultural or horticultural cooperative is allowed as a deduction for the taxable year in which such payment is received an amount equal to the portion of the cooperative's deduction for qualified production activities income that is (i) allowed with respect to the portion of the qualified production activities income to which such payment is attributable, and (ii) identified by the cooperative in a written notice mailed to the patron during the payment period described in section 1382(d).[1958]

The patron's deduction of such amount may not exceed the patron's taxable income for the taxable year (determined without regard to such deduction but after taking into account the patron's other deductions under section 199A(a)). A qualified payment is any amount that (i) is described in paragraph (1) or (3) of section 1385(a) (*i.e.*, patronage dividends and per-unit retain allocations), (ii) is received by an eligible patron from a specified agricultural or horticultural cooperative, and (iii) is attributable to qualified production activities income with respect to which a deduction is allowed to such cooperative. An eligible patron is (i) a taxpayer other than a corporation,[1959] or (ii) another specified agricultural or horticultural cooperative.

Finally, the cooperative cannot reduce its income under section 1382 for any deduction allowable to its patrons under this rule (*i.e.*, the cooperative must reduce its deductions allowed for certain payments to its patrons in an amount equal to the section 199A(g) deduction allocated to its patrons).

Regulatory authority

Specific regulatory authority is provided for the Secretary of the Treasury to promulgate necessary regulations under section 199A(g), including regulations that prevent more than one cooperative taxpayer from being allowed a deduction with respect to the

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[1958] Consistent with the allocation of the cooperative's deduction to its patrons under former section 199 and consistent with the requirements for the payment of patronage dividends in section 1388(a)(1), the cooperative's section 199A(g) deduction is allocated among its patrons on the basis of the quantity or value of business done with or for such patron by the cooperative.

[1959] For this purpose, corporation does not include an S corporation.

same activity (*i.e.*, the same lease, rental, license, sale, exchange, or other disposition of any agricultural or horticultural product that was manufactured, produced, grown, or extracted in whole or in significant part within the United States). In addition, regulatory authority is provided to address the proper allocation of items of income, deduction, expense, and loss for purposes of determining qualified production activities income. The provision provides that the regulations be based on the regulations applicable to cooperatives and their patrons under former section 199 (as in effect before its repeal).[1960]

2. Treatment of cooperative patrons

Repeal of special deduction for qualified cooperative dividends

The provision repeals the special deduction for qualified cooperative dividends. In addition, the provision repeals the rule that excludes qualified cooperative dividends from qualified business income of a qualified trade or business. The provision also clarifies that items of income excluded from qualified items of income, and thus excluded from qualified business income, do not include any amount described in section 1385(a)(1) (*i.e.*, patronage dividends). Accordingly, qualified business income of a qualified trade or business includes any patronage dividend,[1961] per-unit retain allocation,[1962] qualified written notice of allocation,[1963] or any other similar amount received from a cooperative, provided such amount is otherwise a qualified item of income, gain, deduction, or loss (*i.e.*, such amount is (i) effectively connected with the conduct of a trade or business within the United States, and (ii) included or allowed in determining taxable income for the taxable year).[1964]

Reduced deduction for qualified payments received from a specified agricultural or horticultural cooperative

In the case of any qualified trade or business of a patron of a specified agricultural or horticultural cooperative, the deductible amount determined under section 199A(b)(2) for such trade or business is reduced by the lesser of (1) nine percent of the amount of qualified business income with respect to such trade or business as is properly allocable to qualified payments received from such specified agricultural or horticultural cooperative, or (2) 50 percent of the amount of W–2 wages with respect to such qualified trade or business that are properly allocable to such amount.

3. Transition rule relating to the repeal of section 199

The provision clarifies that the repeal of section 199 for taxable years beginning after December 31, 2017, does not apply to a qualified payment received by a patron from a specified agricultural or horticultural cooperative in a taxable year beginning after December 31, 2017, to the extent such qualified payment is attributable to qualified production activities income with respect to which a de-

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[1960] See Treas. Reg. secs. 1.199–1 through –9.
[1961] Defined in sec. 1388(a).
[1962] Defined in sec. 1388(f).
[1963] Defined in sec. 1388(c).
[1964] See sec. 199A(c)(3)(A).

duction is allowable to the cooperative under former section 199 for a taxable year of the cooperative beginning before January 1, 2018. Such qualified payment remains subject to former section 199 and any section 199 deduction allocated by the cooperative to its patrons related to such qualified payment may be deducted by such patrons in accordance with former section 199. In addition, no deduction is allowed under section 199A for such qualified payments.

4. Examples

The following examples illustrate the provision.

Example 1

Cooperative is a grain marketing cooperative with $5,250,000 in gross receipts during 2018 from the sale of grain grown by its patrons. Cooperative paid $4,000,000 to its patrons at the time the grain was delivered in the form of per-unit retain allocations and another $1,000,000 in patronage dividends after the close of the 2018 taxable year. Cooperative has other expenses of $250,000 during 2018, including $100,000 of W–2 wages.

Cooperative has domestic production gross receipts of $5,250,000 and qualified production activities income of $5,000,000[1965] for 2018. Cooperative's section 199A(g) deduction is $50,000 and is equal to the least of nine percent of qualified production activities income ($450,000),[1966] nine percent of taxable income ($450,000),[1967] or 50 percent of W–2 wages ($50,000).[1968] Cooperative passes through the entire section 199A(g) deduction to its patrons. Accordingly, Cooperative reduces its $5,000,000 deduction allowable under section 1382(b) and (c) (relating to the $1,000,000 patronage dividends and $4,000,000 per-unit retain allocations) by $50,000.

Patron's grain delivered to Cooperative during 2018 is two percent of all grain marketed through Cooperative during such year. During 2019, Patron receives $20,000 in patronage dividends and $1,000 of allocated section 199A(g) deduction from Cooperative related to the grain delivered to Cooperative during 2018.

Patron is a grain farmer with taxable income of $75,000 for 2019 (determined without regard to section 199A) and has a filing status of married filing jointly. Patron's qualified business income related to its grain trade or business for 2019 is $50,000, which consists of gross receipts of $150,000 from sales to an independent grain elevator, per-unit retain allocations received from Cooperative during 2019 of $80,000, patronage dividends received from Cooperative during 2019 related to Cooperative's 2018 net earnings of $20,000, and expenses of $200,000 (including $50,000 of W–2 wages).

The portion of the qualified business income from Patron's grain trade or business related to qualified payments received from Cooperative during 2019 is $10,000, which consists of per-unit retain allocations received from Cooperative during 2019 of $80,000, patron-

[1965] $5,250,000 gross receipts – $250,000 expenses = $5,000,000.

[1966] $5,000,000 * .09 = $450,000.

[1967] For this purpose, taxable income is $5,000,000 and is determined without regarding to the section 199A(g) deduction and without regard to the $5,000,000 deduction allowable under section 1382(b) and (c) relating to the $1,000,000 patronage dividends and $4,000,000 per-unit retain allocations.

[1968] $100,000 * .5 = $50,000.

age dividends received from Cooperative during 2019 related to Cooperative's 2018 net earnings of $20,000, and properly allocable expenses of $90,000 (including $25,000 of W–2 wages).[1969]

Patron's deductible amount related to the grain trade or business is 20 percent of qualified business income ($10,000)[1970] reduced by the lesser of nine percent of qualified business income related to qualified payments received from Cooperative ($900)[1971] or 50 percent of W–2 wages related to qualified payments received from Cooperative ($12,500),[1972] or $9,100. As Patron does not have any other qualified trades or business, the combined qualified business income amount is also $9,100.

Patron's deduction under section 199A for 2019 is $10,100, which consists of the combined qualified business income amount of $9,100, plus Patron's deduction passed through from Cooperative of $1,000.

Example 2

Cooperative and Patron have the same facts as above for 2018 and 2019 except that Patron has expenses of $200,000 that include zero W–2 wages during 2019.

Patron's deductible amount related to the grain trade or business is 20 percent of qualified business income ($10,000) reduced by the lesser of nine percent of qualified business income related to qualified payments received from Cooperative ($900), or 50 percent of W–2 wages related to qualified payments received from Cooperative ($0), or $10,000.

Patron's deduction under section 199A for 2019 is $11,000, which consists of the combined qualified business income amount of $10,000, plus Patron's deduction passed through from Cooperative of $1,000.

Effective Date

The provision is effective as if included in the amendments made by sections 11011 and 13305 of Public Law No. 115–97, that is, for taxable years beginning after December 31, 2017.

[1969] Which expenses are properly allocable in a given case will depend on all the facts and circumstances. The example assumes that the fraction of properly allocable W-2 wages differs from the fraction of other properly allocable expenses.

[1970] $50,000 * .2 = $10,000.

[1971] $10,000 * .09 = $900.

[1972] $25,000 * .5 = $12,500.

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN PUBLIC LAW 115–97

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN PUBLIC LAW 115-97

Fiscal Years 2018- 2027

[Millions of Dollars]

Provision	Effective	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
AN ACT TO PROVIDE FOR RECONCILIATION PURSUANT TO TITTLES II AND V OF THE CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 2018 (Public Law 115-97, signed into law by the President on December 22, 2017)												
SUBTITLE A - INDIVIDUAL TAX REFORM												
Part I - Tax Rate Reform												
A. Reduction and Simplification of Individual Income Tax Rates - 10%, 12%, 22%, 24%, 32%, 35%, and 37% Income Tax Rate Brackets (sunset 12/31/25) [1][2]	tyba 12/31/17	-94,077	-135,333	-140,901	-146,387	-152,008	-158,147	-164,308	-171,098	-51,967	[3]	-1,214,227
B. Inflation Adjustments Based on Chained CPI [2]	tyba 12/31/17	761	2,187	5,516	8,176	10,401	12,855	16,658	19,957	25,621	31,419	133,552
Part II - Deduction for Qualified Business Income of Pass-Thru Entities												
A. Deduction for Qualified Business Income - allow 20 percent deduction of qualified business income and certain dividends for individuals and for gross income of agricultural or horticultural cooperatives (sunset 12/31/25) [4]	generally tyba 12/31/17	-27,700	-47,131	-49,925	-51,787	-52,842	-52,240	-53,585	-53,215	-24,239	-1,878	-414,542
B. Limitation on Losses for Taxpayers Other than Corporations - disallow active passthrough losses in excess of $500,000 for joint filers, $250,000 for all others (sunset 12/31/25)	tyba 12/31/17	9,500	16,200	17,200	18,000	18,800	19,600	20,400	19,400	9,300	1,300	149,700
Part III - Tax Benefits for Families and Individuals												
A. Increase in Standard Deduction ($12,000 for singles, $24,000 for married filing jointly, $18,000 for HoH) (sunset 12/31/25) [2]	tyba 12/31/17	-57,208	-82,577	-84,654	-87,531	-90,660	-92,922	-95,691	-99,105	-30,049	[3]	-720,397
B. Increase in and Modification of Child Tax Credit												
1. Modification of child tax credit: $2,000 not indexed; refundable up to $1,400 indexed down to nearest $100 base year 2018; $2,500 refundability threshold not indexed; $500 other dependents not indexed; phase outs $200K/$400K not indexed (sunset 12/31/25) [2]	tyba 12/31/17	-29,326	-67,729	-69,209	-70,361	-71,446	-73,765	-74,908	-75,973	-40,721	---	-573,438
2. Require valid Social Security number of each child to claim refundable and non-refundable portions of child credit, non-child dependents and any child without a valid Social Security number still receives $500 non-refundable credit (sunset 12/31/25) [2]	tyba 12/31/17	---	3,875	3,795	3,758	3,727	3,752	3,746	3,723	2,964	500	29,840

Provision	Effective	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
C. Modifications to the Deduction for Charitable Contributions												
1. Increase percentage limit for charitable contributions of cash to public charities (sunset 12/31/25)	cmi tyba 12/31/17	*Estimate Included in Subtitle A., Part V., Item B.*										
2. Denial of charitable deduction for college athletic event seating rights	cmi tyba 12/31/17	170	177	184	191	199	207	215	224	233	242	2,043
3. Repeal substantiation exception for certain contributions reported by donee organization	cmi tyba 12/31/16	*Negligible Revenue Effect*										
D. Temporarily Allow Increased Contributions to ABLE Accounts, and Allow Contributions to be Eligible for Saver's Credit (sunset 12/31/25)	tyba DOE	[5]	[5]	-1	-1	-2	-2	-3	-3	-4	-4	-19
E. Rollovers Between Qualified Tuition Programs and Qualified ABLE Programs (sunset 12/31/25)	da DOE	[5]	-1	-1	-1	-2	-2	-2	-3	-3	-4	-19
F. Treatment of Certain Individuals Performing Services in the Sinai Peninsula of Egypt (sunset 12/31/25)	spo/a 6/9/15	-6	-1	-1	-1	-1	-1	-1	-1	-2	---	-16
G. Restore a Medical Expense Deduction for Expenses in Excess of 7.5 Percent of Adjusted Gross Income (sunset 12/31/18)	tyba 12/31/18	-3,830	-1,415	---	---	---	---	---	---	---	---	-5,245
H. Relief for 2016 Disaster Areas	DOE	-3,233	-1,310	-40	-55	[5]	[5]	[5]	[5]	[5]	[5]	-4,638
Part IV - Education												
A. Treatment of Student Loans Discharged on Account of Death or Disability (sunset 12/31/25)	doia 12/31/17	-7	-10	-10	-10	-10	-10	-11	-11	-6	---	-85
B. Allow 529 Withdrawals up to $10,000 for Primary and Secondary Education	da 12/31/17	-3	-11	-21	-32	-45	-57	-68	-81	-87	-87	-491
Part V - Deductions and Exclusions												
A. Suspension of Deduction for Personal Exemptions (sunset 12/31/25) [2]	generally tyba 12/31/17	93,253	137,132	141,562	146,391	151,796	157,568	163,345	169,183	51,285	---	1,211,514
B. Modifications to Certain Itemized Deductions [2] (Sunset 12/31/17)	generally tyba 12/31/17	43,522	70,439	72,016	77,056	82,271	87,904	93,951	100,176	41,072	---	668,408
C. Limitation on Itemized Deduction for State and Local, etc. Taxes (sunset 12/31/25) [2]	tyba 12/31/17	*Estimate Included in Subtitle A., Part V., Item B.*										
D. Modification of Deduction for Home Mortgage Interest (sunset 12/31/25) [2]	tyba 12/31/17	*Estimate Included in Subtitle A., Part V., Item B.*										
E. Modification of Deduction for Personal Casualty and Theft Losses (sunset 12/31/25) [2]	tyba 12/31/17	*Estimate Included in Subtitle A., Part V., Item B.*										
F. Suspension of Miscellaneous Itemized Deductions (sunset 12/31/25) [2]	tyba 12/31/17	*Estimate Included in Subtitle A., Part V., Item B.*										
G. Suspension of Overall Limitation on Itemized Deductions (sunset 12/31/25) [2]	tyba 12/31/17	*Estimate Included in Subtitle A., Part V., Item B.*										
H. Repeal Exclusion For Employer-Provided Bicycle Commuter Fringe Benefit (sunset 12/31/25)	tyba 12/31/17	3	4	5	5	5	5	6	6	1	---	40
I. Repeal Exclusion For Employer-Provided Qualified Moving Expense Reimbursements (Other than Members of the Armed Forces) (sunset 12/31/25) [6][7]	tyba 12/31/17	422	564	573	584	600	618	637	656	165	---	4,820
J. Repeal of Deduction For Moving Expenses (Other than Members of the Armed Forces) (sunset 12/31/25)	tyba 12/31/17	592	821	866	910	954	1,000	1,048	1,100	278	---	7,570

Provision	Effective	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
K. Limitation on Wagering Losses (sunset 12/31/25)	tyba 12/31/17	2	12	12	13	13	13	14	14	12	---	105
L. Repeal of Deduction for Alimony Payments and Corresponding Inclusion in Income	generally dosaeia 12/31/18	---	108	228	364	517	686	872	1,087	1,377	1,695	6,933
Part VI - Increase in Estate and Gift Tax Exemption												
A. Double Estate, Gift, and GST Tax Exemption Amount (sunset 12/31/25)	dda & gma 12/31/17	-1,163	-8,126	-8,835	-9,119	-9,579	-10,077	-10,686	-11,059	-11,036	-3,293	-82,972
Part VII - Extension of Time Limit for Contesting IRS Levy												
A. Extension of Time Limit for Contesting IRS Levy	[8]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]
Part VIII - Individual Mandate												
A. Elimination of Shared Responsibility Payment for Individuals Failing to Maintain Minimum Essential Coverage [2][9][10]	mba 12/31/18	---	5,958	9,736	28,387	37,025	40,653	43,491	46,146	49,645	53,310	314,349
SUBTITLE B - ALTERNATIVE MINIMUM TAX												
A. Repeal of Alternative Minimum Tax on Corporations [2]	tyba 12/31/17	-6,764	-6,897	-6,599	-6,800	-6,974	-1,304	-1,299	-1,291	-1,223	-1,111	-40,263
B. Increase the Individual AMT Exemption Amounts and Phase-out Thresholds (sunset 12/31/25)	tyba 12/31/17	-6,875	-82,502	-69,896	-74,930	-80,454	-81,579	-85,578	-90,094	-65,195	[3]	-637,101
SUBTITLE C - BUSINESS-RELATED PROVISIONS												
Part I - Corporate Provisions												
A. 21-Percent Corporate Tax Rate	tyba 12/31/17	-101,306	-125,265	-130,477	-131,130	-132,595	-136,228	-140,728	-144,742	-149,745	-156,314	-1,348,529
B. Reduction in Dividends-Received Deduction to Reflect Lower Corporate Income Tax Rates	tyba 12/31/17	*Estimate Included in Subtitle C., Part I., Item A.*										
Part II - Small Business Reforms												
A. Increase Section 179 Expensing to $1 Million with a Phaseout Range Beginning at $2.5 Million and Expand Definition of Qualified Property	ppisi tyba 12/31/17	-4,733	-7,421	-4,137	-2,570	-1,983	-1,453	-1,044	-880	-870	-851	-25,941
B. Small Business Accounting Method Reform and Simplification	[11]	-7,577	-7,481	-3,344	-2,079	-1,657	-1,542	-1,584	-1,660	-1,737	-1,792	-30,453
Part III - Cost Recovery and Accounting Methods												
Subpart A - Cost Recovery												
A. Temporary 100-Percent Expensing for Certain Business Assets - extension, expansion, and phase down of bonus depreciation (sunset 12/31/26) [12]	paa 9/27/17 apisasd & sppoga 9/27/17	-32,528	-36,477	-24,571	-14,187	-11,595	-4,854	3,319	8,407	12,508	13,698	-86,280
B. Modifications to Depreciation Limitations on Luxury Automobiles and Personal Use Property	ppisa 12/31/17	*Estimate Included in Subtitle C., Part III., Item A.*										
C. Modifications of Treatment of Certain Farm Property	ppisa 12/31/17	-8	-28	-44	-97	-236	-322	-219	-69	-19	-19	-1,062
D. Applicable Recovery Period for Real Property [13]	ppisa 12/31/17	-56	-144	-274	-368	-547	-659	-583	-750	-897	-620	-4,896
E. Use of Alternative Depreciation System for Electing Farming Businesses	tyba 12/31/17	*Estimate Included in Subtitle C., Part IV., Item A.*										
F. Amortization of Research and Experimental Expenditures	apoii tyba 12/31/21	---	---	---	---	24,200	32,890	26,028	18,870	11,401	6,295	119,684
G. Expensing of Certain Costs of Replanting Citrus Plants Lost by Reason of Casualty (sunset 12/22/27)	apoia DOE	-2	-4	-5	-5	-4	-3	-2	-2	-2	-1	-30
Subpart B - Accounting Methods												
A. Certain Special Rules for Taxable Year of Inclusion												
1. In general	tyba 12/31/17	1,190	1,703	1,709	1,715	658	209	216	222	229	236	8,087
2. Related to original issue discount and other similar items	[14]	---	337	677	682	687	693	698	429	161	167	4,532

Provision	Effective	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
Part IV - Business-Related Exclusions and Deductions												
A. Limitation on Deduction for Interest - limit net interest deductions to 30 percent of adjusted taxable income, carryforward of denied deduction	tyba 12/31/17	8,354	17,696	19,662	19,622	24,907	30,243	29,639	31,755	34,703	36,866	253,449
B. Modification of Net Operating Loss Deduction	lai tyba 12/31/17	6,431	9,961	11,082	15,843	25,160	34,150	35,976	30,227	20,836	11,410	201,075
C. Repeal Like-Kind Exchanges Except for Real Property	generally eca 12/31/17	500	900	1,300	1,700	2,200	2,900	3,800	4,700	5,800	7,200	31,000
D. Limitation on Deduction by Employers of Expenses for Fringe Benefits												
1. Meals and entertainment expenses, including meals for the convenience of the employer [15]	apoia 12/31/17 & apoia 12/31/25	1,565	2,193	2,241	2,289	2,339	2,389	2,441	2,494	2,773	2,823	23,548
2. Repeal deduction for qualified transportation fringes, including commuting except as necessary for employee's safety [16]	apoia 12/31/17	1,222	1,635	1,682	1,729	1,786	1,826	1,869	1,926	1,971	2,017	17,663
E. Repeal of Deduction for Income Attributable to Domestic Production Activities	tyba 12/31/17	4,295	8,860	9,314	9,645	9,947	10,276	10,732	11,147	11,560	12,199	97,975
F. Denial of Deduction for Certain Fines, Penalties, and Other Amounts	apoio/a DOE	[17]	17	15	14	14	15	15	16	16	17	138
G. Denial of Deduction for Settlements Subject to Nondisclosure Agreements Paid in Connection with Sexual Harassment or Sexual Abuse	apoia DOE	1	1	1	1	1	1	1	1	1	1	10
H. Repeal of Deduction for Local Lobbying Expenses	apoio/a DOE	34	69	71	74	77	80	83	87	90	94	759
I. Recharacterization of Certain Gains in the Case of Partnership Profits Interests Held in Connection with Performance of Investment Services	tyba 12/31/17	200	200	100	100	100	100	100	100	100	100	1,100
J. Prohibition on Cash, Gift Cards, and Other Non-Tangible Personal Property as Employee Achievement Awards	apoia 12/31/17	2	3	3	3	3	3	3	3	3	3	30
K. Elimination of Deduction for Living Expenses Incurred by Members of Congress	tyba DOE	1	1	1	1	1	1	1	1	1	1	5
L. Certain Contributions by Governmental Entities Not Treated as Contributions to Capital	[18]	107	226	432	737	1,022	1,015	893	776	671	580	6,461
M. Repeal of Rollover of Publicly Traded Securities Gain into Specialized Small Business Investment Companies	sa 12/31/17	120	239	239	240	240	120	120	120	120	120	1,680
N. Certain Self-Created Property Not Treated as a Capital Asset	Da 12/31/17	8	54	54	55	57	59	61	63	66	68	546
Part V - Business Credits												
A. Modification of Orphan Drug Credit - modification of credit for clinical testing expenses for certain drugs for rare diseases or conditions	apoii tyba 12/31/17	723	1,714	2,072	2,505	2,979	3,483	4,002	4,520	5,015	5,516	32,529
B. Rehabilitation Credit Limited to Certified Historic Structures - modify rehabilitation credit to provide 20 percent historic credit ratably over 5 years, repeal credit for pre-1936 property	[19]	29	319	598	579	472	322	219	189	184	188	3,097
C. Employer Credit for Paid Family and Medical Leave (sunset 12/31/19)	tyba 12/31/17	-738	-1,524	-1,100	-481	-274	-206	---	---	---	---	-4,324
D. Repeal of Tax Credit Bonds [2]	bia 12/31/17	10	20	25	40	48	65	73	85	85	85	534

Provision	Effective	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
Part VI - Provisions Related to Specific Entities and Industries												
Subpart A - Partnership Provisions												
A. Treatment of Gain or Loss of Foreign Persons from Sale or Exchange of Interests in Partnerships Engaged in Trade or Business Within the United States	seado/a 11/27/17 & seada 12/31/17	26	181	251	328	411	490	508	528	549	570	3,842
B. Modify Definition of Substantial Built-in Loss in the Case of Transfer of Partnership Interest	topia 12/31/17	[5]	[5]	100	100	100	100	100	100	100	100	500
C. Charitable Contributions and Foreign Taxes Taken into Account in Determining Limitation on Allowance of Partner's Share of Loss	tyba 12/31/17	[17]	100	100	100	100	100	100	200	200	200	1,200
D. Repeal of Technical Termination of Partnerships	ptyba 12/31/17	100	200	100	100	200	200	200	200	200	200	1,600
Subpart B - Insurance Reform												
A. Net Operating Losses of Life Insurance Companies	lai tyba 12/31/17	*Estimate Included in Subtitle C, Part IV., Item B.1.*										
B. Repeal of Small Life Insurance Company Deduction	tyba 12/31/17	5	10	20	20	21	21	23	23	24	24	191
C. Adjustment for Change in Computing Reserves	tyba 12/31/17	75	110	115	117	119	122	124	126	129	132	1,172
D. Repeal of Special Rule for Distributions to Shareholders from Pre-1984 Policyholders Surplus Account	tyba 12/31/17	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]
E. Modification of Proration Rules for Property and Casualty Insurance Companies	tyba 12/31/17	105	205	209	213	217	221	226	230	235	240	2,104
F. Repeal of Special Estimated Tax Payments	tyba 12/31/17	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]
G. Computation of Life Insurance Reserves	tyba 12/31/17	945	1,691	1,699	1,733	1,776	1,821	1,866	1,913	1,206	603	15,253
H. Modification of Rules for Life Insurance Proration for Purposes of Determining the Dividends Received Deduction	tyba 12/31/17	30	60	61	62	63	64	66	67	68	70	611
I. Capitalization of Certain Policy Acquisition Expenses	tyba 12/31/17	105	415	590	690	730	830	884	909	944	1,055	7,152
J. Tax Reporting for Life Settlement Transactions and Clarification of Tax Basis of Life Insurance Transactions, and Exception to Transfer for Valuable Consideration Rules												
1. Tax reporting for life settlement transactions	generally tyba 12/31/17	-5	-20	3	19	25	30	35	38	40	42	207
2. Clarification of tax basis of life insurance contracts	generally teia 8/25/09	*Estimate Included in Subtitle C, Part VI., Subpart B, Item J.1.*										
3. Exception to transfer for valuable consideration rules	ta 12/31/17	*Estimate Included in Subtitle C, Part VI., Subpart B, Item J.1.*										
K. Modification of Discounting Rules for Property and Casualty Insurance Companies	tyba 12/31/17	301	1,750	1,785	1,820	1,857	1,894	1,660	1,355	590	255	13,267
Subpart C - Banks and Financial Instruments												
A. Limitation on Deduction for FDIC Premiums	tyba 12/31/17	450	1,475	1,500	1,522	1,545	1,592	1,645	1,665	1,677	1,689	14,760
B. Repeal of Advance Refunding Bonds	ar bia 12/31/17	400	1,101	1,401	1,701	2,002	2,102	2,150	2,202	2,180	2,158	17,399
Subpart D - S Corporations												
A. Expansion of Qualifying Beneficiaries of an Electing Small Business Trust	1/1/18 feoqb & tyba 12/31/17 fc	-6	-15	-19	-23	-26	-30	-35	-41	-48	-55	-297
B. Charitable Contribution Election for Electing Small Business Trusts	1/1/18 feoqb & tyba 12/31/17 fc	*Estimate Included in Subtitle C, Part VI., Subpart D, Item A.*										
C. Modify Treatment of S Corporation Conversions into C Corporations	DOE	-500	-500	-600	-600	-600	-600	-600	-700	-700	-700	-6,100
Part VII - Employment												
Subpart A - Compensation												
A. Modification of One-Million Dollar Limitation on Excessive Employee Remuneration, With Transition Rule [20]	tyba 12/31/17	44	1,025	991	994	1,001	1,002	999	991	997	1,136	9,181

Provision	Effective	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
B. Excise Tax on Excess Tax-Exempt Organization Executive Compensation - 21-percent excise tax on excess tax-exempt organization executive compensation (certain exceptions provided to non-highly compensated employees, and for certain medical services)	tyba 12/31/17	127	183	185	186	188	189	187	184	179	172	1,781
C. Treatment of Qualified Equity Grants	[21]	-227	-238	-212	-179	-115	-36	-36	-41	-49	-52	-1,185
D. Increase in Excise Tax Rate for Stock Compensation of Insiders in Expatriated Corporations from 15 Percent to 20 Percent	DOE	11	11	11	11	11	11	11	11	11	11	105
Subpart B - Retirement Plans												
A. Repeal of Special Rule Permitting Recharacterization of Roth Conversions	tyba 12/31/17	11	46	48	49	51	53	54	56	58	60	486
B. Modification of Rules Applicable to Length of Service Award Programs for Bona Fide Public Safety Volunteers [22]	tyba 12/31/17	-7	-10	-14	-18	-26	-38	-52	-71	-97	-124	-456
C. Extended Rollover Period for Plan Loan offset Amounts	tyba 12/31/17	*Negligible Revenue Effect*										
Part VIII - Exempt Organizations												
A. Excise Tax Based on Investment Income of Private Colleges and Universities With Endowment Per Student of at Least $500,000	tyba 12/31/17	171	172	174	175	177	179	180	182	184	185	1,779
B. Unrelated Business Taxable Income Separately Computed for Each Trade or Business Activity	generally tyba 12/31/17	220	321	331	341	351	362	373	384	395	407	3,485
C. Unrelated Business Taxable Income Increased by Amount of Certain Fringe Benefit Expenses for which Deduction is Disallowed	apoia 12/31/17	*Estimate Included in Subtitle C., Part IV., Item D.2.*										
Part IX - Other Provisions												
Subpart A - Craft Beverage Modernization and Tax Reform												
A. Production Period for Beer, Wine, and Distilled Spirits (sunset 12/31/19)	generally 1/1/18	-1,623	-1,522	-1,072	---	---	---	---	---	---	---	-4,216
B. Reduced Rate of Excise Tax on Beer (sunset 12/31/19)	generally 1/1/18	*Estimate Included in Subtitle C., Part IX., Subpart A., Item A.*										
C. Transfer of Beer Between Bonded Facilities (sunset 12/31/19)	generally 1/1/18	*Estimate Included in Subtitle C., Part IX., Subpart A., Item A.*										
D. Reduced Rate of Excise Tax on Certain Wine (sunset 12/31/19)	generally 1/1/18	*Estimate Included in Subtitle C., Part IX., Subpart A., Item A.*										
E. Adjustment of Alcohol Content Level for Application of Excise Tax Rates (sunset 12/31/19)	generally 1/1/18	*Estimate Included in Subtitle C., Part IX., Subpart A., Item A.*										
F. Definition of Mead and Low Alcohol by Volume Wine (sunset 12/31/19)	generally 1/1/18	*Estimate Included in Subtitle C., Part IX., Subpart A., Item A.*										
G. Reduced Rate of Excise Tax on Certain Distilled Spirits (sunset 12/31/19)	generally 1/1/18	*Estimate Included in Subtitle C., Part IX., Subpart A., Item A.*										
H. Bulk Distilled Spirits (sunset 12/31/19)	generally 1/1/18	*Estimate Included in Subtitle C., Part IX., Subpart A., Item A.*										
Subpart B - Miscellaneous Provisions												
A. Modification of Tax Treatment of Alaska Native Corporations and Settlement Trusts	[23]	-9	-10	-10	-10	-10	-10	-10	-10	-10	-10	-99
B. Exempt Amounts Paid for Aircraft Management Services from the Excise Taxes Imposed on Transportation by Air	apa DOE	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]
C. Create Qualified Opportunity Zones	DOE	-1,208	-1,654	-1,630	-1,675	-1,554	-1,502	-1,502	-1,593	8,078	2,685	-1,556

Provision	Effective	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
SUBTITLE D - INTERNATIONAL TAX PROVISIONS												
Part I - Outbound Transactions												
Subpart A - Establishment of Participation Exemption System for Taxation of Foreign Income												
A. Deduction for Dividends Received by Domestic Corporations from Certain Foreign Corporations	[24]	-17,808	-28,118	-20,054	-20,337	-20,844	-21,023	-22,134	-23,227	-24,312	-25,766	-223,623
B. Special Rules Relating to Sales or Transfers Involving Certain Foreign Corporations	da 12/31/17 & Ta 12/31/17	121	244	532	825	1,215	1,447	1,666	1,601	1,780	2,366	11,795
C. Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation and Mandatory Inclusion at Two-Tier Rate (8-Percent Rate for Illiquid Assets, 15.5-Percent Rate for Liquid Assets)	[25]	78,567	49,591	16,495	15,611	15,737	27,233	47,547	64,434	33,042	-9,444	338,812
Subpart B - Rules Related to Passive and Mobile Income												
A. Current Year Inclusion of Global Intangible Low-Taxed Income by U.S. Shareholders	[26]	7,654	12,543	9,619	9,499	9,300	9,031	9,174	9,265	15,149	21,177	112,413
B. Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income	tyba 12/31/17	-174	4,890	6,870	6,562	197	-11,425	-15,696	-20,185	-18,418	-16,294	-63,672
C. Elimination of Inclusion of Foreign Base Company Oil Related Income	[26]	-130	-279	-310	-340	-371	-405	-444	-489	-538	-706	-4,012
D. Repeal of Inclusion Based on Withdrawal of Previously Excluded Subpart F Income from Qualified Investment	[26]	5	5	5	5	5	5	5	5	5	5	45
E. Modification of Stock Attribution Rules for Determining Status as a Controlled Foreign Corporation	[27]	*Estimate Included in Subtitle D., Part I., Subpart A., Item A.*										
F. Modification of Definition of United States Shareholder	[26]	95	173	142	126	126	126	126	126	126	126	1,292
G. Elimination of Requirement that Corporation Must be Controlled for 30 Days Before Subpart F Inclusions Apply	[26]	44	65	53	52	51	50	51	51	76	101	593
H. Limitations on Income Shifting Through Intangible Property Transfers	ti tyba 12/31/17	51	104	112	120	128	135	143	152	161	170	1,277
I. Certain Related Party Amounts Paid or Accrued in Hybrid Transactions or With Hybrid Entities	tyba 12/31/17	*Estimate Included in Subtitle D., Part I., Subpart A., Item A.*										
J. Shareholders of Surrogate Foreign Corporations Not Eligible for Reduced Rate on Dividends	dra DOE	6	6	6	7	7	7	7	8	8	8	70
Subpart C - Modifications Related to Foreign Tax Credit System												
A. Repeal of Section 902 Indirect Foreign Tax Credits; Determination of Section 960 Credit on Current Year Basis	[26]	*Estimate Included in Subtitle D., Part I., Subpart A., Item A.*										
B. Separate Foreign Tax Credit Limitation Basket for Foreign Branch Income	tyba 12/31/17	*Estimate Included in Subtitle D., Part I., Subpart B., Item A.*										
C. Source of Income from Sales of Inventory Determined Solely on Basis of Production Activities	tyba 12/31/17	51	51	51	51	51	51	51	51	51	51	510
D. Election to Increase Percentage of Domestic Taxable Income Offset by Overall Domestic Loss Treated as Foreign Source	tyba 12/31/17 & before 1/1/28	-600	-1,100	-1,000	-600	100	400	100	100	100	100	-2,300
Part II - Inbound Transactions												
A. Base Erosion and Anti-Abuse Tax	apoaa 12/31/17	840	4,325	13,293	16,094	17,126	16,776	15,916	16,519	21,630	27,048	149,568

Provision	Effective	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
Part III - Other Provisions												
A. Restriction on Insurance Business Exception to Passive Foreign Investment Company Rules	tyba 12/31/17	100	100	100	100	100	80	100	151	151	151	1,133
B. Repeal of Fair Market Value Method of Interest Expense Apportionment	tyba 12/31/17	37	81	108	65	49	49	49	49	49	49	585
TOTAL		**-135,723**	**-279,995**	**-258,934**	**-220,907**	**-178,116**	**-137,968**	**-119,809**	**-114,708**	**-41,355**	**32,370**	**-1,455,540**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:
- apa = amounts paid after
- apisasd = and placed in service after such date
- apoaa = amounts paid or accrued after
- apoia = amounts paid or incurred after
- apoii = amounts paid or incurred in
- apoio/a = amounts paid or incurred on or after
- ar = advance refunding
- bia = bonds issued after
- cmi = contributions made in
- da = distributions after
- Da = dispositions after
- dda = decedents dying after
- DOE = date of enactment
- doia = discharges of indebtedness after
- dosaeia = divorce or separation agreements entered into after
- eca = exchanges completed after
- fc = for charitable
- feoqb = for expansion of qualifying beneficiaries
- gma = gifts made after
- lai = losses accrued in
- mba = months beginning after
- paa = property acquired after
- ppisa = property placed in service after
- ptyba = partnership taxable years beginning after
- sa = sales after
- seada = sales exchanges and dispositions after
- seado/a = sales, exchanges and dispositions on or after
- spo/a = service provided on or after
- sppoga = specified plants planted or grafted after
- ta = transactions after
- Ta = transfers after
- teia = transactions entered into after
- ti = transfers in
- topia = transfers of partnership interests after
- tyba = taxable years beginning after

[Footnotes for the Table appears on the following pages]

Footnotes for the Table:

[1] The parameters for the beginning of the 24%, 32%, 35%, and 37% rate brackets, and the standard deduction amount use 2018 as the base year. Other indexed parameters are adjusted for inflation from their 2017 values using the chained CPI-U as the inflation measure to determine 2018 values.

[2] Estimate includes the following outlay effects:	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
Reduction and Simplification of Individual Income Tax Rates -10%, 12%, 22%, 24%, 32%, 35%, and 37% income tax rate brackets	---	966	1,064	1,160	1,184	1,218	1,245	1,226	1,253	---	9,316
Inflation Adjustments Based on Chained CPI	---	-286	-645	-1,310	-1,647	-2,086	-2,513	-3,128	-3,582	-4,113	-19,310
Increase in Standard Deduction	---	9,414	9,738	10,146	10,318	10,527	10,610	10,688	10,904	---	82,345
Increase in and Modification of Child Tax Credit	---	21,801	22,065	22,030	21,966	23,144	23,129	23,068	24,055	---	181,257
Require valid Social Security number of each child to claim refundable and non-refundable portions of child credit, non-child dependents and any child without a valid Social Security number still receives $500 non-refundable credit	---	-2,977	-2,872	-2,808	-2,733	-2,711	-2,654	-2,590	-2,564	-500	-22,409
Suspension of Deduction for Personal Exemptions	-10,849	-15,999	-16,426	-16,685	-16,994	-17,303	-17,503	-17,759	-5,355	---	-134,871
Repeal of itemized deductions for taxes not paid or accrued in a trade or business (except for up to $10,000 in State and local taxes), interest on mortgage debt in excess of $750K, interest on home equity debt, non-disaster casualty losses and certain miscellaneous expenses	---	-308	-162	-180	-180	-196	-209	-213	-211	---	-1,659
Elimination of Shared Responsibility Payment for Individuals Failing to Maintain Minimal Essential Coverage	---	-5,802	-12,705	-28,181	-35,199	-38,422	-40,705	-43,046	-45,257	-47,992	-297,308
Repeal of Alternative Minimum Tax on Corporations	2,245	2,339	1,741	1,931	1,928	---	---	---	---	---	10,184
Repeal of Tax Credit Bonds	-10	-20	-25	-40	-48	-65	-73	-85	-85	-85	534

[3] Loss of less than $10 million.

[4] Estimate includes the following budget effects:	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
Total Revenue Effect (SECA interaction)	-1,357	-1,945	-1,736	-1,495	-1,147	1,459	2,517	1,691	1,172	822	-19
On-budget effects	-277	-416	-367	-316	-241	291	538	359	249	174	-6
Off-budget effects	-1,079	-1,529	-1,369	-1,179	-906	1,168	1,979	1,331	923	648	-13

[5] Loss of less than $500,000.

[6] Estimate includes the following budget effects:	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
Total Revenue Effect	422	564	573	584	600	618	637	656	165	---	4,820
On-budget effects	337	448	454	461	474	488	503	518	130	---	3,813
Off-budget effects	85	116	119	123	126	130	134	138	35	---	1,006

[7] Estimate includes policy that retains exclusion under section 217(g) (related to members of the Armed Forces).

[8] Effective with respect to: (1) levies made after the date of enactment; and (2) levies made on or before the date of enactment provided that the nine-month period has not expired as of the date of enactment.

[9] Estimate provided by the Joint Committee on Taxation staff in collaboration with the Congressional Budget Office.

[10] Estimate includes the following budget effects:	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
Total Revenue Effect	---	5,958	9,736	28,387	37,025	40,653	43,491	46,146	49,645	53,310	314,349
On-budget effects	---	5,881	8,971	26,500	34,751	38,257	40,794	43,250	46,715	50,490	295,609
Off-budget effects	---	77	765	1,887	2,274	2,396	2,696	2,895	2,930	2,820	18,740

[11] The expansion of the threshold allowing the use of the cash method, the creation of an exemption from the requirement to use inventories, and the expansion of the exception from the uniform capitalization rules are effective for taxable years beginning after December 31, 2017. The expansion of the exception from the requirement to use the percentage of completion method is effective for contracts entered into after December 31, 2017, in taxable years ending after such date. The threshold applicable to each provision is indexed for inflation for taxable years beginning after December 31, 2018.

[12] The percentage is phased down from 100 percent by 20 percent per calendar year beginning in 2023 (2024 for certain longer production period property and certain aircraft).

[Footnotes for the Table continue on the following page]

Footnotes for the Table continued:

[13] The requirement that real property trades or businesses electing out of the interest limitation of section 163(j) use ADS to depreciate certain real and improvement property is effective for taxable years beginning after December 31, 2017.

[14] Generally effective for taxable years beginning after December 31, 2017. Effective for taxable years beginning after December 31, 2018 for income from a debt instrument having original issue discount.

[15] Estimate includes the following budget effects:

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
Total Revenue Effect	1,565	2,193	2,241	2,289	2,339	2,389	2,441	2,494	2,773	2,824	23,548
On-budget effects	1,291	1,823	1,863	1,904	1,945	1,988	2,032	2,077	2,348	2,390	19,661
Off-budget effects	274	370	378	385	393	401	409	417	426	434	3,887

[16] Estimate includes the following budget effects:

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
Total Revenue Effect	1,222	1,635	1,682	1,729	1,786	1,826	1,869	1,926	1,971	2,017	17,663
On-budget effects	976	1,324	1,358	1,393	1,429	1,463	1,500	1,536	1,575	1,612	14,166
Off-budget effects	246	311	324	336	357	363	369	390	396	405	3,497

[17] Gain of less than $500,000.

[18] Effective for contributions made after date of enactment, except that the provision does not apply to contributions pursuant to plans approved prior to date of enactment.

[19] Generally effective for amounts paid or incurred after December 31, 2017, with a transition rule providing that for buildings owned or leased at all times after December 31, 2017, the 24-month or 60-month period for making qualified rehabilitation expenditures begins no later than 180 days after the date of enactment, and the repeal is effective for such expenditures paid or incurred after the end of the taxable year in which such 24-month or 60-month period ends.

[20] Transition rule for any remuneration under a written binding contract which was in effect on November 2, 2017, and which was not modified thereafter in any material respect.

[21] Effective for options exercised or restricted stock units settled after December 31, 2017. The penalty for failure to provide a notice is effective for failures after December 31, 2017.

[22] Estimate includes the following budget effects:

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-27
Total Revenue Effect	-7	-10	-14	-19	-26	-37	-52	-71	-97	-124	-456
On-budget effects	-4	-6	-8	-11	-15	-22	-31	-42	-57	-73	-269
Off-budget effects	-3	-4	-6	-8	-11	-15	-21	-29	-40	-51	-187

[23] Generally, taxable years beginning after December 31, 2016. The deduction for contributions to a Settlement Trust is effective for taxable years for which the Native Corporation's refund statute of limitations period has not expired, with a one-year waiver of the refund statute of limitations period in the event that the period expires before the end of the one-year period beginning on the date of enactment.

[24] Effective for distributions made (and for purposes of determining a taxpayer's foreign tax credit limitation under section 904, deductions in taxable years ending) after December 31, 2017.

[25] Effective for the last taxable year beginning before January 1, 2018, of a foreign corporation and with respect to U.S. shareholders for the taxable years in which or with which such taxable year of the foreign corporation ends.

[26] Effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

[27] Effective for the last taxable year beginning before January 1, 2018, of a foreign corporation and all subsequent years, and with respect to U.S. shareholders for the taxable years in which or with which such taxable year of the foreign corporation ends.